5 Auditing and Assurance Standards

Learning Outcomes

This chapter enables you to understand:

- The scope and authority of the Hong Kong Auditing Standards.
- The scope and authority of other pronouncements relating to auditing, assurance and related services issued by the HKICPA.
- The general contents of the Hong Kong Auditing Standards and other Hong Kong Engagement Standards.

Introduction

1. Since 2001, the HKICPA has adopted the policy of achieving convergence of its auditing and assurance standards with the International Standards on Quality Control, Auditing, Assurance and Related Services (International Auditing Standards) issued by the International Auditing and Assurance Standards Board (IAASB) which is a standing committee of the International Federation of Accountants (IFAC). The HKICPA has mandated its Auditing and Assurance Standards Committee (AASC) to develop Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services (Hong Kong Auditing Standards), which replace its extant Statements of Auditing Standards (SASs) and Standards on Assurance Engagements.

2. In 2003, in seeking continually to improve its standards, the IAASB undertook to review the drafting conventions used in its International Standards on Auditing (ISAs). The objective of the review was to identify ways to improve the clarity, and thereby the consistent application, of International Standards issued by the IAASB. In 2006, the IAASB approved amendments to the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface)". The amended Preface establishes the conventions to be used by the IAASB in drafting future ISAs, and the obligations of auditors who follow those ISAs.

3. Pursuant to the amended conventions in drafting ISAs, the IAASB completed a clarity project to comprehensively review all of its ISAs and International Standards on Quality Control (ISQCs) to improve their clarity and, thereby, their consistent application. Consequently, pursuant to the convergence policy, the HKICPA issued all redrafted, revised and/or new standards issued by the IAASB. Based on the standing convergence policy of the HKICPA, all these clarified HKSAs come into effects for audits of financial statements for periods beginning on or after 15 December 2009.

In 2015 and 2016, the HKICPA issued new **HKSA 701** and revised various HKSAs, including **HKSA 700** (see Chapter 32), in response to the IAASB's completion of its projects on auditor reporting to enhance auditor's reports for investors and other users of financial statements, and addressing disclosures in the audit of financial statements. These new and revised HKSAs are effective for audits of financial statements for periods ending on or after 15 December 2016.

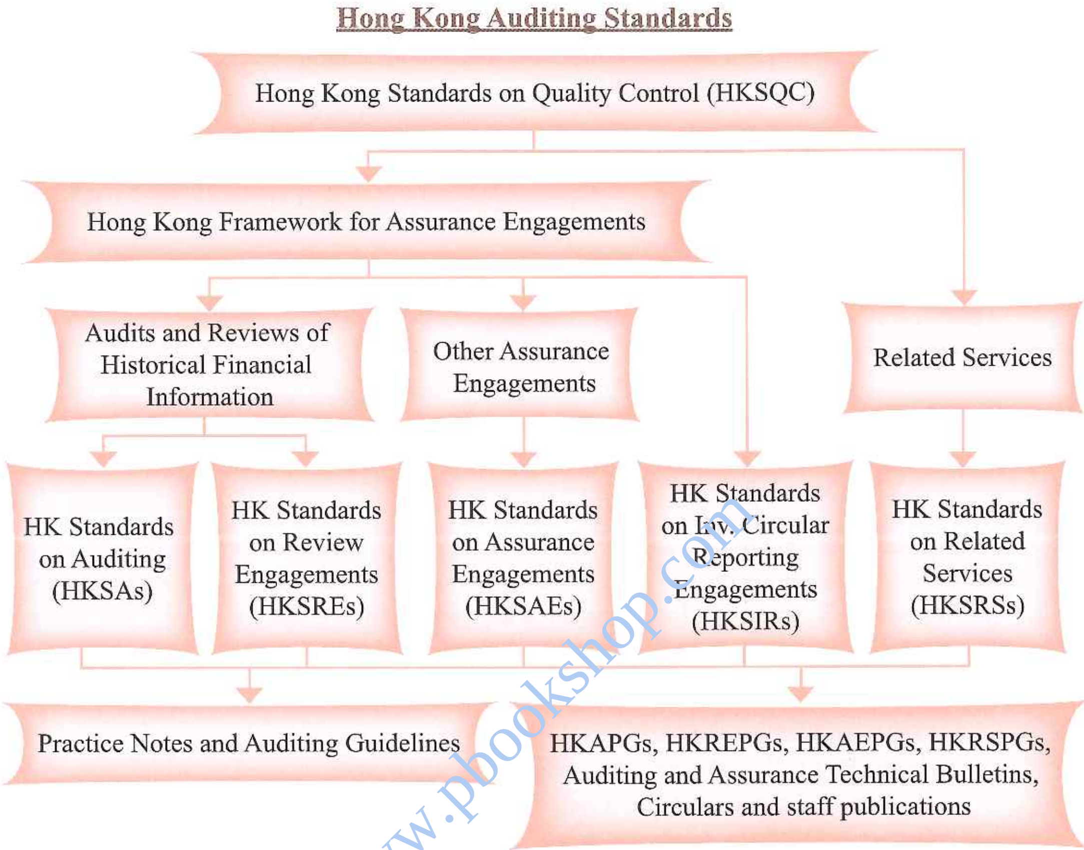
4. Despite of the convergence policy, the HKICPA may consider it appropriate to include additional requirements in a Hong Kong Auditing Standard or, in some exceptional cases, to deviate from an International Auditing Standard. Each Hong Kong Auditing Standard issued by the HKICPA contains information about the extent of conformity with the equivalent International Auditing Standard. This chapter outlines the purpose and scope of the Hong Kong Auditing Standards relating to auditing, assurance and related services issued by the HKICPA.

HONG KONG AUDITING STANDARDS

5. A completed set of Hong Kong Auditing Standards includes:

   a. **Hong Kong Standards on Quality Control** (HKSQCs), which are to be applied for all services falling under Hong Kong Engagement Standards;
   b. **Hong Kong Framework for Assurance Engagements**; and
   c. **Hong Kong Engagement Standards**, which in turn include:
      i. **Hong Kong Standards on Auditing** (HKSAs), which are to be applied in the audit of historical financial information;
      ii. **Hong Kong Standards on Review Engagements** (HKSREs), which are to be applied in the review of historical financial information;
      iii. **Hong Kong Standards on Assurance Engagements** (HKSAEs), which are to be applied in assurance engagements other than audits or reviews of historical financial information;
      iv. **Hong Kong Standards on Investment Circular Reporting Engagements** (HKSIRs), which are to be applied in investment circular reporting engagements; and
      v. **Hong Kong Standards on Related Services** (HKSRSs), which are to be applied to compilation engagements, engagements to apply agreed-upon procedures to information and other related services engagements as specified by the AASC.

Figure 5.1: Structure of Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services



6. The HKICPA members must comply with the Hong Kong Auditing Standards. Apparent failure by the HKICPA members to comply with Hong Kong Auditing Standards may be enquired into by the appropriate committee of the HKICPA and may lead to disciplinary action, including withdrawing the CPA's practising certificate. Moreover, the courts will consider compliance with the Hong Kong Auditing Standards in negligence cases against the auditors.

