



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

Quality Assurance

Report 2014

Content

Foreword		Annex:	
Oversight of our work	1	Members of the Standards & Quality Accountability Board in 2014	54
Our work and review outcomes			
Practice review programme	2	Members of the Practice Review Committee in 2014	55
Professional standards monitoring programme	12	Members of the Professional Standards Monitoring Expert Panel in 2014	56
Our findings			
Practice review programme	18		
Professional standards monitoring programme	32		
Communication with members	53		

Foreword

Fellow members

I am pleased to present to you our eighth annual report on the activities and output of our quality assurance department and to share with you significant and frequently encountered matters identified through our practice review and professional standards monitoring programmes.

In 2014, we again exceeded our targeted number of practice reviews. In order to shorten the review cycle for all practices and better utilize our resources, in late 2014 we introduced desktop reviews for small practice units without any pre-determined risk factors. As a result, we expect to be able to carry out more reviews in the years to come.

In our 2013 report, we highlighted the Top 5 Findings that require particular attention. We are disappointed to find these same deficiencies in initial practice reviews carried out in 2014. To tackle this, we have taken further steps to make practices' aware that we are prepared to take stronger actions against practices that are found to have made no or insufficient effort to address deficiencies that have been widely communicated. Towards the end of 2014, a few cases were referred to the Institute's disciplinary system and more will be expected through 2015 if the same issues continue to be identified.

We are also considering some new initiatives in 2015 to help practices improve their audit quality using some of the ideas and guidance in the IAASB Framework for Audit Quality and better prepare for a practice review. We hope these will help to bring down the overall number of practice review cases that require follow up actions.

In 2014, we continued to make referrals of cross border engagements to the Ministry of Finance ("MOF") in Mainland China for review. We have had several discussions with the MOF to further enhance our memorandum of understanding regarding cross border engagements. We very much appreciate the support given by the MOF for the Institute to properly discharge its practice review function.

We are pleased that our professional standards monitoring programme identified no major issues in the initial application of a number of new standards that have come into effect in 2013. However, some practices might have overlooked some of the changes required by the new standard on fair value measurement. We continued to identify some issues concerning established standards that had been found in previous years, particularly on the accounting for share based payments and business combinations and the calculation of earnings per share.

The main developments in the reform of regulation of listed company auditors were the completion in January 2014 of the Institute's member consultation and a public consultation conducted by the government in mid 2014. No conclusion has yet been published. The Institute will meanwhile remain the sole statutory body in Hong Kong responsible for auditor regulation.

Last but not least, I would like to thank the members and practices for their cooperation with our reviews, without which we would not be able to attain the full value of our quality assurance programmes.

Elsa Ho
Director, Quality Assurance
March 2015

Oversight of our work

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

The responsibility for oversight of QAD activities rests with the Standards and Quality Accountability Board (“the SQAB”). The SQAB ensures that QAD activities are carried out in accordance with strategies and

policies determined by the Council and in the public interest. The SQAB receives and reviews yearly plans and budgets and regular progress reports from management and reports to the Council on its observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB.

Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all practising certificate holders in Hong Kong engaging in provision of audit and other related assurance services. The Professional Accountants Ordinance (“PAO”) has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards.

The Practice Review Committee (“the PRC”) is a statutory committee responsible for exercising the powers and duties given to the Institute as the

regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. The QAD reports to the PRC who makes decisions on the results of practice reviews. According to section 32A of the PAO, at least two thirds of the PRC members must hold practising certificates. The practising members of the PRC are drawn from the full spectrum of audit firms, representing small practices through to the Big Four. The composition of the PRC is reviewed by the Nomination Committee of the Institute every year to ensure a balanced composition. Please refer to Annex for members of the PRC.

Our work

The practice review process can be divided into three stages:

Stage 1 – Preparation

- Select practice for visit
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents

Stage 2 – On-site visit / inhouse desktop review

- Opening meeting *
- Conduct interviews *
- Review compliance with HKSQC 1 and review selected audit files
- Summarize findings and recommendations
- Exit meeting *

* These procedures are carried out by telephone under the desktop review approach

Stage 3 – Reporting

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

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

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

Note:

1. This recognizes the significance of listed and other public interest entities in Big 4 client portfolios.
2. Practices with more than 20 listed clients will receive an interim review in addition to a full review every three years.
3. This is in line with international best practice.
4. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers are given priority for reviews. A number of practices are selected for reviews on a random basis to ensure that all practices will have a chance of being selected. Practices with few audit clients and without any predetermined risk factors ("small practice") are selected for desktop reviews.

The scope of each review includes obtaining an understanding of the practice's system of quality control, assessing compliance of policies and procedures with HKSQC1 "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements" and reviewing conduct of audit work. The detail and extent of review work that the QAD carries out varies from practice to practice depending on the size of the practice and the nature of the client base.

In late 2014, desktop reviews were introduced for small practices in order to shorten the review cycle for all practices and better utilize our resources. Desktop reviews take place at the Institute's office and comprise a review of the latest monitoring report and a selected engagement of the practice.

Matters identified during a review are fully discussed with the practice. The QAD is responsible for drawing conclusions and making recommendations to the PRC for consideration and decision. The PRC having regard to the report and any response by the

practice to the matters raised in the report may act under the power given by the PAO, to:

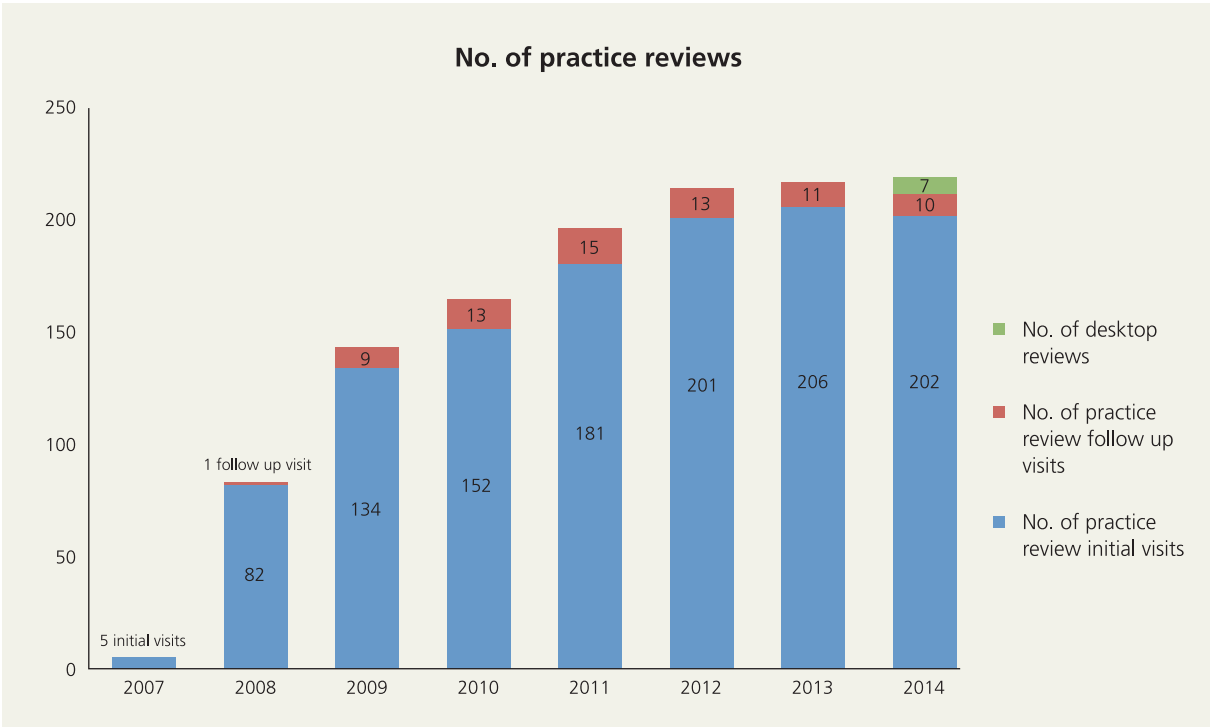
- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct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

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

If an auditing, reporting or relevant irregularity is identified in respect of a listed company, the PRC may, via the Council of the Institute, refer the case to the Financial Reporting Council ("the FRC").

Our review outcomes

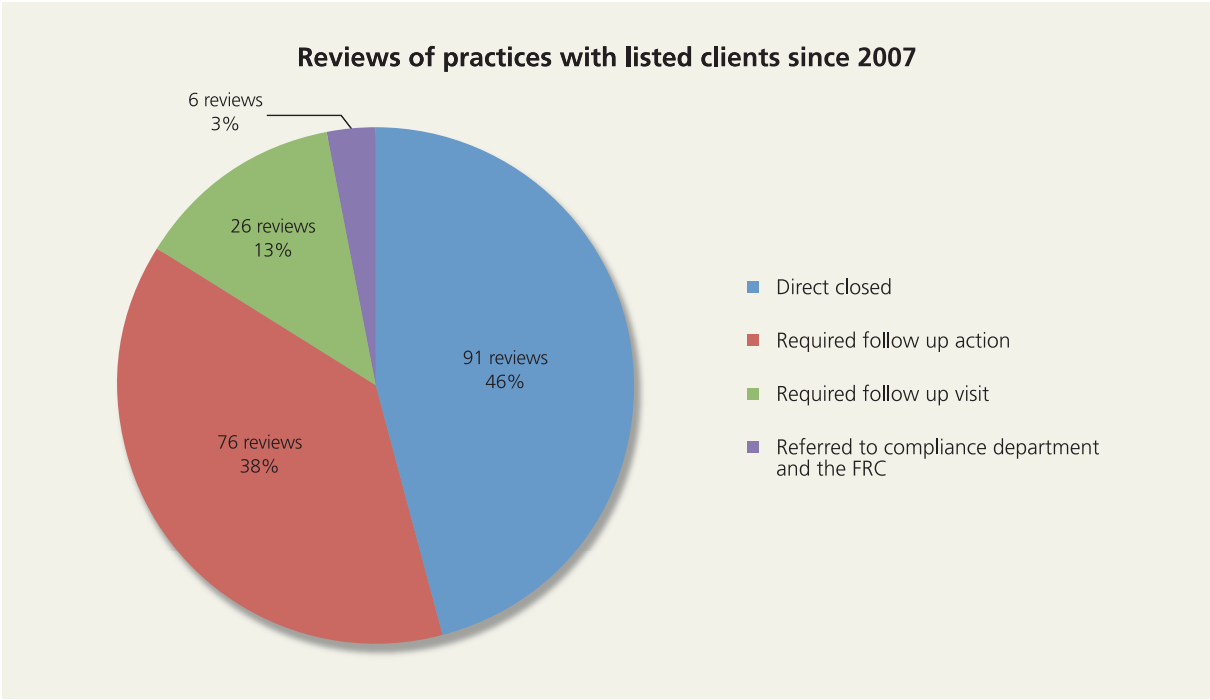
The number of reviews carried out each year has increased steadily from 83 in 2008 to 219 in 2014.



In 2014, the QAD carried out 21 visits on practices with listed clients. We referred five cross border engagements to the Ministry of Finance (“MOF”) in Mainland China for review under the memorandum of understanding between the MOF and the Institute that provides for mutual assistance in discharging their respective regulatory functions. The MOF’s review reports and the responses from the practices formed part of the practice review reports on the practices. The Institute very much appreciates the assistance provided by the MOF and will maintain dialogue with the MOF to enhance cooperation and coordination of review work on cross border engagements.