7. Before issue, proposed Hong Kong Auditing Standards called Exposure Drafts are issued so that all interested parties can comment. Once a Hong Kong Auditing Standard is issued, it is binding on all the HKICPA members. Exposure drafts, however, have no standing at all although they may represent what a large number of people consider to be the best practice.

8. The AASC is now issuing Exposure Drafts and Hong Kong Auditing Standards concurrently with the IAASB as this process is considered to be a more effective and efficient way for AASC to achieve its mandate of achieving international convergence (as far as practicable) of Hong Kong Auditing Standards with the International Auditing Standards issued by the IAASB.

9. Current Hong Kong Auditing Standards are:

Hong Kong Standards on Quality Control (HKSQCs 1 - 99)

HKSQC 1	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services EngagementsH

Hong Kong Standards on Auditing (HKSAs 100 - 999)

HKSA 200 - 299	*General Principles and Responsibilities*
HKSA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing
HKSA 210	Agreeing the Terms of Audit Engagements
HKSA 220	Quality Control for an Audit of Financial Statements
HKSA 230	Audit Documentation
HKSA 240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
HKSA 250	Consideration of Laws and Regulations in an Audit of Financial Statements
HKSA 260	Communication with Those Charged with Governance
HKSA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
HKSA 300 - 499	*Risk Assessment and Response to Assessed Risks*
HKSA 300	Planning an Audit of Financial Statements
HKSA 315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
HKSA 320	Materiality in Planning and Performing an Audit
HKSA 330	The Auditor's Responses to Assessed Risks
HKSA 402	Audit Considerations Relating to an Entity Using a Service Organization
HKSA 450	Evaluation of Misstatements Identified during the Audit
HKSA 500 - 599	*Audit Evidence*
HKSA 500	Audit Evidence
HKSA 501	Audit Evidence — Specific Considerations for Selected Items
HKSA 505	External Confirmations
HKSA 510	Initial Audit Engagements — Opening Balances
HKSA 520	Analytical Procedures
HKSA 530	Audit Sampling
HKSA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
HKSA 550	Related Parties
HKSA 560	Subsequent Events
HKSA 570	Going Concern
HKSA 580	Written Representations
HKSA 600 - 699	*Using Work of Others*
HKSA 600	Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)
HKSA 610	Using the Work of Internal Auditors
HKSA 620	Using the Work of an Auditor's Expert
HKSA 700 - 799	*Audit Conclusions and Reporting*
HKSA 700	Forming an Opinion and Reporting on Financial Statements

STANDARDS OTHER THAN HKSAs

16. Standards other than HKSAs, including HKSREs, HKSAEs, HKSIRs and HKSRSs, contain **basic principles and essential procedures** (identified in bold type lettering and by the word "should") together with related guidance in the form of **explanatory and other material**, including appendices.

17. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a standard to understand and apply the basic principles and essential procedures. The basic principles and essential procedures are to be applied in all cases where they are relevant in the circumstances of the engagement. In exceptional circumstances, however, a professional accountant may judge it necessary to depart from a relevant essential procedure in order to achieve the purpose of that procedure.

PRACTICE NOTES AND AUDITING GUIDELINES

18. The HKICPA also issues Practice Notes (PNs) and Auditing Guidelines (AGs) to provide interpretative guidance and practical assistance to its members in implementing Hong Kong Engagement Standards and to promote good practice. PNs and AGs can be local guidance developed by the HKICPA in response to emerging regulatory issues or new reporting requirements, or guidance adopting Practice Statements (PSs) issued by the IAASB.

19. The HKICPA members should be aware of and consider PNs and AGs applicable to the engagement. A member who does not consider and apply the guidance included in a relevant PN/AG should be prepared to explain how the basic principles and essential procedures in the Hong Kong Engagement Standards addressed by the PN/AG have been complied with.

20. Current PNs and AGs are:

PN 600.1	Reports by auditors under the Hong Kong Companies Ordinance (Cap.622)
PN 620.2	Communications between auditors and the Insurance Authority
PN 720	Acting as scrutineer at a general meeting of a listed issuer
PN 730	Guidance for auditors regarding preliminary announcements of annual results
PN 740	Auditor's letter on Continuing Connected Transaction under the Hong Kong Listing Rules
PN 750	Review of Financial Information under the Hong Kong Listing Rules for a Very Substantial Disposal
PN 810.1	Insurance brokers — compliance with the minimum requirements specified by the Insurance Authority under Sections 69(2) and 70(2) of the Insurance Companies Ordinance
PN 810.2	The duties of auditors under the Insurance Companies Ordinance
PN 820	The audit of licensed corporations and associated entities of intermediaries
PN 830	Reports by auditors under the Banking Ordinance

PN 840	The audit of solicitors' accounts under the Solicitors' Accounts Rules and the Accountant's Report Rules
PN 850	Reporting on flag days and general charitable fund-raising activities covered by Public Subscription Permits issued by the Social Welfare Department
PN 851	Review of the annual financial reports of non-governmental organizations
PN 852	Review of lottery accounts
PN 860.1	The audit of retirement schemes
PN 870	The assessments of Certification Authorities under the Electronic Transactions Ordinance
PN 871	Engagement to report on compliance with the Billing and Metering Integrity Scheme of OFTA
PN 900	Audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard
AG 3.283	Guidance for internal auditors
AG 3.340	Prospectuses and the reporting accountant

AUDITING AND ASSURANCE BULLETINS

21. The HKICPA also issues Auditing and Assurance Bulletins and Auditing Bulletins. They are informative publications issued by the AASC on subjects of topical interest and are intended to assist members or to stimulate debate on auditing and assurance issues. They do not require the approval of the HKICPA's Council and do not have the same authority as Hong Kong Auditing Standards. Current Auditing and Assurance Bulletins include:

AATB 1	Assistance Options to New Applicants and Sponsors in connection with Due Diligence Obligations, including Internal Controls over Financial Reporting
AATB 2	Guidance to the Auditor when Responding to Questions at an Annual General Meeting
AATB 3	Implementation Guidance on Revised Hong Kong Standard on Investment Circular Reporting Engagements (HKSIR) 400 Comfort Letters and Due Diligence Meetings
AATB 4	Guidance on Section 408 of the Companies Ordinance
TB 13	Drug Trafficking (Recovery of Proceeds) Ordinance 1989
TB 19	Opening Stocks - Alternative Audit Procedures

HONG KONG AUDITING PRACTICE GUIDANCE AND OTHER PRACTICE GUIDANCE

22. Following the practice of the IAASB in issuing non-authoritative practice notes, the AASCA also issues non-authoritative practice notes in Hong Kong but, to avoid confusion, names them as practice guidance (PG), including "Hong Kong Auditing Practice Guidance" (HKAPG), Hong Kong Review Engagement Practice Guidance (HKREPG), Hong Kong Assurance Engagement Practice Guidance (HKAEPG), and Hong Kong Related Services Practice Guidance (HKRSPG). The current HKAPGs include:

HKAPG 1000	Special considerations in auditing financial instruments

23. Other non-authoritative pronouncements for informative purpose or raising the practitioners' awareness include Auditing and Assurance Technical Bulletins, Circulars, and staff publications (including those issued by IAASB).