Since the launch of the revised practice review programme in 2007 up to December 2014, the QAD performed 199 reviews of practices with

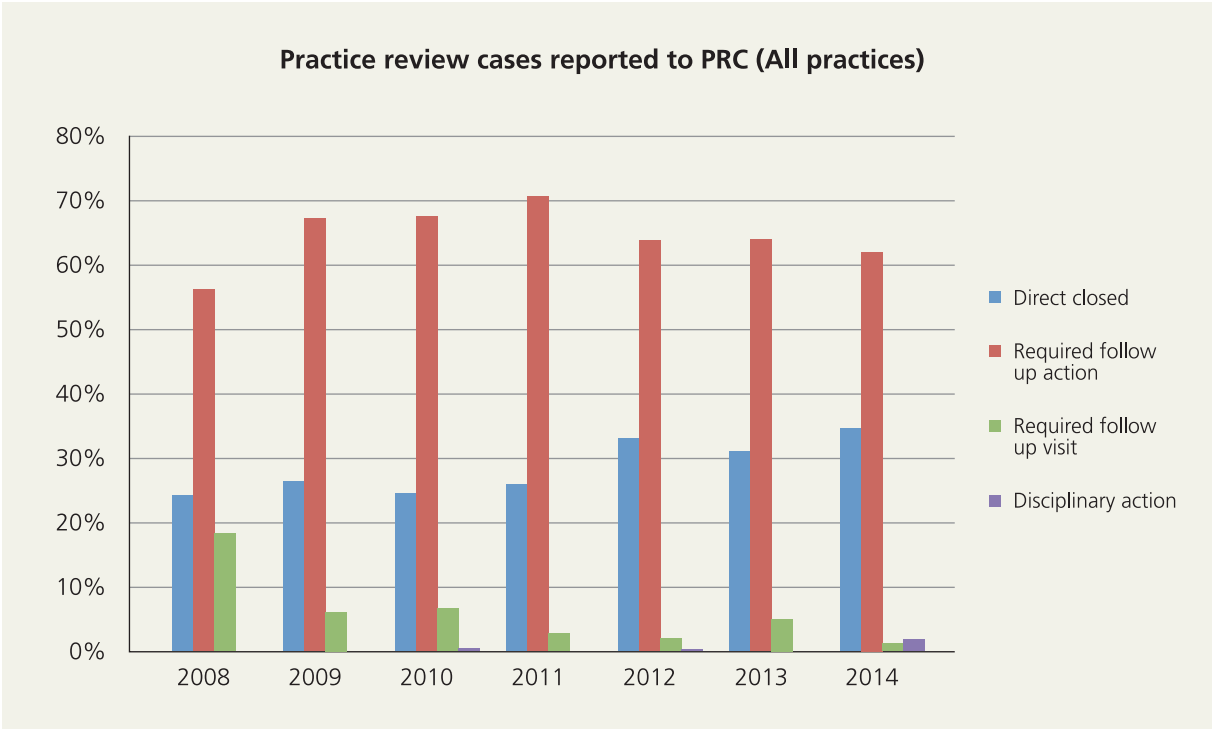
listed clients covering 88 individual practices. For practices with listed clients where significant findings were identified, the PRC directed the QAD to conduct follow up visits to ensure that findings had been properly addressed and that improvement was made on weaknesses identified. The PRC also considered referrals of those findings to the FRC. Up to December 2014, a total of six cases have been referred to the FRC for investigation. Two investigations resulted in complaints against two practices with listed clients as a result of serious non-compliance with professional standards and serious technical failings. The complaints resulted in disciplinary actions against both practices. Two further cases are going through disciplinary proceedings. The remaining two cases are still under investigation by the FRC.



The PRC met on eleven occasions in 2014 and considered 195 reports on practice reviews. The PRC concluded that 64 “initial visit” cases should be closed without requiring any follow up actions. For 116 “initial visit” cases, practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Three cases required a follow up visit to assess the effectiveness of remedial actions taken. Four cases, including a practice with listed clients, proceeded to complaints.

In addition to the 187 initial practice reviews including 7 desktop reviews, 8 follow up visits were reported to the PRC in 2014. Three cases were closed on the basis that adequate remedial actions had been taken, three cases required further follow up actions and, two cases proceeded to complaints.

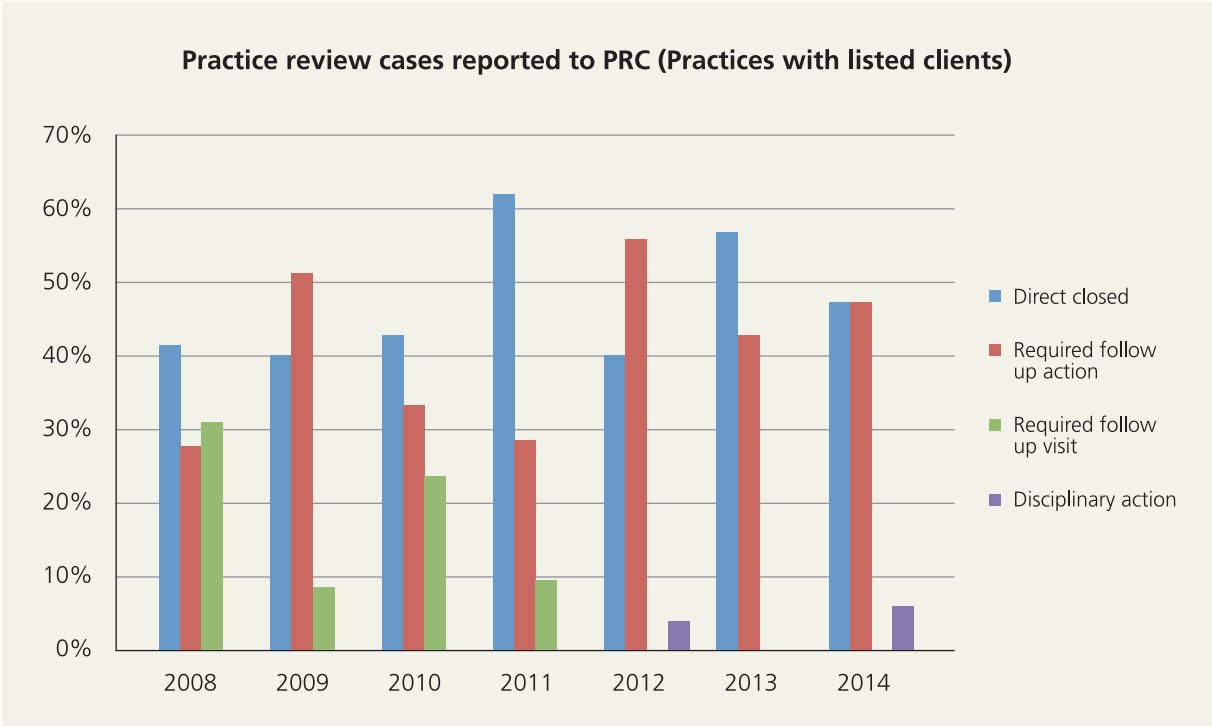
The initial practice review cases reported to the PRC which have been directly closed increased from 31% in 2013 to 34% in 2014. The majority of reviews have continued to require remedial action, follow up visits or even disciplinary action.



For practices with listed clients, directly closed reviews have decreased from 57% in 2013 to 47% in 2014 while reviews requiring follow up action have increased from 43% in 2013 to 47% in 2014. This is discouraging as the outcomes indicate the need for improvement in the quality of practices with listed clients.

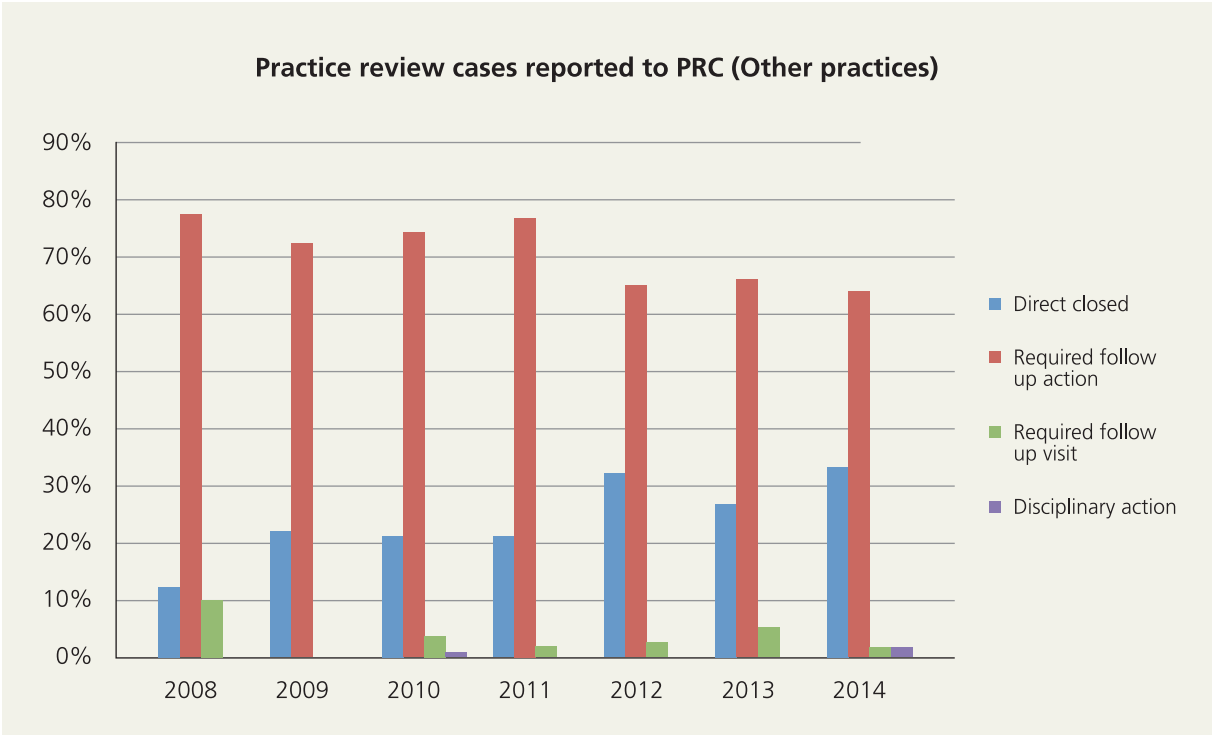
In 2014, the PRC considered practice review reports on 17 practices with listed clients, 16 of

which have previously been reviewed at least once in the three-year cycle of reviews for listed company auditors. Although these practices generally improved on prior year findings, the most recent reviews of some practices resulted in the PRC directing follow up actions and referrals to the FRC. This reflects that some practices have not met the standards required for audits of listed entities which generally demand a high level of resources and technical knowledge.



33% of the reviews of other practices were directly closed in 2014, representing an increase of 5% from 2013. The cases that required follow up action have remained high at 64%. The results of reviews suggest that the level of compliance with

professional standards, especially HKSQC 1 has not significantly improved. In the coming year, we plan to implement some initiatives to help practices improve their audit quality and better prepare for a practice review.



In some cases, findings identified during practice review were considered to be very significant and the PRC directed the QAD to conduct follow up visits to ensure that findings had been properly addressed and that improvement was made on weaknesses identified.

Where findings identified in a first visit amount to serious professional misconduct or in subsequent

visits show that the practice has still failed to observe, maintain or apply professional standards in a significant way, the PRC may decide to make a complaint against the practising member(s) which may ultimately result in disciplinary action. Five reviews of other practices in 2014, including one first time review, have resulted in complaints being raised by the PRC for action under the Institute's disciplinary process.

Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory programme set up in 1988 with the objective of enhancing the quality of financial reporting and the application of professional standards in Hong Kong. It monitors compliance with professional standards by members engaged in the preparation or audit of listed company financial statements.

Under this programme, the QAD carries out reviews of published financial statements and issues enquiry letters to members (primarily auditors of the listed companies) on issues identified and determines appropriate follow up actions. The follow up actions include issuing letters with comments pointing out areas for future improvement. We often note that changes are made to the subsequent financial statements in light of our comments made in the letters. If the issues identified indicate potential significant non-compliance with professional standards, the financial statements, and our concerns, are referred to the Financial Reporting Council (“FRC”) for investigation.

This programme also serves an educational purpose. Through the reviews, the QAD identifies common weaknesses in the application of professional standards. The QAD communicates those common weaknesses to members through different channels such as the annual joint financial reporting forums and reports. Through communication, we hope

that members can gain a better understanding of how to apply professional standards in preparing or auditing financial statements.

The programme is supported by the Professional Standards Monitoring Expert Panel (“Expert Panel”) and independent external review firms and reviewers (“Independent Reviewers”).

The Expert Panel is an advisory panel that gives advice to the QAD on the appropriate course of actions on significant, complex or controversial issues. Members of the Expert Panel are drawn from the Big Four and medium-sized practising firms, a representative from Hong Kong Exchanges and Clearing Limited (“HKEx”) and two non-practising members. Please refer to Annex for composition of the Expert Panel.

The Independent Reviewers provide assistance to the QAD by conducting initial reviews of financial statements. The QAD assesses the observations identified by the reviews and determines whether an enquiry is warranted.

The FRC and the HKEx have similar financial reporting review programmes to monitor the quality of financial statements of listed companies in Hong Kong. The Institute regularly communicates with the other bodies to avoid duplication of work.

Our work

The professional standards monitoring programme focuses on financial reporting although there are occasions where significant auditing matters are also identified. Enquiries are raised on matters identified from the reviews which indicate potential non-compliance with professional standards. Sometimes enquiries may also ask members to provide information about certain significant transactions or items in the financial statements if the disclosures are insufficient for the QAD to assess the appropriateness of the accounting treatment. In the course of correspondence, the QAD gives advice and suggestions to improve disclosures and other elements of financial

reporting where appropriate.

When significant, complex or controversial issues are identified, the QAD consults members of the Expert Panel to seek their views on the appropriateness of the application of professional standards by the listed companies. The Expert Panel also advises the QAD on formulation of enquiry letters and determination of appropriate follow up actions and conclusions. With the strong support of the Expert Panel, the QAD ensures that enquiries made and conclusions reached are appropriate.

There are three stages in the review process:

Stage 1 – Initial review

- Published financial statements assigned by the QAD to Independent Reviewers for initial reviews

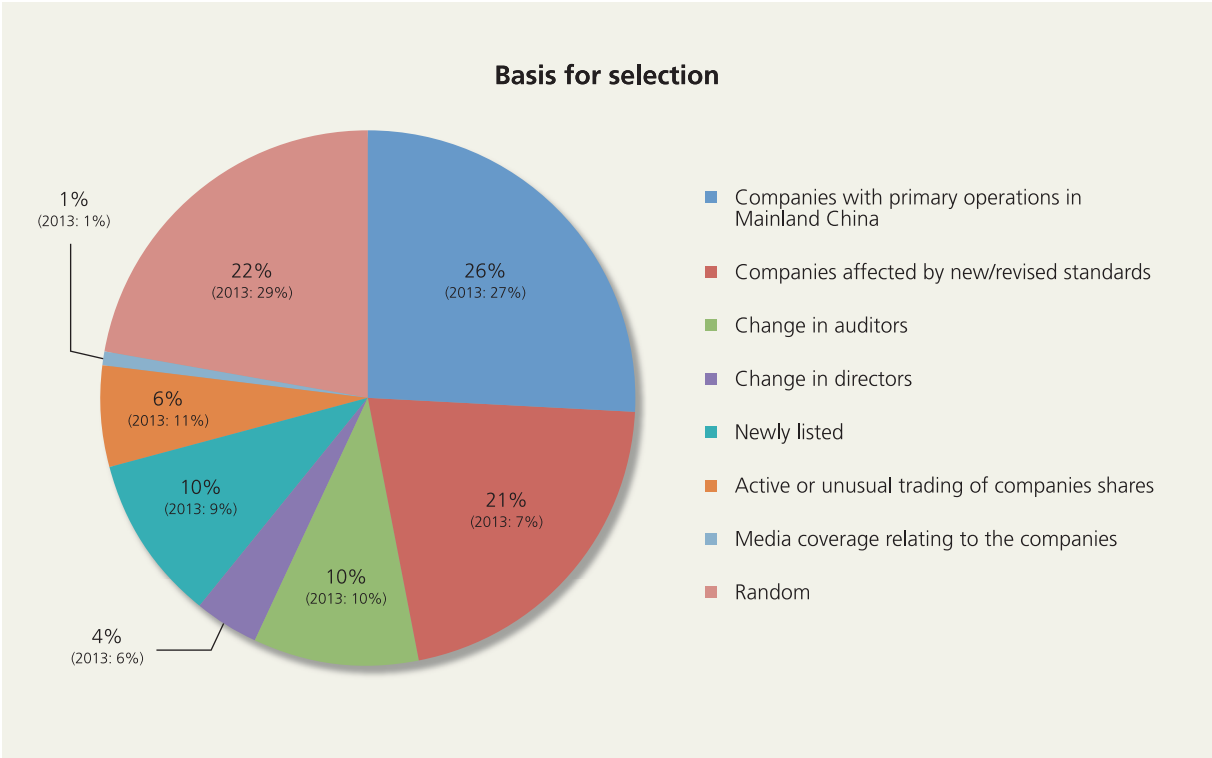
Stage 2 – QAD review

- The QAD reviews reports prepared by Independent Reviewers and issues enquiry letters to members when necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

Stage 3 – Follow up

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

The programme is risk-based. The following chart shows the basis of selection of financial statements for review in 2014.



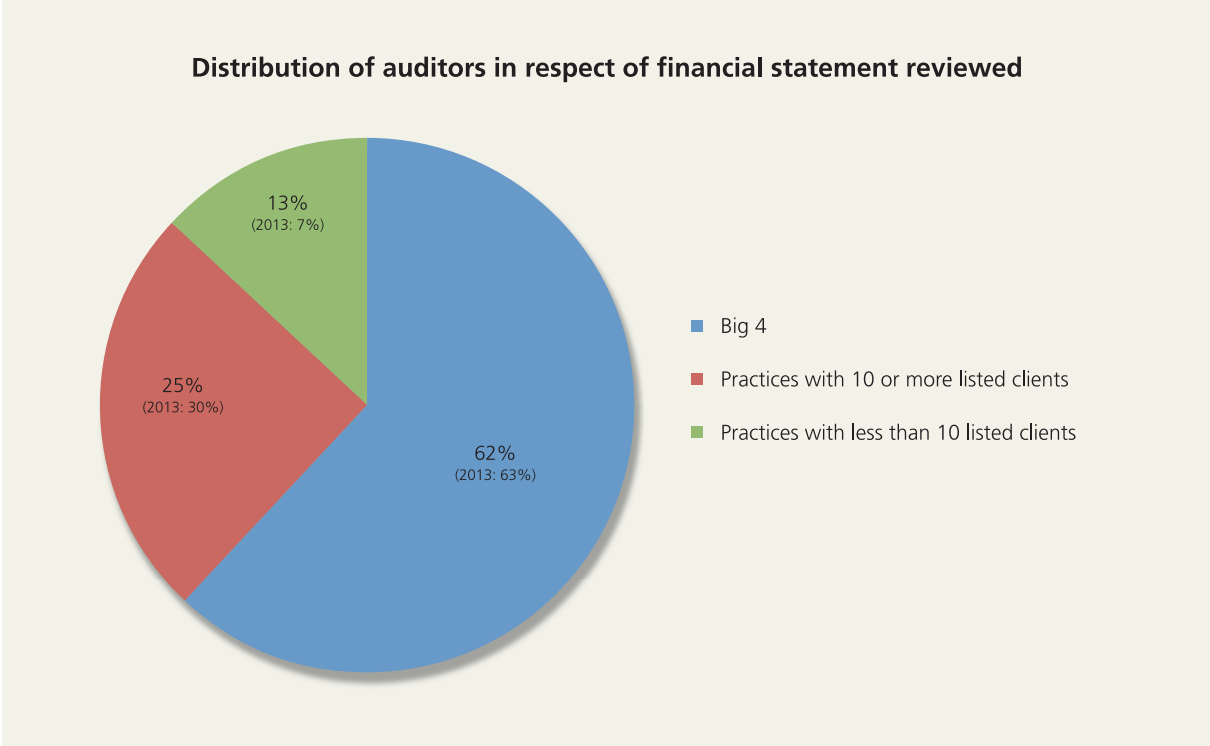
A number of new financial reporting standards became effective for annual periods beginning on or after 1 January 2013. Therefore, as compared to 2013, a greater portion of financial statements reviewed in 2014 was for “Companies affected by new/revised standards”. Findings and educational points identified from our reviews regarding initial application of new/revised financial reporting standards are set out in the section on “Our findings – professional standards

monitoring programme” below.

There were no other significant changes in the basis of selection in 2014 as compared to 2013. As for previous years, a number of financial statements reviewed were for “Companies with primary operations in China” including some financial statements which were prepared under China Accounting Standards for Business Enterprises (“CASBE”).

In the selection of financial statements for review, the QAD also considers the proportion of market share of respective auditors. This means auditors which have more listed clients have a higher number

of financial statements audited by them selected for our review. The following chart shows the overall distribution of auditors regarding the financial statements reviewed in 2014:

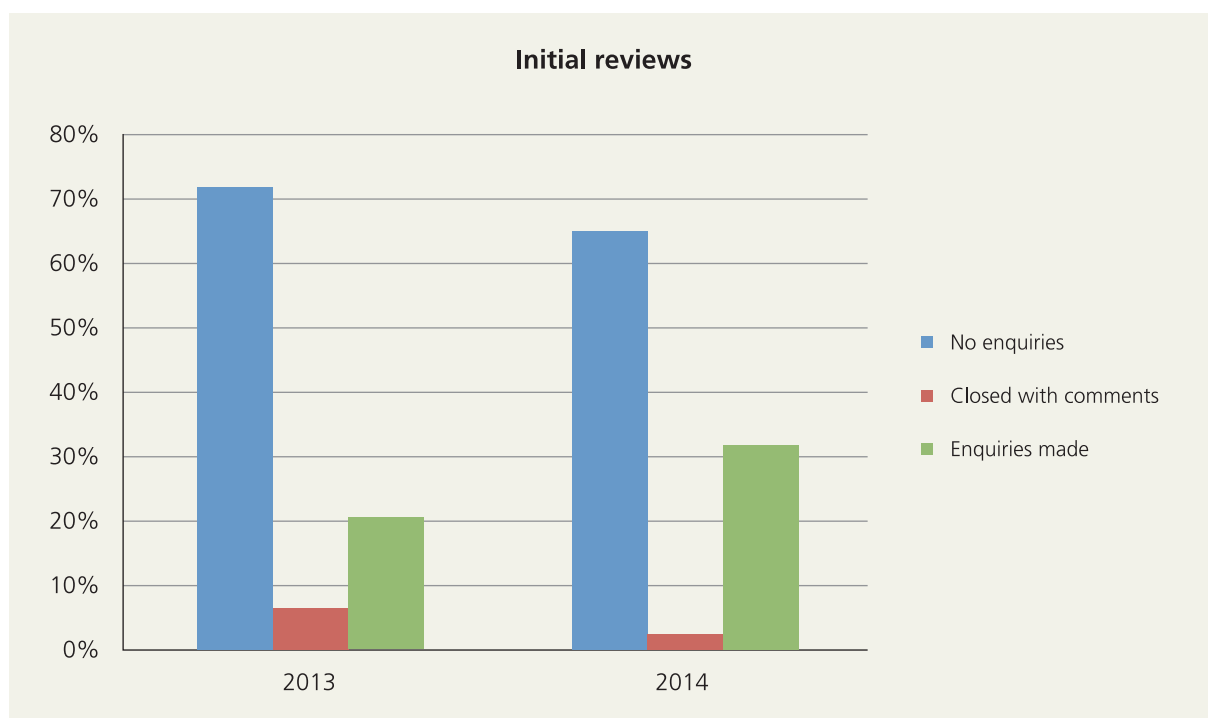


Our review outcomes

In 2014, the QAD reviewed 78 sets of published financial statements and followed up 6 cases brought forward from the previous year. During the year, the QAD issued 38 letters enquiring about matters identified from reviews or making recommendations on improvements in presentation and disclosures. The QAD handled a total of 26

responses from auditors during the year. There were 70 cases closed during the year including 5 which were brought forward from the previous year.