Summary

24. The HKICPA has published guidance to members on auditing practice.
25. These are formalised by publishing the Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services and Practice Notes.
26. Apparent failures by the auditor in Hong Kong to comply with the Hong Kong Auditing Standards may lead to investigation and penalties.
27. Compliance with the auditing standards would generally be considered in the court to ascertain whether an auditor's procedures are sufficient and adequate.
28. The HKSAs contain introductory material, objectives, requirements, definitions and application and other explanatory material. The requirements of each HKSA are contained in a separation section and applied in the context of the other material included in the HKSA.
29. Hong Kong Engagement Standards other than HKSAs contain basic principles and essential procedures, which are mandatory, and explanatory and other material, including appendices, which is guidance for their application.

Review Questions with Answers

1. What are Hong Kong Auditing Standards and Hong Kong Standards on Auditing? (1, 5)
2. Describe the clarity project of the IAASB and its effect in Hong Kong Auditing Standards. (2 - 3)
3. What is the relationship between the auditor and the Hong Kong Auditing Standards? (6)
4. What Hong Kong Auditing Standards are in issue? (9)
5. What material is contained in a Hong Kong Standard on Auditing? (14 - 15)
6. What material is contained in a Hong Kong Engagement Standard other than Hong Kong Standard on Auditing? (16 - 17)
7. What is the purpose of Practice Notes and Auditing Guidelines? (18)
8. What is the purpose of Auditing and Assurance Bulletins? (21)

Case Study 1

General CyberMotor HK Limited is a company listed in Hong Kong and has just appointed your firm, A.J.S. & Partners CPA to be its statutory auditor and also requested your firm to review its interim financial statements. General CyberMotor HK Limited was founded by Miss Winnie Lau and has operations in China and Hong Kong. In view of its inventories located in various cities in China, the previous auditor was required to visit different cities to attend the physical inventory count and inspect the retail shop there.

Discussion

As an auditor in A.J.S & Partners CPA, list the Hong Kong Auditing Standards that may be relevant to your audit.

6 Financial Reporting Standards and the Auditor

Learning Outcomes

This chapter enables you to understand:

- The general regulatory framework of financial reporting in Hong Kong.
- The Hong Kong Financial Reporting Standards in effect in Hong Kong and the relevant pronouncements issued by the HKICPA.
- The importance of financial reporting standards in auditing and assurance.
- The general environment of financial reporting standard for small and medium-sized entity in Hong Kong.

Introduction

1. Financial statements of a company must be prepared in accordance with generally accepted accounting principles (GAAP). If the company is incorporated in Hong Kong, then financial reporting standards in Hong Kong will be part of the GAAP and the auditor will be required to examine whether the financial statements are properly prepared in accordance with them. The financial reporting standards in Hong Kong are named as Hong Kong Financial Reporting Standards (HKFRSs), which have been fully converged to the financial reporting standards issued by the International Accounting Standards Board (IASB) since 2005.

2. This book focuses on auditing and assurance and cannot include a comprehensive discussion of all the financial reporting standards. For comprehensive coverage, readers will need to refer to a financial reporting textbook or visit HKICPA's website at *http://www.hkicpa.org.hk*.

3. This chapter discusses the HKFRSs in effect in Hong Kong and lists the relevant pronouncements issued by the HKICPA. Since the HKICPA will issue new financial reporting standards and amend them continuously, the students and, of course, the auditors have to ensure that the standards they refer to are the most updated ones with the most updated contents and amendments.

HKFRSs IN ISSUE

Hong Kong Financial Reporting Standards (HKFRSs) are standards and interpretations issued by the HKICPA. They comprise:

- Hong Kong Financial Reporting Standards;
- Hong Kong Accounting Standards (HKASs); and
- Interpretations.

IMPORTANCE OF FINANCIAL REPORTING STANDARDS IN AUDIT AND ASSURANCE

5. The subject matter of an audit, review and other engagements are usually financial statements prepared in accordance with generally accepted accounting principles (GAAP) in Hong Kong. The GAAP in Hong Kong should of course include the HKFRSs, HKASs and Interpretations.

6. In most cases, the auditor is required to report whether the financial statements give a true and fair view and/or have been prepared in accordance with the Companies Ordinance in Hong Kong. To give a true and fair view, the financial statements must comply with the requirements in the Companies Ordinance and the applicable accounting standards, which are defined as the financial reporting standards issued by the HKICPA. The concept for a true and fair view is discussed at length in Chapter 32.

7. Consequently, an auditor must know and understand the financial reporting standards, i.e. HKFRSs, HKASs and Interpretations, in detail. This is because an opinion of an auditor on financial statements is, in effect, an opinion of the auditor as to whether all financial reporting standards have been followed and applied appropriately in the preparation of the financial statements.

INTERPRETATIONS OF HKFRSs

8. The HKICPA has issued Interpretations of HKFRSs, including HK (IFRIC) Interpretations (HK (IFRIC)-Int), HK (SIC) Interpretations (HK (SIC)-Int) and HK Interpretations (HK-Int). The Interpretations of HKFRSs are to give authoritative guidance on newly identified financial reporting issues not specifically addressed in HKFRSs or issues where unsatisfactory or conflicting interpretations have developed or seem likely to develop in the absence of such guidance. Entities shall apply interpretations if their financial statements are described as being prepared in accordance with HKFRSs. The following Interpretations of HKFRSs are in effect:

HK(IFRIC)-Int 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
HK(IFRIC)-Int 2	Members' Shares in Co-operative Entities and Similar Instruments
HK(IFRIC)-Int 4	Determining Whether an Arrangement Contains a Lease
HK(IFRIC)-Int 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
HK(IFRIC)-Int 6	Liabilities Arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment
HK(IFRIC)-Int 7	Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies
HK(IFRIC)-Int 8	Scope of HKFRS 2
HK(IFRIC)-Int 9	Reassessment of Embedded Derivatives
HK(IFRIC)-Int 10	Interim Financial Reporting and Impairment

AB 5 Guidance for the Preparation and Presentation of a Business Review under the Hong Kong Companies Ordinance Cap. 622

AB 6 Guidance on the Requirements of Section 436 of the Hong Kong Companies Ordinance Cap. 622

FINANCIAL REPORTING STANDARDS FOR SMALL AND MEDIUM-SIZED ENTITY

11. In addition to HKFRSs, HKICPA issued its locally developed "Small and Medium-sized Entity (SME) Financial Reporting Framework (SME Framework) and Financial Reporting Standards (SME Standard)" in August 2005. HKICPA clarified that the SME Framework and SME Standard were developed to spare smaller Hong Kong companies the burden of the more complex financial reporting rules while at the same time providing information useful to users, such as owners, tax authority and lenders.

12. The SME Framework sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the SME Standard. SME Standard sets out the recognition, measurement, presentation and disclosure requirements for an entity that prepares and presents the financial statements in accordance with the SME-FRS. Chapter 38 explains more on the audit of small companies.

13. In July 2009, the IASB issued the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs). HKICPA considers that IFRS for SMEs should be adopted in Hong Kong as a reporting option for eligible private entities. Then, in April 2010, Hong Kong Financial Reporting Standard for Private Entities (HKFRS for PE) was issued with certain amendments to suit Hong Kong's circumstances.