The chart below shows that follow up action was not needed for the majority of financial statements reviewed in 2014.



Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. Since 2010, a total of 8 cases have been referred to the FRC including 2 cases in 2014. In 2014, one case was referred directly to the Professional Conduct Committee of the Institute for consideration of disciplinary action against the auditor as there was sufficient evidence to support a complaint based on information collected in the programme. As the matters also constituted Relevant Irregularities or Relevant Non-compliance as defined under

section 4 and 5 of Financial Reporting Council Ordinance, the FRC has also been informed about this case.

By mid March 2015, only three cases that were referred to the FRC in 2013 and 2014 are still under assessment or investigation by the FRC. Of the 5 cases that the FRC has completed investigation, 2 cases have been closed with no follow up action needed and 1 case has proceeded to a complaint. The remaining 2 are under consideration by the Institute for further regulatory action.

CASBE financial statements

As for previous years, the QAD, the FRC and HKEx share the review of financial statements of “A+H” and “H-share only” companies that are prepared under CASBE. As agreed amongst the three parties, the QAD reviewed 8 sets in 2014. There were no major issues identified from the reviews.

Other educational activities

The Institute held an annual joint financial reporting forum with the FRC and HKEx on 19 November 2014 and attracted approximately 300 attendees. Representatives of the three bodies shared common or significant observations identified from reviews of Hong Kong listed companies’ financial statements. A webcast of the event is available on the Institute’s website as part of its e-learning programme.

Our findings

Practice review programme

This is the eighth annual report on our revised practice review programme. Every year we use the annual report to communicate common findings identified in practice reviews to allow practices to consider whether they have similar problems that need attention and key messages from the Practice Review Committee (“the PRC”).

In 2014, we carried out 212 on site reviews which slightly exceeded our target. With the aim of reducing the time it will take to review all practices and better utilizing our resources, we streamlined our existing practice review procedures and in the later part of 2014 trialed desktop reviews for some small practice units that did not exhibit any pre-determined risk factors. On the basis of our experience of the completed trial desktop reviews in 2014, we expect to be able to carry out more reviews in the years to come.

Continuing the changes introduced in 2013 we categorize review findings into significant findings and other points for attention in order to draw focus on more important issues identified during practice reviews. Significant findings are findings that may have a more direct or material impact on the quality control system or audit opinion and therefore require more urgent attention.

On 28 April 2014, we issued a letter to all practices drawing their attention to the Top 5 Findings that had been identified in the 2013 annual report. The findings were: (1) no or insufficient quality control policies and procedures; (2) no or ineffective monitoring function; (3) failure to carry out adequate audit procedures to satisfy requirements of auditing

standards; (4) lack of control over subcontractors’ work; and (5) inappropriate use of modified opinion to circumvent necessary audit procedures. Practices were advised that if they had such deficiencies in their own policies, procedures, audit methodology and working practices, they should take immediate remedial actions. If, in a subsequent practice review, a practice is found to have made no or insufficient effort to correct those deficiencies, such behavior will be regarded by the PRC as amounting to serious professional misconduct and consideration will be given to raising a complaint against the practice.

Responses to the 2014 electronic self-assessment questionnaire revealed that a number of practices had not performed any monitoring reviews. Given that the requirement for monitoring reviews is set out in HKSQC 1, which was first introduced in 2005, this is a disappointing reflection on the commitment of some of our members to compliance with professional standards. On 5 November 2014, we issued another letter to those practices requesting them to provide us with confirmation, by 31 March 2015, that a monitoring review has been completed. The letter advises that if a practice fails to provide us with a confirmation by the deadline, a referral to the Professional Conduct Committee (“PCC”) will be made with a recommendation to issue a letter of disapproval to the practice. The practice will also be prioritized for a practice review.

In 2015, we will continue to focus on the Top 5 Findings. The PRC believes that all practices have been given ample opportunities to rectify those deficiencies that have been regularly communicated and are prepared to take a strong line against practices that have not done so. Towards the end of

2014 a few such cases were referred to the Institute's disciplinary system and the numbers are expected to increase through 2015. We are also considering some new initiatives for 2015 that aim to help practices improve their audit quality and better prepare for a practice review so that the outcomes of practice reviews could be improved in future. More details of these initiatives will be provided when they are launched.

There was an important event in February 2014 when the International Auditing and Assurance Standards Board ("IAASB") issued a Framework for Audit Quality. The Framework is not a new standard but it is helpful guidance for practices to reflect on and seek to improve audit quality. The Framework clearly sets out that the responsibility for performing quality audits of financial statements rests with auditors but that audit quality is best achieved in an environment where there is support from, and appropriate interactions among stakeholders, including management, those charged with governance, etc.

The Framework acknowledges that to deliver a quality audit an engagement team and/or audit practice should:

- A) Exhibit appropriate values, ethics and attitudes
- B) Be sufficiently knowledgeable, skilled and experienced
- C) Apply rigorous quality control procedures and audit process
- D) Provide useful and timely reports
- E) Interact appropriately with relevant stakeholders

To show how the Framework has practical relevance, we summarized below the common practice review findings in 2014 (including the Top 5 findings, as indicated by "*") by reference to the above factors to illustrate how those findings indicate a lack of audit quality and how addressing them should assist the development of an environment that encourages audit quality.

A) Exhibit appropriate values, ethics and attitudes

- **Fee dependence on listed clients**

For smaller practices that have one or a few listed clients, fee dependence giving rise to independence threats on those clients is frequently an issue. The Code of Ethics requires a practice to implement additional safeguards if fee income from a listed client exceeds 15% of the total fees of the practice for two consecutive years. If such circumstances arise, the practice should disclose this fact to those charged with governance and apply relevant safeguards such as the use of external pre-issuance review and/or post-issuance review of the audit engagement to reduce the threats to an acceptable level. If no safeguard is considered appropriate, the practice should terminate the audit relationship.

- **Assistance in preparation of financial statements**

Non-assurance services may be provided to non public interest entities, but practices should first go through a "threats and safeguards" evaluation. However, the Code of Ethics allows non-assurance services to public interest entity audit clients only in very limited circumstances as the audits of those clients demand a much

higher degree of independence. Assistance in preparation of financial statements is disallowed under the Code. We encountered circumstances that indicate some practices have drafted or assisted in drafting the financial statements for listed clients. The explanations are generally that assistance was limited to providing technical advice on notes to the financial statements prepared by clients. Given that the distinction between involvement in preparation and providing technical advice might not be readily apparent, practices should take extra care to ensure that independence is not compromised by any form of assistance provided to clients in relation to their financial statements.

- **Lack of involvement in audits led by authorized signatories**

In some practices, the sole practitioner focuses mainly on business development and has little involvement in daily operations of his or her practice, having assigned the responsibilities for audit engagement review and signing of audit reports to an authorized signatory. However, the sole practitioner cannot assign or avoid ultimate responsibility for audit quality and the responsibility as engagement partner for all audit engagements. The practitioner must have appropriate involvement in the engagements, in particular the engagement file review process, to ensure sufficient evidence is obtained to support the audit opinion before it is signed, by an authorized signatory or him/herself.

- **(Top 5) Lack of control over subcontractors' work***

In previous reports and forums, we have explained that subcontracting arrangements are

considered an acceptable mechanism to engage staff resources, as long as the practices exercise appropriate control over the subcontractors' work. However, we often found the quality of the work of subcontractors to be unsatisfactory, generally as a result of practitioners having little involvement in those audit engagements. Common problems include:

- a) Practices accepted new audit clients referred by subcontractors but where the subcontractors will act as the engagement team without considering whether the practices have sufficient resources to properly supervise the number of new audit engagements and whether the subcontractors are competent to perform audits;
- b) Practices did not have an adequate knowledge of their subcontractors' other business activities, particularly whether the subcontractors also provided non-assurance services to the audit clients. The potential independence threats created by such an arrangement should be fully considered before accepting those clients;
- c) Subcontractors performed almost all audit procedures and managed the client relationship without involvement of the practices. Therefore, the practices had little understanding of their audit clients and did not control or get involved in any critical parts of the audits, such as risk assessment and development of risk responses or review of the subcontractors' work before signing the audit opinion; and

d) Subcontractors did not follow the practices' quality control system and/or audit methodology. As well as the obvious departure from requirements of HKSQC 1, this also creates serious doubts over how the practices control or be satisfied with the quality of subcontractors' work.

Practices with subcontracting arrangements must understand that they bear ultimate responsibility for all audits, including subcontracted engagements. The use of a subcontractor is not a defense for the practice to avoid its responsibilities in case of an audit failure. Subcontractors only act in the capacity of staff, albeit engaged by a different mechanism. In many situations, the use of incompetent subcontractors and lack of proper involvement of practices in engagements are main factors leading to poor audit quality. If a practice cannot properly control or supervise the work of a subcontractor, the subcontracting arrangement should not continue.

B) Be sufficiently knowledgeable, skilled and experienced

- **Not meeting the criteria for reporting under SME-FRS**

We continued to find examples of practices failing to identify that their clients did not meet the criteria for reporting under SME-FRS. In one case, a practice overlooked the fact that the ownership of its client had changed from individuals to a Hong Kong incorporated company during the year, meaning that it no longer met the criteria set out in Section 141D of the predecessor Companies Ordinance. As a

result, the practice concurred with the client's continual use of SME-FRS for reporting and issued an inappropriate audit report. Given that there are three financial reporting frameworks in Hong Kong, two of which have specific qualifying criteria, practices should always check that their clients still meet the respective qualifying criteria before the start of each engagement.

Practices are reminded that the requirements of Part 9 of the new Companies Ordinance (Cap. 622) relating to financial statements and directors' reports will come into operation for accounting periods beginning on or after 3 March 2014. For companies with a March-year end, the requirements will first affect their financial statements and directors' report for the year ended 31 March 2015. Practices should review their client portfolio and discuss with relevant clients their eligibility for adopting SME-FRS under the new Companies Ordinance. The Institute provides some guidance materials in the New Companies Ordinance Resource Centre available on its website <http://www.hkicpa.org.hk/en/standards-and-regulations/standards/new-co/>.