14. Private entities are defined in HKFRS for PE as entities that do not have public accountability, and publish general purpose financial statements for external users.

15. After the effective date in 2014, the new Companies Ordinance (Cap. 622) allows the Hong Kong incorporated entities meeting the reporting exemptions choose to prepare the financial statements by using SME Standards or HKFRS for PE as financial reporting options.

Summary

16. It is important for an auditor to be familiar with financial reporting standards.

17. Financial reporting standards in Hong Kong are named as Hong Kong Financial Reporting Standards, which include Hong Kong Accounting Standards and Interpretations.

18. All financial statements reporting under the Companies Ordinance must give a true and fair view, which implies, inter alia, a compliance with Hong Kong Financial Reporting Standards.

19. Interpretations are authoritative guidance on the application of financial reporting standards. Accounting Guidelines are persuasive in nature and they help defining accounting practice in the particular area or sector to which they refer. Accounting Bulletins are informative publications on subjects of topical interest.

ii. A member of the audit team, a member of that individual's **immediate family**, or the audit firm shall not have a direct financial interest or a material indirect financial interest in:

(1) The audit client, or

(2) An entity that has a controlling interest in the audit client, and the client is material to the entity.

Immediate family refers to a spouse (or equivalent) or dependent.

Close family refers to a parent, child or sibling who is not an immediate family member.

Office is a distinct sub-group, whether organized on geographical or practice lines.

iii. When an audit team member has a **close family member** who the audit team member knows has a direct financial interest or a material indirect financial interest in the audit client, a **self-interest threat** is created. Safeguards shall be applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) The close family member disposing, as soon as practicable, of all of the financial interest or disposing of a sufficient portion of an indirect financial interest so that the remaining interest is no longer material;

(2) Having a professional accountant review the work of the audit team member; or

(3) Removing the individual from the audit team.

iv. **Other partners in the office** in which the engagement partner practices in connection with the audit engagement, or their immediate family members, shall not hold a direct financial interest or a material indirect financial interest in that audit client.

v. Other partners and managerial employees who provide non-audit services to the audit client, except those whose involvement is minimal, or their immediate family members, shall not hold a direct financial interest or a material indirect financial interest in that audit client.

vi. **A self-interest threat** may be created if the firm or a member of the audit team, or a member of that individual's immediate family, has a financial interest in an entity and an audit client also has a financial interest in that entity.

(1) The firm shall not have such interest.

(2) Any individual with such a material interest shall, before becoming an audit team member, either dispose of the interest or dispose of a sufficient amount of the interest so that the remaining interest is no longer material.

vii. A self-interest, familiarity or intimidation threat may be created if a member of the audit team, or a member of that individual's immediate family, or the firm, has a financial interest in an entity when a director, officer or controlling owner of the audit client is also known to have a financial interest in that entity.

viii. Holding a direct financial interest or a material indirect financial interest in the audit client **as a trustee** creates a self-interest threat and is only permitted when:

(1) Neither the trustee, nor an immediate family member of the trustee, nor the firm are beneficiaries of the trust;

(2) The interest in the audit client held by the trust is not material to the trust;

(3) The trust is not able to exercise significant influence over the audit client; and

(4) The trustee, an immediate family member of the trustee, or the firm cannot significantly influence any investment decision involving a financial interest in the audit client.

ix. When a direct financial interest or a material indirect financial interest in an audit client is involuntarily received by way of an **inheritance, gift** or as a result of a **merger**:

(1) If the interest is received by the firm, the financial interest shall be disposed of immediately, or a sufficient amount of an indirect financial interest shall be disposed of so that the remaining interest is no longer material [*Note:* all direct financial interest should be disposed of];

(2) If the interest is received by a member of the audit team, or a member of that individual's immediate family, the individual who received the financial interest shall immediately dispose of the financial interest, or dispose of a sufficient amount of an indirect financial interest so that the remaining interest is no longer material; or

(3) If the interest is received by an individual who is not a member of the audit team, or by an immediate family member of the individual, the financial interest shall be disposed of as soon as possible, or a sufficient amount of an indirect financial interest shall be disposed of so that the remaining interest is no longer material.

x. When an **inadvertent violation** of Section 290 as it relates to a financial interest in an audit client occurs, it is deemed not to compromise a firm's independence if:

(1) The firm has established policies and procedures that require prompt notification to the firm of any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the audit client;

(2) The actions described in paragraph 35b(ix) are taken as applicable; and

(3) The firm applies other safeguards when necessary to reduce any remaining threat to an acceptable level. Examples of such safeguards include having a professional accountant review the work of the audit team member or excluding the individual from any significant decision-making concerning the audit engagement.

xi. In addition, the firm shall determine whether to discuss the inadvertent violation with those charged with governance.

c. **Loans and Guarantees**

i. A loan, or a guarantee of a loan, from an audit client that is a bank or a similar institution to a member of the audit team, or a member of that individual's immediate family, does not create a threat to independence if the loan or guarantee is made under normal lending procedures, terms and conditions. Examples of such loans include home mortgages, bank overdrafts, car loans and credit card balances. **Self-interest threat** is created in all other situations unless the loan or guarantee is immaterial to both (1) the firm, or the member of the audit team and the immediate family member, and (2) the client.

ii. If a firm or a member of the audit team, or a member of that individual's immediate family, has deposits or a brokerage account with an audit client that is a bank, broker or similar institution, a threat to independence is not created if the deposit or account is held under normal commercial terms.

d. **Business Relationships**

i. A close business relationship arising from a commercial relationship or common financial interest between (1) a firm, or a member of the audit team, or a member of that individual's immediate family, and (2) the audit client or its management may create **self-interest** or **intimidation threats**.

ii. Examples are: having a material financial interest in a joint venture; marketing combined services or products with reference to both the firm and the client; and acting as a distributor or marketer of the client's products or services, or the client acting as the distributor or marketer of the firm's products or services.

iii. **Table 7.6** describes the action to be taken when the financial interest is material or the business relationship is significant.

Table 7.6
Actions to be Taken when the Financial Interest is Material or the Business Relationship is Significant

The audit firm	The business relationship shall not be entered into, or shall be reduced to an insignificant level or terminated.
A member of the audit team	The individual shall be removed from the audit team.
An immediate family member of a member of the audit team	The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

iv. Purchasing goods and services from an audit client does not generally create a threat to independence if the transaction is in the normal course of business and at **arm's length**. The significance of any self-interest threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) Eliminate or reduce the magnitude of the transaction; or

(2) Removing the individual from the audit team.

e. **Family and Personal Relationships**

i. Family and personal relationships between (1) a member of the audit team and (2) a director or officer or certain employees (depending on their role) of the audit client may create **self-interest, familiarity or intimidation threats**.

(1) In case of an **immediate family member**:

(a) When the immediate family member is a director or officer of the audit client or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, remove the individual from the audit team.

(b) When the immediate family member is an employee in a position to exert significant influence over the client's financial position, financial performance or cash flows, remove the individual from the audit team or structure the responsibilities of the audit team so that the professional does not deal with matters that are within the responsibility of the immediate family member.