- **Not familiar with regulatory requirements for insurance and securities broker clients**

It is not uncommon for practices with securities and insurance broker clients to misinterpret the compliance requirements of the relevant regulations and believe that performing normal audit procedures would also address compliance work requirements. As a result, some compliance work required was omitted or wrongly performed.

a) Insurance brokers

In April 2013, revised 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” was issued. The revisions were not due to a change in the Insurance Companies Ordinance, but to align the guidance with current auditing standards, e.g. to align content of compliance report with HKSAE 3000 “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information” and to provide additional suggested procedures for compliance reporting. Although the changes resulting from revised PN 810.1 did not in themselves appear to cause problems, we continued to find some practices that did not understand the compliance requirements:

Minimum requirements for professional indemnity insurance

Under section 73 of the Insurance Companies Ordinance, practices are required to report on the insurance broker’s compliance with the minimum requirements for professional indemnity insurance. Minimum level of the insurance required should be two times the aggregate insurance brokerage income for the twelve months immediately preceding the date of commencement of the professional indemnity insurance cover. However, in some cases, practices misinterpreted the requirements and compared the actual coverage with two times

the aggregate insurance brokerage income for the twelve months immediately preceding the “ending” rather than “commencement” date of the professional indemnity insurance cover, resulting in them reaching a wrong conclusion on compliance with section 73.

Sample selection

The revised PN 810.1 suggests that practices should select three dates at a minimum for certain compliance testing, one of which should be the year end date. The guidelines issued by the Insurance Authority require that the dates selected for testing should be at least three months apart. In one practice review a practice had only selected samples for compliance tests from the last three months of the year, which is not in compliance with the guidelines.

b) Entities regulated under the Securities and Futures Ordinance (“SFO”)

Understanding and testing of internal controls

Auditors of entities regulated under the Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules are required to issue a compliance report on their clients’ internal controls. Practices should therefore have sufficient understanding of their securities broker clients’ internal controls and perform relevant tests on key controls to obtain sufficient assurance to support the issuance of an appropriate compliance opinion. Some practices did not obtain

an adequate understanding of their securities broker clients' internal controls, in particular those on their trading systems nor perform any tests on their key controls and often relied on standard financial statement audit procedures to address the compliance requirements.

Practices should review securities broker clients' procedural manuals and identify key controls over client monies and client securities as a starting point for understanding their clients' business and relevant controls.

Not holding client's monies

To limit the risk involved in serving clients that are regulated entities under the SFO, some practices only accepted clients, which either did not hold or were restricted from holding clients monies under their licenses. However, some of those practices overlooked that they needed to take extra steps in their compliance work to ensure that no client monies were held by these clients, as suggested in PN 820 "The Audit of Licensed Corporations and Associated Entities of Intermediaries".

Before accepting new regulated clients such as insurance and securities brokers, practices should ensure they have appropriate and sufficient resources and knowledge to carry out the engagements. Significant efforts are required to acquire the necessary skills and understanding if practices have no prior experience in auditing those regulated entities.

- (Top 5) Failure to carry out adequate audit procedures to satisfy requirements of auditing standards*

Almost a decade has passed since the Hong Kong Standards on Auditing ("HKSA") issued by the Institute became effective. HKSA became effective in December 2005 to mark the convergence of Hong Kong auditing standards with International Standards on Auditing introducing many basic requirements that remain unchanged today. However, there are still practices that are unable or unwilling to meet a number of these basic requirements, especially on determination of materiality levels, review of design and implementation of internal controls, risk assessment procedures including fraud risk assessment, subsequent event review and going concern assessment. The number of practices that continue to fail to carry out some of the procedures required by HKSA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", e.g. testing of journal entries and review of accounting estimates for management biases, is also a cause for concern.

The Institute developed and published the Audit Practice Manual ("APM") to provide a model for the application of auditing standards and to facilitate better audit documentation. Many practices consider that acquiring the APM is imperative to meet the expectations of practice reviewers but they fail to make use of the APM guidelines and programmes when carrying out their audits. Some practices simply used the basic "Flat Holdings Limited" example from the APM to reproduce identical documentation for every audit resulting in the documentation often not being relevant to the audits of their clients.

Practices need to, and should, know that purely substantive work featuring high volume of vouching tests would not attain the level of assurance necessary to support an audit opinion. Adequate audit planning and completion procedures are important. A good audit plan helps audit teams to identify key risk areas at an early stage so that audit work can be focused on more risky areas. Proper completion procedures are also necessary to ensure that appropriate audit work has been properly carried out and completed before the audit report is signed.

In a practice review, practices should be able to demonstrate they have:

- a) ensured their audits meet the requirements of all relevant auditing standards regardless of the size of the audit clients;
 - b) taken steps to keep abreast of the current development of professional standards and updated their audit manual accordingly; and
 - c) provided appropriate training to staff to ensure they are able to fully understand and properly apply auditing standards in their work.
- **Irregularities in application of financial reporting standards**

A number of irregularities in application of financial reporting standards were also identified by the Professional Standards Monitoring Programme. Further details are set out in the section “Our findings – Professional standards monitoring programme” of this report.

C) Apply rigorous quality control procedures and audit process

- l) **Apply rigorous quality control procedures**
- **(Top 5) No or insufficient quality control policies and procedures***

HKSQC 1 has been effective for almost ten years. However, practice reviews continue to find that many smaller practices still do not have quality control policies and procedures to the extent required by HKSQC 1. Deficiencies include:

- a) Quality control policies and procedures do not cover all the six elements of quality control set out in HKSQC 1;
- b) Quality control policies and procedures have been introduced just prior to site visits; and
- c) The Institute’s A Guide to Quality Control has been “adopted” but quality control policies and procedures had not been tailored to suit the practice’s own circumstances, which resulted in inconsistencies between policies and procedures set out in the quality control manual and applied in practice.

Many practices with listed clients use a self developed quality control manual. However, some have no or inappropriate policies and procedures to address specific requirements for listed companies audits, e.g. partner rotation and engagement quality control review.

Audit documentation and time records provided by practices sometimes indicate that participation of engagement quality control reviewer in the

audits of listed companies was minimal. An engagement quality control review is required for every listed audit and an engagement quality control reviewer should objectively evaluate the significant judgments made and conclusions reached by the engagement team in arriving at the audit opinion. Although the engagement partner has the prime responsibility for the audit, the engagement quality control reviewer has an important role to ensure audit quality is up to an acceptable standard. In a recent disciplinary case, the engagement partner and the engagement quality control reviewer received the same punishment for an audit failure.

HKSQC 1 applies to practices of all sizes. However, the level of sophistication and complexity of quality controls necessary to meet the requirements of HKSQC 1 will be far less for smaller practices than bigger practices with a higher risk client base. Each practice should establish quality control policies and procedures that address all the elements required by HKSQC 1 and that are suitable for its size and operating characteristics. Practices should appreciate that having appropriate policies and procedures in place will enhance quality of audit work.

- **(Top 5) No or ineffective monitoring function***

A monitoring review is a key element of HKSQC 1. It is a process to ensure practices' quality control systems are relevant, adequate, and operating effectively. In previous reports, we emphasized the importance of monitoring and suggested a number of possible ways that practices could meet their responsibilities in respect of monitoring. Responsibility for

monitoring should be entrusted to an individual, internally or externally, with sufficient and appropriate experience and authority to assume that role.

Initial practice reviews in 2014 continued to identify that some practices had no monitoring function in place. This ignores a fundamental requirement of HKSQC 1 and means that a monitoring report will not be available for assessment as part of practice review. As mentioned above, the PRC has started taking stronger action against practices that have not performed a monitoring review.

Where practices have carried out monitoring reviews, there were some commonly identified shortcomings:

- a) The review only covered simple or dormant engagements that were not representative of the client base;
- b) There was little documentation to evidence the monitoring procedures performed;
- c) Findings identified were significantly less than found in practice review;
- d) There was no follow up plan to address the issues identified;
- e) The frequency of monitoring reviews did not meet the requirement of HKSQC 1 (i.e. annually for review of quality control system and periodically for review of completed engagement of each engagement partner with a cycle that is expected to span no more than three years); and

- f) An individual without appropriate technical expertise and authority carried out the review.

These findings bring into question the effectiveness and robustness of the monitoring review process and need to be effectively addressed before the practice review is fully concluded.

II) Apply rigorous audit process

- Lack of reliable audit evidence

The primary objective of an audit is to enable the auditor to obtain sufficient appropriate audit evidence in order to draw reasonable conclusions on the matters on which the auditor is to report. Practice review findings often raise questions about the sufficiency and appropriateness of audit evidence.

In carrying out audit tests, many smaller practices still relied solely on documents generated by the client without giving due consideration to their reliability. Typical examples were (a) checking sales invoices/ service billings in transaction and cut-off tests; and (b) relying on ageing reports to assess recoverability of receivables and appropriateness of inventory provision.

The reliability of external evidence is not always a given. For instance, where external confirmations are received through (a) clients and/or (b) electronic means, e.g. by fax or email the auditor should take steps to ensure they are genuine and from a third party. A failure to properly assess the reliability of the confirmations may result in drawing wrong conclusions on the matters confirmed.

HKSA 500 "Audit Evidence" requires the auditor to consider the reliability of information used as audit evidence. The reliability of information used as audit evidence is influenced by its source and nature and the circumstances under which it is obtained. The following are the guidelines set out in HKSA 500:

- a) Reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- b) Reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- c) Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- d) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally.
- e) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Practices are advised to bear the above guidelines in mind when determining whether reliable evidence has been obtained to support their conclusions.

- **Over-reliance on experts**

Previous reports have emphasized the need to properly assess the work of experts if practices intend to rely on their work. In 2014, there were numerous examples of practices making insufficient efforts to meet the requirements of HKSA 500 and HKSA 620 “Using the Work of an Auditor’s Expert”.

Practices sometimes relied on management experts or engaged external experts to assist them in their audits. However, in dealing with this area of audit work, practices have the sole responsibility for the audit opinion expressed and that responsibility is not reduced by the use of work of either management or their own experts. Auditing standards require that before relying on expert work, practices are required to at least perform the following audit work:

- a) Evaluate whether the professional valuation is adequate for the audit purpose;
- b) Evaluate competence, capabilities and objectivity of the expert;
- c) Obtain an understanding of the expert work;
- d) Evaluate appropriateness of the expert work (including key assumptions and valuation methods);
- e) Review or test data used by the expert, in particular the information provided by management; and
- f) Properly document all work performed.

Valuation is a common area where practices would rely on the work of experts. Since valuation always involves significant judgments, which can have a material impact on the outcome of the valuation, practices should apply sufficient professional skepticism in reviewing the work of experts. It is not uncommon for practices to record only audit evidence that corroborates the expert work. However, to make a critical assessment practices also need to appropriately challenge the valuation. Practices are expected to have considered all reasonably available evidence for and against the assumptions made by an expert when auditing the valuation.

- **Insufficient work performed by group auditors**

Many entities have divisions, associates, joint ventures or subsidiaries (components) that are not audited by the group auditors but by component auditors. However, group auditors remain responsible for the group audit opinion and thus should obtain sufficient audit evidence in relation to the components. Shortcomings identified in group audits included the following:

- a) Some small practices only obtained audited financial statements from components’ auditors for group audit purposes. This approach is not sufficient to meet the procedures required by HKSA 600 “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)”, in particular involvement of the group auditor in risk assessment and development of risk responses.