(2) In case of a **close family member**: remove the individual from the audit team; or structure the responsibilities of the audit team so that the professional does not deal with matters that are within the responsibility of the close family member.

(3) In case of other personal and family relationship, a member of the audit team who has such relationship shall consult in accordance with firm policies and procedures. When necessary, the firm applies safeguards similar to those mentioned for close family members as per (2) or assigns a professional accountant to review the relevant audit work performed.

f. **Employment with an Audit Client**

i. **Familiarity or intimidation threats** are created and independence would be deemed to be compromised if a former member of the audit team or partner joins the audit client as a director or officer, or as an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the CPA firm will express an opinion and a significant connection remains between the firm and the individual, unless:

(1) The individual is not entitled to any benefits or payments from the firm, unless made in accordance with fixed pre-determined arrangements, and any amount owed to the individual is not material to the firm; and

(2) The individual does not continue to participate or appear to participate in the CPA firm's business or professional activities.

ii. If there is **no significant connection** remained between the CPA firm and the individual, the significance of any threats created shall be evaluated and safeguards applied when necessary to eliminate the threats or reduce them to an acceptable level. Examples of such safeguards include:

(1) Modifying the audit plan;

(2) Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client; or

(3) Having a professional accountant review the work of the former member of the audit team.

iii. If a former partner of the CPA firm has previously joined an entity in such a position and the entity subsequently becomes an audit client of the firm, the significance of any threat to independence shall be evaluated and safeguards applied when necessary, to eliminate the threat or reduce it to an acceptable level.

iv. **Future or potential employment** with the audit client creates a **self-interest threat**.

(1) Firm policies and procedures shall require members of an audit team to notify the firm when entering employment negotiations with the audit client; and

(2) Safeguards include removing the individual from the audit team or performing a review of any significant judgments made by that individual while on the team.

g. **Temporary Staff Assignments**

i. The lending of staff by a CPA firm to an audit client may create a **self-review threat**. Such assistance may be given for a short period of time and the loaned staff shall not assume management responsibilities or be involved in providing non-assurance services that would not be permitted under section 290 of the Code.

ii. The audit client shall be responsible for directing and supervising the activities of the loaned staff.

iii. The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) Conducting an additional review of the work performed by the loaned staff;

(2) Not giving the loaned staff audit responsibility for any function or activity that the staff performed during the temporary staff assignment; or

(3) Not including the loaned staff as a member of the audit team.

h. **Recent Service with Audit Clients**

i. **Self-interest, self-review or familiarity threats** may be created if a member of the audit team has recently served as a director, officer, or employee of the audit client. This would be the case when, for example, a member of the audit team has to evaluate elements of the financial statements for which the member of the audit team had prepared the accounting records while with the client.

ii. For period covered by the audit report, such individuals shall not be assigned to the audit team.

iii. For period before the period covered by the audit report, the significance of any threat shall be evaluated and safeguards applied when necessary to reduce the threat to an acceptable level. An example of such a safeguard is conducting a review of the work performed by the individual as a member of the audit team.

i. **Serving as an Officer or Director on the Board of Audit Clients**

i. This creates **self-review and self-interest threats**. No partner or employees shall serve as a director or officer of an audit client.

ii. If a partner or employee of the firm serves as **Company Secretary** for an audit client, **self-review and advocacy threats** are created. Performing routine administrative services to support a company secretarial function or providing advice in relation to company secretarial administration matters does not generally create threats to independence, as long as client management makes all relevant decisions.

j. **Long Association of Senior Personnel (including Partner Rotation) with an Audit Client**

   i. **Familiarity and self-interest threats** are created by using the same senior personnel on an audit engagement over a long period of time. The significance of the threats shall be evaluated and safeguards applied when necessary to eliminate the threats or reduce them to an acceptable level. Examples of such safeguards include:

      (1) Rotate the senior personnel off the audit team;

      (2) Have a professional accountant who was not a member of the audit team review the work of the senior personnel; or

      (3) Perform regular independent internal or external quality reviews of the engagement.

   ii. For **listed companies**, an individual shall not be a **key audit partner** for more than seven years. After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years.

   iii. The long association of **other partners** with an audit client that is a listed company creates **familiarity and self-interest threats**. The significance of the threats shall be evaluated and safeguards applied when necessary to eliminate the threats or reduce them to an acceptable level. Examples of such safeguards include:

      (1) Rotating the partner off the audit team or otherwise ending the partner's association with the audit client; or

      (2) Regular independent internal or external quality reviews of the engagement.

   iv. If an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation for a listed company audit where the CPA firm has only a few people with the necessary knowledge and experience to serve as a key audit partner on the audit, an individual may remain a key audit partner for more than seven years, in accordance with such regulation, provided that the independent regulator has specified alternative safeguards which are applied, such as a regular independent external review.

k. **Provision of Non-Audit Services to Audit Clients**

   i. Provision of non-audit services may create **various threats** to the independence, particularly with respect to perceived threats to independence. The threats are more often self-review, self-interest and advocacy threats **(see Table 7.7)**.

Table 7.7 Types of Non-audit Services and Types of Threats	
Types of Non-audit Services	**Types of Threats**
Preparing accounting records and financial statements	Self-review threat
Performing valuation services	Self-review threat
Provision of taxation services to audit clients	Self-review and advocacy threats
Provision of internal audit services to audit clients	Self-review threat
Provision of IT systems services to audit clients	Self-review threat
Provision of litigation support services to audit clients	Self-review and advocacy threats
Provision of legal services to audit clients	Self-review and advocacy threats
Provision of recruiting services	Self-interest, familiarity and intimidation threats
Provision of corporate finance services to audit clients	Self-review and advocacy threats

ii. Safeguards to reduce the threats created by providing non-audit services to audit clients to an acceptable level include:

(1) Establish policies and procedures to prohibit professional staff from making management decisions for the audit client, or assuming responsibility for such decisions.

(2) Discuss independence issues with those charged with governance.

(3) The audit client establishes policies to oversight responsibility for provision of non-audit services by the firm.

(4) Having a professional who was not involved in providing the non-audit service review the non-audit work performed.

(5) Obtaining advice on the non-audit service from an external professional.

(6) Ensures the client acknowledges its responsibility for the results of the work performed by the firm.

(7) Disclose the nature and extent of fees charged to those charged with governance.

(8) Using professionals who are not members of the audit team to perform the service.

l. **Fees**

i. When the **total fees** from an audit client represent **a large proportion** of a firm's total fees, the dependence on that client and concern about losing the client creates a **self-interest or intimidation threat**. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) Take action to reduce dependency on the client;

(2) Perform external quality control reviews; and

(3) Consulting a third party, such as a professional regulatory body or another professional accountant, on key audit judgments.

ii. A **self-interest or intimidation threat** is also created when the fees generated from an audit client represent a large proportion of the revenue from an **individual partner's** clients or a large proportion of the revenue of an **individual office** of the firm. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) Reducing the dependency on the audit client;

(2) Having a professional accountant review the work or otherwise advise as necessary; or

(3) Regular independent internal or external quality reviews of the engagement.

iii. **Long overdue fees** may create a **self-interest threat**. Safeguards include:

(1) Having an additional professional accountant who did not take part in the audit engagement, provide advice or review the work performed; and

(2) Discuss the level of outstanding fees with the audit committee, or others charged with governance.

iv. **Contingent Fees**

(1) **Audit engagements**. A firm shall not charge contingent fees because they create a **self-interest threat** that is so significant that no safeguards could reduce the threat to an acceptable level.