- b) It is not uncommon that practices fail to
 - (i) evaluate professional competence and independence of component auditors; (ii) determine group and component materiality; and (iii) perform analyses to identify significant components and determine the scope of work for components.
- c) Communication between group audit teams and component auditors continues to be insufficient. Some practices have templates for group instructions and reporting but these are not always used effectively and potential problems are not followed up with component auditors. The following are examples:
 - i. Audit questionnaires completed by the component auditors show inconsistent information;
 - ii. Working papers provided by component auditors indicated that component auditors did not follow group instructions; and
 - iii. Responses to audit questionnaires showed “yes”, “no” and “n/a” without providing sufficient detail of the work done by the component auditors.
- d) If components do not have a conterminous year-end with the group, adjustments are generally made to reflect activities undertaken by the component in the period between the component and the group’s year-ends. However, practices did not always perform audit work on the appropriateness of adjustments made.

- e) Where components’ financial statements prepared under their local accounting frameworks were used for consolidation, the auditor did not always consider the potential impact on the group financial statements of the use of different accounting frameworks.

Limiting the approach to a group audit to receiving documents (e.g. audit questionnaires and clearance) from component auditors without adequate involvement by group auditors is not sufficient. Group auditors should understand and participate in the work performed by the component auditors and evaluate whether additional work should be performed by them to support their group audit opinion. Group auditors should also fully document their involvement.

- **Insufficient audit documentation**

The cause of many findings identified during practice reviews is the lack of proper audit documentation.

Paragraph 8 of HKSA 230 “Audit Documentation” requires auditors to prepare audit documentation that is sufficient to enable an experienced auditor, including the practice reviewers, having no previous connection with the audit, to understand:

- a) The nature, timing, and extent of the audit procedures performed to comply with the auditing standards and applicable legal and regulatory requirements;
- b) The results of the audit procedures performed, and the audit evidence obtained; and

- c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

Some small practices perceive that given their knowledge of their clients, it is unnecessary to document details of the client's background and audit work, including risk assessment procedures, carried out. The type of relationship an auditor has with a client does not override the requirements of HKSA 230. There is further guidance specific to smaller entities in paragraphs A16 and A17 of HKSA 230.

Paragraph A16 specifically states that documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. In the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team. Nevertheless, the engagement partner should comply with the overriding requirement of paragraph 8.

Paragraph A17 then states that, when preparing audit documentation, it may be helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples include understanding of client and its internal controls, overall audit strategy and audit plan, materiality determined in accordance with HKSA 320 "Materiality in Planning and Performing an Audit", assessed risks, significant matters noted during the audit, and conclusions reached.

Practices often blame time pressure and constraints to explain failures in audit documentation. While such issues exist, they cannot override the requirements of auditing standards. Without proper documentation to evidence audit work, it is difficult to accept that adequate work had been performed to support the audit opinion and comply with relevant professional standards.

D) Provide useful and timely reports

- (Top 5) Inappropriate use of modified opinion to circumvent necessary audit procedures*

Some practice review findings indicated that practices used a modified opinion to circumvent necessary audit procedures. This practice is not acceptable. Common examples are as follows:

a) Reporting deadlines

Client information was only made available to the auditor near the reporting deadlines, which for many companies are tax filing deadlines. In order to meet the tight deadlines, some practices issued modified reports that disclaimed all parts of the financial statements on which they failed to obtain sufficient evidence before the deadlines. Lack of time is not a valid reason for issuing a modified audit opinion. The auditor should assess the potential impact of time constraints and resource requirements before making the acceptance or continuance decision.

b) Inventory counts

Some practices issued modified opinions year after year because clients did not invite them to attend the year end inventory count. It was often difficult to establish whether there is a real limitation or it is only a way to avoid carrying out an audit procedure that may have been inconvenient for the client and the auditor. Suspicions are heightened when a similar limitation of scope has persisted for years.

Where a scope limitation is truly imposed by a client, practices should consider alternative audit procedures and should issue a modified opinion only when there are no alternative procedures or where such alternative procedures fail. Paragraph A9 of HKSA 705 "Modifications to the Opinion in the Independent Auditor's Report" states that limitations imposed by management may have other implications that need to be addressed by the auditor such as in engagement continuance. Section 410.52 of the Code of Ethics also states that significant limitations imposed by client may infringe on the practice's statutory duties as auditor. Practices should normally not accept appointment or reappointment as auditor in those circumstances.

- **Inappropriate audit opinion**

Deciding whether or not to issue a modified opinion will generally involve significant professional judgment. However, practices sometimes failed to document the thought process that explained how they had assessed

the impact of a qualification which raised questions on whether the modified opinion given was appropriate. The following are some examples found during practice reviews:

- a) A practice was not able to explain why a qualified opinion instead of an adverse opinion was given on a disagreement about non-consolidation of a subsidiary that was significantly larger in size than the parent.
- b) In the prior period, the predecessor auditor had issued a disclaimer of opinion in relation to a scope limitation. In the current year, the practice as an incoming auditor issued a disclaimer of opinion on the comparative figures without carrying out work required by HKSA 510 "Initial Audit Engagements – Opening Balances" and considering the brought forward effect of the previous qualification in accordance with HKSA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".
- c) There was no evidence in the working papers to demonstrate how the auditor had reached the decision on which type of modified opinion was appropriate.

Practices should refer to HKSA 700 "Forming an Opinion and Reporting on Financial Statements". HKSA 705 and HKSA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" for guidance on drafting audit reports and provide instructions to audit staff on applying the relevant standards and documenting how the audit opinion was reached.

E) Interact appropriately with relevant stakeholders

- Lack of evidence on communication with management and those charged with governance

Practices with listed company audits were generally aware of the requirements to communicate with management and those charged with governance on the:

- a) Planned scope and timing of audits;
- b) Information about threats to auditors and the safeguards applied; and
- c) Significant findings from the audits.

Some larger practices have developed templates to assist audit teams' communication with audit committees. However, the templates were not always used properly and therefore audit teams failed to address certain requirements. Other deficiencies included:

- a) Evidence of communication with the audit committees including when and to whom the audit teams had communicated, was unavailable.
- b) Audit documentation did not show whether audit teams had made inquiries of management and audit committees to determine whether they had knowledge of any actual, suspected or alleged fraud affecting the clients.
- c) Audit teams did not provide breakdowns of non-assurance services in their communication with audit committees to assist audit committees in assessing the effect

of provision of non-assurance services on the practices' independence.

Written communication that usually takes the form of a report to the audit committee provides value to clients by informing management and those charged with governance about significant matters arising from the audit so that appropriate actions can be taken to address them. Appropriate communication will also help enhance the general efficiency and effectiveness of an audit.

OUR EXPECTATIONS

To establish a suitable environment for ensuing audit quality, practices should exhibit appropriate values, ethics and attitudes at all times, and set the tone at the top. Regular updates on the requirements of professional standards and provision of sufficient training for audit staff are vital in the ever-changing environment of the modern audit profession.

An appropriate level of professional skepticism must also be maintained during audits. Engagement partners, engagement quality control reviewers and audit staff should maintain questioning minds, obtain sufficient evidence, and not be over-reliant on management's and experts' information without performing appropriate audit procedures thereon.

Practices might recognize that some of the deficiencies set out in this report also exist in their own quality control systems and/or audit methodology. This report has also provided some suggestions on how such deficiencies could be addressed. Practices are strongly encouraged to take pro-active actions to remediate deficiencies relevant to them and uphold quality of their work which is the foundation of the audit profession.

Our findings

Professional standards monitoring programme

We carry out regular reviews of published financial statements in Hong Kong under this programme. Summarized below are the more significant or common findings identified from our reviews in 2014 so that readers can gain a better understanding of how to apply the Standards in preparing or auditing financial statements.

As in previous years, our reviews of financial statements included an assessment of initial application of new and revised financial reporting Standards. A number of new financial reporting Standards issued in 2011 came into effect for the 2013 financial statements reviewed in 2014. This report highlights areas to which we consider it is worth drawing members' attention including new concepts and changes brought about by the new Standards.

The first section of this report covers application and disclosure issues related to new Standards. The second section deals with application issues for other Standards. The third section provides an overview of other common disclosure deficiencies identified from our reviews.

Section I – Initial application of new and revised Standards

1. HKFRS 10 *Consolidated Financial Statements*

HKFRS 10 provides a single consolidation model that identifies control as the basis for consolidation of all types of entities. HKFRS 10

paragraph 7 states that an investor controls an investee if and only if the investor has all of the following three criteria:

- a. Power over the investee;
- b. Exposure, or rights, to variable returns from its involvement with the investee; and
- c. The ability to use its power over the investee to affect the amount of the investor's returns.

To determine whether control exists, entities shall follow the guidance of HKFRS 10 and assess all available facts and circumstances. Factors to consider include purpose and design of the investee, relevant activities and how decisions about relevant activities are made and whether the investor is exposed, or has rights, to variable returns from its involvement with the investee. In most cases, the aforesaid assessment is straightforward because in the absence of an indication of any other factors, the reporting entity holding more than 50% shareholding in the investee should be able to exercise control over the investee. Situations where entities holding less than 50% interests in an investee but with other indications that control might exist would require more thorough assessment under the new requirements of HKFRS 10. No major issues were identified by our reviews although some examples were found that raised doubts as to whether sufficient assessment had been carried out. One area that

seemed to cause more problems is identification and differentiation of substantive rights and protective rights.

Substantive rights versus protective rights

One set of financial statements reviewed disclosed that the reporting entity had 20% interest in an investee and an option (right) to acquire the remaining 80% interest. Insufficient information was disclosed to explain whether the existing option (right) gave the entity a current ability to direct relevant activities (HKFRS 10 paragraph 10) of the investee and whether the option had constituted a substantive right (HKFRS 10 paragraphs B9 and B22). For the purpose of assessing power, only substantive rights which are not protective shall be considered. For a substantive right, the holder must have the practical ability to exercise that right.

In this example, in order to determine whether the option is a substantive right, the company should give due regard to the exercise or conversion price of the option (HKFRS 10 paragraphs B23(c), B47 to B50). The terms and conditions of the potential voting rights are more likely to be substantive when the instrument is “in the money” or the investor would benefit for other reasons (e.g. by realizing synergies between the investor and the investee) from exercise or conversion of the option. On the other hand, the potential voting rights are less likely to be substantive if the potential voting rights are “out of the money”. The investor should also evaluate whether there are any operational barriers to exercising the

option by the investor. To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made (HKFRS 10 paragraph B24). All relevant facts and circumstances should be carefully analysed before drawing a conclusion on whether the right is substantive and that the investor has current practical ability to direct the relevant activities of the investee. This determination may be more complex when the right is subjected to various terms and conditions.

Management of a reporting entity should also identify whether there are any substantive rights held by other parties, not just the rights held by the investor, such as any potential voting rights or other power held by the other parties that prevent the reporting entity from exercising control over the investee. A list of factors (not exhaustive) for determining whether the rights are substantive is set out in HKFRS 10 paragraphs B23 to B25 for further guidance.

As determining whether rights are substantive requires judgement, auditors should design and perform audit procedures to properly assess the appropriateness of the judgement made by management. Even when an investor holds more than 50% interest in an investee, auditors need to maintain a questioning mind and exercise professional skepticism before coming to a conclusion based on all relevant facts and circumstances.