(2) **Non-assurance engagements**. A firm shall not accept engagements which fees are contingent on the result of the audit engagement. For other types of contingent fee arrangements, apply appropriate safeguards where necessary.

m. **Compensation and Evaluation Policies**

i. A **self-interest threat** is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client.

ii. The significance of the threat shall be evaluated and, if the threat is not at an acceptable level, the firm shall either revise the compensation plan or evaluation process for that individual or apply safeguards to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

(1) Removing such members from the audit team; or

(2) Having a professional accountant review the work of the member of the audit team.

iii. A key audit partner shall not be evaluated on, or compensated based on, that partner's success in selling non-assurance services to the partner's audit client.

n. **Gifts and Hospitality**. Accepting gifts or hospitality from an audit client may create **self-interest and familiarity threats** unless the value is trivial and inconsequential. Consequently, a firm or a member of the audit team shall not accept such gifts or hospitality.

o. **Actual or Threatened Litigation**

i. When litigation takes place, or appears likely, between the firm or a member of the audit team and the audit client, **self-interest and intimidation threats** are created.

ii. If the following safeguards do not reduce the threats to an appropriate level, the only appropriate action is to withdraw from, or decline, the audit engagement;

(1) If the litigation involves a member of the audit team, remove that individual from the audit team; or

(2) Having a professional review the work performed.

PART C - PROFESSIONAL ACCOUNTANTS IN BUSINESS

36. A professional accountant in business:

a. May be a salaried employee, a partner, director (whether executive or non-executive), an owner-manager, a volunteer or another working for one or more employing organization.

b. May be solely or jointly responsible for preparing and reporting financial and other information, which both their employing organizations and third parties (e.g., investors, creditors, and government bodies) may rely on.

c. Has a responsibility to further the legitimate aims of the accountant's employing organization.

d. Is expected to encourage an ethics-based culture in an employing organization if he holds a senior position within an organization.

e. Shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles.

37. **Table 7.8** gives some examples of threats to compliance with the fundamental principles for a professional accountant in business.

Table 7.8 **Examples of Threats for Professional Accountants in Business**	
Self-interest threat	i. Holding a financial interest in, or receiving a loan or guarantee from the employing organization. ii. Participating in incentive compensation arrangements offered by the employing organization. iii. Inappropriate personal use of corporate assets. iv. Concern over employment security. v. Commercial pressure from outside the employing organization.

v. Appropriate disciplinary processes.
vi. Leadership that stresses the importance of ethical behavior and the expectation that employees will act in an ethical manner.
vii. Policies and procedures to implement and monitor the quality of employee performance.
viii. Timely communication of the employing organization's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
ix. Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.
x. Consultation with another appropriate professional accountant.

40. If a professional accountant in business believes that unethical behavior or actions by others will continue to occur within the employing organization, he shall consider obtaining legal advice and may, as a last resort, resign from the employing organization.

41. **Conflicts of Interest (Section 310)**

a. A professional accountant in business may be faced with a conflict of interest when undertaking a professional activity. A conflict of interest creates a threat to objectivity and may create threats to the other fundamental principles. Examples of situations in which conflicts of interest may arise include:

   i. Serving in a management or governance position for two employing organizations and acquiring confidential information from one employing organization that could be used by the professional accountant to the advantage or disadvantage of the other employing organization.
   ii. Undertaking a professional activity for each of two parties in a partnership employing the professional accountant to assist them to dissolve their partnership.
   iii. Preparing financial information for certain members of management of the entity employing the professional accountant who are seeking to undertake a management buy-out.
   iv. Being responsible for selecting a vendor for the accountant's employing organization when an immediate family member of the professional accountant could benefit financially from the transaction.
   v. Serving in a governance capacity in an employing organization that is approving certain investments for the company where one of those specific investments will increase the value of the personal investment portfolio of the professional accountant or an immediate family member.

b. A professional accountant shall not allow a conflict of interest to compromise professional or business judgment.

c. When making disclosures or sharing information within the employing organization and seeking guidance of third parties such as a professional body, legal counsel or another professional accountant, the professional accountant in business shall remain alert to the fundamental principle of confidentiality.

c. **Self-interest or intimidation threats** are created where a professional accountant in business is pressured (either externally or by the possibility of personal gain) to prepare or report information in a misleading way or to become associated with misleading information through the actions of others.

d. The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Safeguards include consultation with superiors within the employing organization, the audit committee or those charged with governance, or with a relevant professional body.

e. Where it is not possible to reduce the threat to an acceptable level, a professional accountant in business shall refuse to be or remain associated with the misleading information. Upon becoming aware of unknowingly associated misleading information, the professional accountant in business shall take steps to be disassociated from that information. In determining whether there is a requirement to report the circumstances outside the organization, the professional accountant in business may consider obtaining legal advice. In addition, the professional accountant may consider whether to resign.

43. **Acting with Sufficient Expertise (Section 330)**

a. A professional accountant in business shall not intentionally mislead an employer as to the level of expertise or experience possessed and shall seek appropriate expert advice and assistance when required.

b. **Threats** to compliance include:

i. Insufficient time for properly performing or completing the relevant duties.

ii Incomplete, restricted or otherwise inadequate information for performing the duties properly.

iii. Insufficient experience, training and/or education.

iv. Inadequate resources for the proper performance of the duties.

c. Examples of **safeguards** include:

i. Obtaining additional advice or training.

ii. Ensuring that there is adequate time available for performing the relevant duties.

iii. Obtaining assistance from someone with the necessary expertise.

iv. Consulting, where appropriate, with superiors, independent experts, or a relevant professional body.

d. When threats cannot be eliminated or reduced to an acceptable level, professional accountants in business shall determine whether to refuse to perform the duties in question.

44. **Financial Interests, Compensation and Incentives Linked to Financial Reporting and Decision Making (Section 340)**

a. **Self-interest threats** to objectivity or confidentiality are created when the professional accountant in business or an immediate or close family member:

i. Holds a direct or indirect financial interest in the employing organization and the value of that financial interest could be directly affected by decisions made by the professional accountant;

Example 18.8

Kimmie CPA Limited is auditing the financial statements of Happy Resources Corporation, which has an estimated profit before tax of $2.7 million.

Materiality for the financial statements as a whole

Kimmie, the engagement partner, determines the materiality for the financial statements at $135,000. This is based on 5% of the estimated profit before tax figure and it is a consistent basis to that used in previous audits. She considers that the unadjusted profit before tax figure is appropriate as there are no exceptional items affecting profit before tax and the levels of directors' remuneration are not abnormally high.

(Adapted from UK APB)[1]

22. Another important base is a percentage of total assets (e.g. ACCA examinations use 1% to 2% of the total assets while HKICPA QP uses 0.5% to 1% of the total assets).