Protective rights are *“Rights designed to protect the interest of the party holding those rights*

without giving that party power over the entity to which those rights relate" (HKFRS 10 Appendix A). An investor with only protective rights cannot have power or prevent another party from getting power over the investee and therefore those rights are irrelevant for determining whether control exists. A careful analysis should be carried out to ascertain whether the rights are merely protective or should be included in the control assessment. A reassessment of control should also be performed when facts and circumstances indicate that there are changes to the elements of control as set out in HKFRS 10 paragraph 7 (HKFRS 10 paragraphs 8 and B80 to B85).

The factors supporting management's significant judgement and assumptions in determining whether the investor has control over the investee shall be disclosed but this is sometimes omitted. The relevant disclosure deficiencies are summarized below under the heading HKFRS 12 *Disclosure of Interests in Other Entities*.

2. HKFRS 11 *Joint Arrangements*

HKFRS 11 supersedes HKAS 31 *Interests in Joint Ventures* by establishing principles that are applicable to the accounting for all joint arrangements. HKFRS 11 and HKAS 31 are both built on the concept of joint control. However, HKFRS 11 classifies joint arrangements by focusing on the "rights and obligations" of the arrangement, rather than its legal form (as is the case under HKAS 31). The accounting for a joint arrangement depends on its classification as a joint operation or a joint venture.

HKFRS 12 requires an entity to disclose information about significant judgements and assumptions in determining whether it has joint control of an arrangement. Disclosures of investments in joint ventures in some financial statements are insufficient to show how management of the reporting entities arrived at the conclusions that the investments were joint ventures under HKFRS 11. For example, one reporting entity only disclosed the shareholding held by respective shareholders without providing further information on the voting rights and decision making mechanism. In another example, the disclosure mentioned that the reporting entity classified the investment as a joint venture because it had a right to enjoy certain economic benefits derived from the equity interest in the investee held by a "third party" although the reporting entity did not have any direct equity interest in the investee. Enquiries were raised to ask the auditors to explain why they had accepted management's justification for the accounting treatments.

A joint arrangement is an arrangement of which two or more parties have joint control (HKFRS 11 paragraph 4). HKFRS 11 paragraph 7 defines joint control as "the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control" (underline added). HKFRS 11 paragraph 16 further states that "A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers" (underline

added). Accordingly, in the above examples, the relevant auditors were also asked to explain the audit procedures they had carried out and what audit evidence they had obtained to satisfy themselves that the reporting entity was a party to a “joint arrangement” and had “joint control” collectively with other joint venturers in the arrangement; and that under the contractual arrangement the reporting entity has the rights to share the “net assets” of the investee so as to support the conclusion that the arrangement was a joint venture rather than a joint operation.

A joint arrangement that is not structured through a separate vehicle (e.g. a limited liability company) is a joint operation (HKFRS 11 paragraph B16) but a joint arrangement that is structured through a separate vehicle can be either a joint operation or joint venture (HKFRS 11 paragraph B19) depending on the rights and obligations of the parties arising from the arrangement. Therefore, an assessment of the parties’ rights and obligations arising from the arrangement, e.g. whether they have rights to the “assets” and obligations for the “liabilities” (i.e. a joint operation) or rights to the “net assets” (i.e. a joint venture) is needed. For further guidance, reference may be made to the flow chart set out in HKFRS 11 paragraph B21 for determination of whether a joint arrangement is a joint operation or a joint venture and the flow chart set out in HKFRS 11 paragraph B33 for classifying a joint arrangement structured through a separate vehicle. When facts and circumstances change, the investor should reassess whether it still has joint control of the arrangement (HKFRS 11 paragraph 13).

Similar to determining whether or not the investee is a subsidiary, judgement is also required when evaluating whether an arrangement is a joint arrangement and whether the joint arrangement is a joint venture or a joint operation. Consideration should be given to the terms and structure of the contractual arrangement and all other relevant facts and circumstances.

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

HKFRS 12 is a new and combined disclosure Standard for all forms of interests in other entities, including subsidiaries, joint arrangements, associates and consolidated and unconsolidated structured entities. The objective of HKFRS 12 is to require disclosures to enable users of financial statements to evaluate the nature of, and risks associated with, interests in other entities and the effects of those interests on the financial position, financial performance and cash flows of the reporting entity. HKFRS 12 sets out the minimum disclosure requirements but additional disclosures should be provided if minimum disclosures are not sufficient in the entity’s circumstances to meet the disclosure objective of the Standard.

HKFRS 12 does not apply to separate financial statements of an entity unless the entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements (HKFRS 12 paragraph 6(b)). Common disclosure deficiencies were:

a. Disclosures for subsidiaries

- No or insufficient disclosure of summarized financial information (e.g. cash flows) of subsidiaries that have material non-controlling interests as required by HKFRS 12 paragraphs 12 and B10.

HKFRS 12 does not provide specific guidance on determination of the materiality of non-controlling interest. Therefore application of judgement by management is required. Judgement should be made on a consistent basis and disclosure of the basis for determining “material non-controlling interests” to assist users of financial statements in understanding the disclosure is encouraged. The summarized financial information should represent amounts before inter-company eliminations (HKFRS 12 paragraph B11) and exclude any subsidiaries classified as held for sale under HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (HKFRS 12 paragraph B17).

b. Disclosures for associates and joint arrangements

- No or insufficient disclosure of summarized financial information of individually material associates and joint ventures as required by HKFRS 12 paragraphs B12 to B14. In one example, only the share of operating results was disclosed instead of summarized financial information of joint ventures as required by HKFRS 12.

- No or insufficient information as to why a reporting entity that held more than 50% interest in an investment but the management classified the investment as an associate. The reporting entity disclosed the fact that it had significant influence but did not have unilateral control over the investment. However management’s significant judgements and assumptions applied in determining the classification of the investment as an associate rather than as a subsidiary as required by HKFRS 12 paragraphs 7 to 9 were not disclosed. Similar disclosure deficiencies were also found in circumstances where a reporting entity held more than 20% equity interest in an investment but the investment was classified as an available-for-sale investment.
- No or insufficient disclosure of the nature of a reporting entity’s relationship with material joint arrangements or associates, e.g. a description of the nature of the activities of the joint arrangement or associate and whether they were strategic to the reporting entity’s activities as required by HKFRS 12 paragraph 21(a)(ii).

As a reminder, *Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011) – Investment Entities* issued in December 2012 have been effective from 1 January 2014. Under the Amendments, a parent entity that meets the definition of an investment entity is required to account for subsidiaries at fair value through profit or loss in accordance with HKAS 39 *Financial*

Instruments: Recognition and Measurement. The Amendments also introduce new disclosure requirements for investment entities in HKFRS 12.

4. HKFRS 13 *Fair Value Measurement*

HKFRS 13 defines fair value, sets out a framework for measuring fair value and requires disclosures relating to fair value measurement. Except as specified in HKFRS 13 paragraphs 6 and 7, HKFRS 13 applies to both financial instrument and non-financial items for which other HKFRS require or permit fair value measurement and disclosures.

a. Fair value measurement of investment properties

HKFRS 13 defines fair value as *“the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”* (i.e. exit price). HKFRS 13 does not change the circumstances in which fair value measurement or disclosure is required. However, due to the new fair value definition and other guidance on measuring fair value, HKFRS 13 may have an impact on the amount recognized or disclosed in the financial statements depending on the nature and characteristics of the item. A typical example is that the fair value measurement of investment properties using the fair value model is now required by HKFRS 13 to be based on their *“highest and best use”* whereas there was no explicit requirement previously in HKAS

40 Investment Property. From the review of a set of financial statements, we identified the following findings regarding the application of the concepts and requirements of HKFRS 13.

A reporting entity acquired most of the properties in a building at a purchase consideration determined by reference to a market valuation and accounted for them as investment properties. The market valuation used for the purpose of the acquisition accounting took into account the future redevelopment of the investment properties, as the company planned to demolish the whole building after it had acquired all properties to redevelop it into a high rise commercial building. At the year end, a significant *“fair value loss”* was recognized based on another valuation performed by the same valuer. The disclosures in the financial statements revealed that the valuer had applied an existing use basis for determining the fair value of the reporting entity’s investment properties at the year end. Both the acquisition value and the year end value were claimed to be reflecting the then market value even though they were determined using different measurement bases. Owing to the inconsistent bases of valuation, we raised questions on the application of HKFRS 13 in the year end financial statements.

Fair value is a market-based measurement but not an entity-specific measurement (HKFRS 13 paragraph 2). Because fair

value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value (HKFRS 13 paragraph 3). Furthermore, HKFRS 13 paragraph 16 requires that a fair value measurement assumes that the transaction to sell the asset takes place in the principal market or in the absence of a principal market, in the most advantageous market for that asset. HKFRS 13 paragraph 19 then states that the principal (or most advantageous) market (and thus, market participants) shall be considered from the perspective of the entity, thereby allowing for differences between and among entities with different activities. Judgement may therefore be required to identify the principal or the most advantageous market in which the transactions would take place in order to arrive at an appropriate measure of fair value. In this example, the property redeveloper market might be one that should have been considered as there is information suggesting that the reporting entity is a property developer. The auditor should obtain adequate audit evidence to satisfy itself that management of the entity had made appropriate assessment of the principal or most advantageous market for the properties and that the fair value at the year end date was determined from the perspective of that market's participants. In addition, the fair value should be based on

the "highest and best use", which refers to use of the non-financial asset by market participants that would "maximize" the value of the asset.

The "highest and best use" is an important concept in HKFRS 13. HKFRS 13 paragraph 27 states that "*A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use" (underline added). Therefore proper determination of the "highest and best use" is crucial for determining an appropriate fair value for non-financial assets, like the investment properties of this example.*

HKFRS 13 states that the "highest and best use":

- is the use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used (HKFRS 13 Appendix A); and
- takes into account the use of the asset that is physically possible, legally permissible and financially feasible (HKFRS 13 paragraph 28);

HKFRS 13 paragraphs 29 and 30 require that the "highest and best use" is determined from the perspective of market participants,

even if the entity intends a different use or determines not to use the non-financial asset in a way consistent with its highest and best use. An entity's current use of a non-financial asset is "presumed" to be its highest and best use unless market or other factors suggest that a different use by market participants would maximize the value of the asset. The management of the reporting entity in the above example should consider whether a different use (e.g. demolishing and redeveloping the properties as a new building in that district) would maximize the value of the investment properties before concluding that it was appropriate to measure fair value of those properties based on their existing use at the year end. The auditor is also expected to obtain adequate audit evidence and apply professional skepticism in judging management's explanation. The auditor should also ensure the valuation performed by the valuer takes into account the requirements of HKFRS 13 before placing reliance on it.

b. Fair value measurement issues of other assets

Questions on fair value measurement for other kinds of assets such as investments and biological assets were also raised by our reviews. In one example, we noted that inconsistent fair value measurement bases were used to measure the fair value of an unlisted investment which was carried at fair value through profit or loss. One disclosure note indicated that the fair value of the investment was determined

using the "market approach" based on "market comparables" whereas another disclosure note stated that the fair value was determined based on the "net book value" of the unlisted investment. Therefore enquiries were raised to ask the auditor to explain how they were satisfied that an appropriate fair value measurement basis had been applied by their client's management according to HKFRS 13.

In respect of valuation techniques, HKFRS 13 paragraph 61 states that "*An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs*". HKFRS 13 recognizes that the market approach, cost approach and income approach are three widely used valuation techniques. Of which, HKFRS 13 paragraph B5 states that "*The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business*" (underline added). Therefore in the above example, the auditor should have ensured that management had obtained adequate and relevant "market comparables" to support the fair value measurement if a market approach was really used. The auditor should also be alert to contradictory evidence or that which calls into question the reliability of information obtained from management.

c. Judgements and estimates in valuation

A lot of judgements are required when measuring fair value. Critical judgements include identifying the characteristics of the assets, determining the principal market (or the most advantageous market) and the highest and best use; and determining an appropriate valuation technique and inputs for the valuation. Judgements may also be required when determining the level within which the fair value measurement is categorized.