23. There are arguments that when an entity is in a breakeven situation or is making losses, those alternative bases can be used, including turnover, total assets, gross margin and equity. For gross margin and equity, HKICPA QP normally suggests 5% and 1% respectively.

MATERIALITY LEVELS TO PARTICULAR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES OR DISCLOSURES

24. In addition to materiality for the financial statements as a whole, an auditor must also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures when, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

25. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Example 18.9

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1 *Practice Note 26 (Revised): Guidance on Smaller Entity Audit Documentation,* The Auditing Practices Board of UK, 2009.

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, disclosures about segments or a significant business combination).

Example 18.10

As set out in Example 18.8, 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.

Lower levels of materiality for particular classes of transactions, account balances and disclosures

Kimmie understands that the users of the financial statements are the shareholders and the bank. A lower level of materiality should be set in respect of the transactions between the company and individual family owners (relevant to the non-family shareholders), say $60,000.

(Adapted from UK APB)

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.

Performance materiality

In assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures, Kimmie sets performance materiality:

- For the financial statements (i.e. overall level) at $100,000, and
- For transactions between the company and individual family owners at $50,000.

Kimmie judges that the above levels of performance materailtiy to be sufficient as, on the basis of past audit errors (which have been primarily of a cut-off nature), there is a low probability that the aggregate of uncorrected and undetected misstatements will exceed the overall materiality.

(Adapted from UK APB)

Figure 18.1 illustrates different levels of materiality. The terms "overall" and "specific" used in the figure and in the text below are used for the purposes of illustration and are not terms used in the HKSAs. Overall materiality refers to materiality for the financial statements as a whole; specific materiality relates to materiality for particular classes of transactions, account balances or disclosures.

EVALUATING MISSTATEMENTS IDENTIFIED – ACCUMULATING IDENTIFIED MISSTATEMENTS

32. In evaluating the **misstatements**, as discussed above, the objective of the auditor is to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements.

> **Misstatement** is defined to be:
>
> - A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.
>
> When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Example 18.13

Misstatements may result from:

a. An inaccuracy in gathering or processing data from which the financial statements are prepared;
b. An omission of an amount or disclosure, including inadequate or incomplete disclosures, and those disclosures required to meet disclosure objectives of certain financial reporting frameworks as applicable;
c. An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;
d. Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate;
e. An inappropriate classification, aggregation or disaggregation, of information; and
f. For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.

Examples of misstatements arising from fraud are provided in **HKSA 240** (see Chapter 3).

33. **HKSA 450** specifically requires the auditor to accumulate misstatements identified during the audit, other than those that are **clearly trivial**.

EVALUATING MISSTATEMENTS IDENTIFIED – CONSIDERING IDENTIFIED MISSTATEMENTS

37. The auditor is required to determine whether the overall audit strategy and audit plan need to be revised if:

    a. The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or
    b. The aggregate of misstatements accumulated during the audit approaches materiality determined, including materiality for the financial statements as a whole and performance materiality, in accordance with **HKSA 320** as discussed above.

38. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

39. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with **HKSA 320**, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.

40. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements.

41. If, at the auditor's request, management has examined and corrected such misstatements that were detected, the auditor must perform additional audit procedures to determine whether misstatements remain.

EVALUATING MISSTATEMENTS IDENTIFIED – COMMUNICATING AND CORRECTING MISSTATEMENTS

42. When misstatements are accumulated during the audit, the auditor is required to:

    a. Communicate all such accumulated misstatements with the appropriate level of management, unless prohibited by law or regulation; and
    b. Request management to correct those misstatements.

43. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the classes of transactions, account balances and disclosures are misstated, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

50. In determining whether uncorrected misstatements by nature are material, the auditor considers uncorrected misstatements in amounts and disclosures. Such misstatements may be considered material either individually, or when taken in combination with other misstatements.

51. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements.

Example 18.15

If revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses.

It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.

52. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios.

There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements.

Example 18.16

A misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

53. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole.

Example 18.17

The following types of misstatement will be more important to users even though their amounts may be lower than the materiality for the financial statements as a whole:

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

23. Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

    a. Whether the events or conditions constitute a material uncertainty;
    b. Whether the use of the going concern basis of accounting is appropriate in the preparation of the financial statements; and
    c. The adequacy of related disclosures in the financial statements.
    d. Where applicable, the implications for the auditor's report.

SIGNIFICANT DELAY IN THE APPROVAL OF FINANCIAL STATEMENTS

24. When there is significant delay in the approval of the financial statements, the auditor shall inquire as to the reasons for the delay. If the delay could be related to events or conditions relating to the going concern assessment, the auditor shall:

    a. Perform those additional audit procedures necessary as described in paragraph 16 above; and
    b. Consider the effect on the auditor's conclusion regarding the existence of a material uncertainty.

Summary

25. Management shall make an assessment of an entity's ability to continue as a going concern and the auditor shall consider the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

26. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

27. Indications of inapplicability of going concern can be categorized into financial, operating and other.

28. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

29. When the auditor identifies events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall perform further audit procedures.

30. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. Appropriate audit opinion will then be expressed accordingly.

31. When events or conditions identified may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall communicate them with those charged with governance.

32. The auditor shall take appropriate action when there is significant delay in the approval of the financial statements by the management.

Review Questions with Answers

1. What is the going concern basis of accounting? (1 - 2)
2. What is management's responsibility in respect of going concern basis? (4)
3. What is the auditor's responsibility in respect of going concern basis? (6)
4. List possible indications of inapplicability of going concern. (10)
5. List mitigating factors to support going-concern basis. (11)
6. How to evaluate management's assessment of the entity's ability to continue as a going concern? (12 - 15)
7. What further audit procedures could be performed when events or conditions that may cast significant doubt on the entity's ability to continue as a going concern are identified? (16 - 18)
8. What kinds of auditor's reports can be issued if the entity encounters material uncertainty? (20 - 21)
9. What matters regarding going-concern shall the auditor communicate to those charged with governance? (23)
10. What should the auditor do when there is significant delay in the approval of the financial statements? (24)

Case Study 1

You are the audit manager of a CPA firm. You are responsible for the audit of the financial statements of a new client, KLM, for the year ended 31 December 2017.

The auditor of KLM's financial statements for the year ended 31 December 2016 have modified the auditor's report by adding an Emphasis of Matter paragraph on the material uncertainty in respect of KLM's ability to continue as a going concern. Your assistant has suggested to you that the modification will not affect the audit work for the current year since the modification did not affect the reliability of individual items of information reported in the audited financial statements for the year ended 31 December 2016.

Discussion

Do you concur with your audit assistant's view about the modification in the auditor's report for KLM's financial statements for the year ended 31 December 2017 with regard to KLM's going concern? Explain your views.

(HKICPA adapted)

Case Study 2

Southern Telecom is a large telecommunications company that is listed on the Stock Exchange of Hong Kong. It is highly geared because, like many such companies, it borrowed a large sum to pay for a license to operate a mobile phone network with technology that has not proved popular. The company's share price has dropped by 50% during the last three years and there have been several changes of senior management during that period. There has been considerable speculation in the press over the last six months about whether the company can survive without being taken over by a rival. There have been three approaches made to the company by other companies regarding a possible takeover but all have failed, mainly because the bidders pulled out of the deal as a result of the drop in share prices generally.

The company has net assets, but has found it necessary to severely curtail its capital investment program. Some commentators consider this to be fundamental to the future growth of the business; others consider that the existing business is fundamentally sound. It has also been necessary for the company to restructure its finances. Detailed disclosures of all of these matters have always been made in the financial statements. No reference has been made to the going concern status of the company in previous auditor's reports on financial statements and the deterioration in circumstances in the current year is no worse than it has been in previous years.

Discussion

a. Describe independent auditor's responsibilities and the work that the auditor shall perform in relation to the going concern status of companies.
b. Describe the possible auditor's reports that can be issued where the going concern status of a company is called into question; your answer shall describe the circumstances in which they can be issued.
c. On the basis of the information provided above, describe the auditor's report that you consider is likely to be issued in the case of Southern Telecom, giving reasons.
d. Explain the difficulties that would be faced by Southern Telecom and its auditor if Southern Telecom's audit report made reference to going concern issues.

(ACCA adapted)

Case Study 3

The auditor has a duty to express an opinion on the truth and fairness of the financial statements. In forming his opinion, the auditor shall consider whether there are reasonable grounds to accept that the going concern principle is appropriate. If during the audit the auditor becomes aware of indications that the company may not be a going concern, the auditor shall carry out additional audit procedures.

Case Study 6

Consider again CASE STUDY 9 of Chapter 3 (Day and Night).

Discussion

a. Briefly explain how Nancy should consider the going concern assumption in ADL's financial statements.

b. Identify and discuss examples of events or conditions which may invalidate the going concern assumption in ADL's financial statements.

(HKICPA adapted)

Case Study 7

You are the audit manager of Kiwi & Co. and you have been provided with financial statements extracts and the following information about your client, Strawberry Kitchen Designs Co. (Strawberry), who is a kitchen manufacturer. The company's year end is 30 April 2017.

Strawberry has recently been experiencing trading difficulties, as its major customer who owes $0.6m to Strawberry has ceased trading, and it is unlikely any of this will be received. However, the balance is included within the financial statements extracts below. The sales director has recently left Strawberry and has yet to be replaced.

The monthly cash flow has shown a net cash outflow for the last two months of the financial year and is forecast as negative for the forthcoming financial year. As a result of this, the company has been slow in paying its suppliers and some are threatening legal action to recover the sums owing.

Due to its financial difficulties, Strawberry missed a loan repayment and, as a result of this breach in the loan covenants, the bank has asked that the loan of $4.8m be repaid in full within six months. The directors have decided that in order to conserve cash, no final dividend will be paid in 2017.

Financial statements extracts for year ended 30 April:

	DRAFT 2017 $m	ACTUAL 2016 $m
Current Assets		
Inventory	3.4	1.6
Receivables	1.4	2.2
Cash	–	1.2
Current Liabilities		
Trade payables	1.9	0.9
Overdraft	0.8	–
Loans	4.8	0.2

- A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Significant deficiency in internal control — A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

HKSA 260 COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

OBJECTIVES

3. The objectives of the auditor are to:
   a. Communicate clearly with those charged with governance the auditor's responsibilities in relation to the financial statement audit, and an overview of the planned scope and timing of the audit.
   b. Obtain information relevant to the audit from those charged with governance. For example, they may assist the auditor in understanding the entity and its environment, identifying appropriate sources of audit evidence, and providing information about specific transactions or events.
   c. Provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
   d. Promote effective two-way communication between the auditor and those charged with governance, which is important in assisting:
      i. The auditor and those charged with governance in understanding matters related to the audit in context and developing a constructive working relationship;
      ii. The auditor in obtaining from those charged with governance information relevant to the audit; and
      iii. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

4. Communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor's responsibility to communicate them.

5. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

THOSE CHARGED WITH GOVERNANCE

6. The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

7. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. In some jurisdictions, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a "one-tier board" structure). The diversity in entities' governance structures makes it difficult to establish a universal identification of the person(s) with whom the auditor is to communicate particular matters.

8. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a management committee, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.

9. In some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate.

10. When the auditor communicates with a subgroup of those charged with governance, for example, an audit committee or an individual, the auditor is required to determine whether he also needs to communicate with the governing body after assessing how effectively and appropriately the subgroup communicates relevant information with the governing body.

11. If all of those charged with governance are involved in managing the entity (e.g. a small business where a single owner manages the entity and no one else has a governance role), the matters required to be communicated with person(s) with management responsibilities need not be communicated again with those same person(s) in their governance role.

12. Communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:
    a. The auditor will be invited to regularly attend meetings of the audit committee.
    b. The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
    c. The audit committee will meet the auditor without management present at least annually.

MATTERS TO BE COMMUNICATED

13. The auditor shall communicate with those charged with governance the auditor's responsibilities in relation to the financial statement audit, including:

    a. The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance. These matters include significant matters arising from the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.

b. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan.

15. **Significant Findings from the Audit**

The auditor shall communicate with those charged with governance:

a. The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. This may include comment on the acceptability of significant accounting practices.

b. Significant difficulties, if any, encountered during the audit **(see Example 35.2)**.

Example 35.2

Question:

The auditor shall communicate with those charged with governance the significant difficulties, if any, encountered during the audit. Give some examples of such significant difficulties.

Answers:

Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

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

i. Written representations the auditor is requesting; and

ii. Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management. For example,

(1) Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.

(2) Concerns about management's consultations with other accountants on accounting or auditing matters.

(3) Discussions or correspondence dealing with the initial or recurring auditor appointment relating to accounting practices, the application of auditing standards, or fees for audit or other services.

(4) Significant events or transactions that occurred during the year.

(5) Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

(2) Communication with Third Parties:

- Those charged with governance may wish to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor.
- When such written communication is provided to third parties, it may be important to inform the third parties that the communication was not prepared with them in mind.
- In some jurisdictions, the auditor may be required by laws or regulations to notify a regulatory or enforcement body of certain matters (e.g. misstatements) communicated with those charged with governance.
- Unless required by laws or regulations to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

b. **Forms of Communication**

i. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. Written communications may include an engagement letter that is provided to those charged with governance.

ii. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

iii. The auditor of a listed entity shall communicate in writing with those charged with governance regarding auditor independence.

c. **Timing of Communication**

i. The auditor shall communicate with those charged with governance on a timely basis.

ii. The appropriate timing for communication depends on matters such as the significance and nature of the matter, and the action expected to be taken by those charged with governance **(see Example 35.4)**.

Example 35.4

Question:

The appropriate timing for communication varies with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. Illustrate this with examples.

Example 35.5

Question:

If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, what actions could the auditor take?

Answers:

The auditor may take actions such as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g. a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g. shareholders in a general meeting), or the responsible government minister in the public sector.
- Withdrawing from the engagement.

18. **Documentation**

    a. Where matters required to be communicated to those charged with governance are communicated orally, the auditor shall document them, and when and to whom they were communicated.

    b. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

    c. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

HKSA 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

OBJECTIVE

19. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL

20. Based on the audit work performed, the auditor shall determine whether he has identified one or more deficiencies in internal control, and determine whether, individually or in combination, these deficiencies are significant.