Valuation experts may be engaged to perform a valuation. Auditors shall obtain objective audit evidence in evaluating the appropriateness of the valuation before placing reliance on the valuation. For example, for Level 2 measurement, objective evidence should be obtained to support that all significant inputs are observable. Significant adjustments which use unobservable inputs made to a Level 2 input should result in a fair value measurement being categorized within Level 3 (HKFRS 13 paragraph 75).

d. Impact on HKAS 36 Impairment of Assets

HKFRS 13 also impacted other Standards such as HKAS 36. In determining “fair value less costs of disposal” of the cash-generating unit (“CGU”) or the asset, an entity is required to follow HKFRS 13 for the relevant fair value measurement requirements, even if the entity has no intention of selling the particular asset or CGU.

The management of a reporting entity recognized an impairment loss by writing down the carrying amount of a CGU to its recoverable amount based on “fair value less costs of disposal”. It was disclosed that “fair value less costs of disposal” was determined using cash flow projections based on financial budgets approved by the directors covering a five-year period. From this disclosure, it was unclear whether the recoverable amount was in fact based on value in use as it was unclear how the management took into account the assumptions that market participants would use in measuring the fair value of the CGU.

For impairment assessment disclosures, an entity needs only to follow the disclosure requirements of HKAS 36. The disclosure requirements of fair value measurement under HKFRS 13 do not apply (HKAS 36 paragraph 134(e)), even if the recoverable amount is determined based on fair value less costs of disposal. The amendments made to HKAS 36 paragraphs 130 and 134 in June 2013 have been effective from 1 January 2014.

e. Fair value disclosures

HKFRS 13 sets out a fair value hierarchy that prioritizes the inputs to the valuation techniques used to measure fair value into three levels: unadjusted quoted price (Level 1), observable inputs (Level 2) and unobservable inputs (Level 3). HKFRS 13 requires disclosure of fair value hierarchy information not only for financial

instruments but also for all other assets and liabilities as long as their measurement or disclosure is within the scope of HKFRS 13 (see HKFRS 13 paragraphs 5 to 8 for the scope of HKFRS 13).

HKFRS 13 requires both quantitative and qualitative disclosures. The extent of disclosures depends on whether the fair value measurement is on a recurring or non-recurring basis and the level of fair value hierarchy within which the fair value measurement is categorized. More extensive disclosures are required for recurring and lower level (in particular Level 3) fair value measurements. The following disclosures are commonly overlooked:

- the level of fair value hierarchy within which the fair value measurement is categorized (HKFRS 13 paragraph 93(b));
- for recurring and non-recurring fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) and the inputs used in the fair value measurement (HKFRS 13 paragraph 93 (d));
- for recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement (HKFRS 13 paragraph 93(h)(i)).

In one example the management of a reporting entity had categorized the fair value measurement of a private bond as Level 1. However as the private bond was not listed, it is unlikely that “quoted price in active market for an identical asset” is available, raising doubts about the appropriateness of classifying the fair value measurement as Level 1. Careful assessment is important for determining whether the fair value measurement is recurring or non-recurring and the level of fair value hierarchy into which the measurement is categorized as it will affect the disclosures to be made in the financial statements.

Section II – Common or significant findings of other Financial Reporting Standards

1. Share-based payment transactions with employees or consultants

It is not uncommon that entities grant share options to employees and consultants as reward for services provided by them. This kind of transaction constitutes a share-based payment transaction, which is required to be recognized in the financial statements under HKFRS 2 *Share-based Payment*. The 2009 QAD annual report covered recognition and measurement issues on this type of arrangement. However similar findings have arisen in subsequent years so a reminder of the requirements of HKFRS 2 seems timely.

HKFRS 2 paragraph 2 identifies three types of share-based transactions and provides specific requirements for each of them: “*equity-settled*

share-based payment transactions”, “cash-settled share-based payment transactions”; and “transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the suppliers of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments”. The accounting treatments are different for different types of share-based payment transactions.

Disclosures in some financial statements mentioned that the reporting entities engaged consultants to undertake certain work or projects and their remuneration included share options. The fair value of services received from the consultants were measured indirectly, by reference to the fair value of the options granted as the fair value of the services could not be estimated reliably by the reporting entity. These transactions were treated as equity-settled share-based payment transactions under HKFRS 2. Without sufficient disclosures, it was unclear whether the treatment complied with the requirements of HKFRS 2.

HKFRS 2 requires that a share-based payment transaction is recognized when the entity obtains the goods or services. Equity-settled share-based payment transactions and the corresponding increase in equity are measured at the fair value of the goods or services received, unless the fair value cannot be estimated reliably (HKFRS 2 paragraph 10). For transactions with “employees and others providing similar services”, HKFRS 2 paragraph 11 recognizes that it is difficult to estimate the fair value of services received by

the entity reliably and therefore requires the entity to measure the fair value of the services received by reference to the fair value of the equity instruments granted at the grant date, which is often referred as “grant date fair value”. However, for transactions with “parties other than employees”, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably and that fair value shall be measured at the date the entity obtains goods or services. The reporting entity can only rebut the presumption and measure the fair value of services by reference to the fair value of the equity instruments granted in rare cases that the fair value of goods or services cannot be estimated reliably (HKFRS 2 paragraph 13).

To comply with the above requirements, a two-step approach is recommended. First, an assessment should be made on whether the consultants are individuals providing services similar to employees e.g. by reviewing the terms of contracts with the consultants to understand the nature of the services provided; and where appropriate, comparing them with the contracts of employees providing similar services. The second step is that if the services provided by the consultants are determined to be similar to those provided by employees, then the entity follows the measurement principle as for employees providing similar services (i.e. determining the fair value of services by reference to the fair value of the equity instruments granted). Otherwise, the entity shall measure the fair value of the services received directly and only in rare cases by reference to the fair value of the equity instruments granted.

The determination of whether the parties are “similar to employees” requires judgement. A thorough assessment of the terms of contracts with consultants is needed, as the results of the assessment may affect the amount of share-based payment expense (or assets as appropriate) to be recognized in the financial statements. The definition of “employees and others providing similar services” is set out in HKFRS 2 Appendix A. Factors to consider include whether the individuals work for the entity under its direction and whether the services rendered are similar to those rendered by employees.

In one example, the share-based payment expense recognized (by reference to the fair value of the share options granted) was very significant as compared to the entity’s turnover and size of operations. The nature and period of services provided by the consultants and when the consultants started rendering the services were unclear. We consider that the accounting policy for dealing with this type of transactions and the information of the major contract terms should have been clearly disclosed to enable readers to understand the justification of the accounting treatment.

It is worth highlighting that HKFRS 2 uses the term “fair value” in a way that differs in some respects from the definition of fair value in HKFRS 13. Therefore, when applying HKFRS 2 an entity measures fair value in accordance with HKFRS 2, not HKFRS 13 (HKFRS 2 paragraph 6A). The measurement principles and disclosure requirements in HKFRS 13 do not apply to share-based payment transactions within the scope of HKFRS 2 (HKFRS 13 paragraph 6).

2. Measurement period adjustments and contingent consideration in a business combination

a. Measurement period adjustments

Measurement period is the period after the acquisition date during which the acquirer may adjust the provisional values recognized for a business combination (HKFRS 3 (2008) *Business Combinations* paragraph 46).

Review findings suggested that some reporting entities have the misconception that for any changes after the business acquisition date they can freely make retrospective measurement period adjustments (increase or decrease) to the amounts recognized for the business acquired in the consolidated financial statements, as long as such adjustments are made within one year of the acquisition date. A typical example is that a reporting entity’s subsidiary received a government subsidy in the current year after the entity acquired the subsidiary in the preceding year. Due to the receipt of the subsidy, the reporting entity made a prior year adjustment to recognize a government subsidy receivable at the acquisition date and as a result, the bargain purchase gain arising from the business combination increased significantly. There was no disclosure in the preceding year’s financial statements that the initial accounting for the acquisition was incomplete or any amounts recognized were provisional. Enquiries were raised on the following matters:

- (i) As there was no disclosure in the prior year's financial statements that the numbers used in the acquisition accounting were provisional, readers would expect that the accounting for the acquisition had been completed by the end of the preceding year. The subsequent restatement raised doubts as to whether an adequate assessment had been carried out in identifying and measuring identifiable assets and liabilities at the acquisition date.
- (ii) It was unclear how the subsequent receipt of the subsidy of itself was sufficient to support a retrospective adjustment to recognize an additional receivable at the acquisition date under HKFRS 3 (2008).
- (iii) In view of the significance of the bargain purchase gain, it was also unclear whether the entity even after the restatement had adequately identified and properly measured all identifiable assets and liabilities at fair value at the acquisition date.

All of the above relate to the application of some fundamental recognition principles of HKFRS 3 (2008).

HKFRS 3 (2008) paragraph 45 states that *"During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information*

*obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date. During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that **existed as of the acquisition date** and, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period shall not exceed one year from the acquisition date"* (bold and underline added).

Therefore, management of a reporting entity shall assess whether additional assets or liabilities should be recognized if the new information obtained provides evidence of facts and circumstances that existed as of the acquisition date. In the above example, the management should assess whether the new information obtained (e.g. subsequent receipt of the government subsidy) is sufficient to prove that the entity had a receivable for the government subsidy (asset) at the acquisition date.

HKFRS 3 (2008) paragraph 11 states that *"To qualify for recognition as part of applying*

the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the Framework for the Preparation and Presentation of Financial Statements at the acquisition date (underline added). BC113 also states that *“In determining whether an item should be recognised at the acquisition date as part of the business combination, the boards decided that the appropriate first step is to apply the definitions of assets and liabilities in the IASB’s Framework or FASB Concepts Statement No. 6 Elements of Financial Statements, respectively”* (underline added).

Conceptual Framework for Financial Reporting paragraph 4.4(a) states that *“An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”*. Therefore in order to fulfil the definition of an asset, the entity must be able to control the asset before recognizing it in the accounting for the business combination.

Furthermore, the acquirer shall go through the two steps required by HKFRS 3 (2008) paragraph 36 before recognizing a gain on a bargain purchase i.e. firstly, a reassessment to check whether all identifiable assets and liabilities are recognized; and then, a review of the procedures used to measure the amounts recognized in the business combination. These steps are particularly important when the bargain purchase gain is significant.

b. Contingent consideration

As stated in HKFRS 3 (2008) Appendix A, contingent consideration usually refers to an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration may also give the acquirer the right to the return of previously transferred consideration if specified conditions are met. The consideration transferred in a business combination (including any contingent consideration) is measured at fair value (HKFRS 3 (2008) paragraph 37). Accounting guidance on contingent consideration is set out in HKFRS 3 (2008) paragraphs 39, 40 and 58.

There were examples where the consideration for business combinations included significant contingent considerations which would be satisfied by cash, promissory notes and / or shares of the reporting entities. However the acquirers did not disclose the basis for determining the fair value of contingent consideration and an estimate of the range of outcomes as required by HKFRS 3 (2008) paragraph B64(g).

There were also cases where the classification of contingent consideration might not have been properly determined and that resulted in inappropriate subsequent accounting.

For example, where the contingent consideration is in the form of a promissory note and the reporting entity accounted for it at “amortised cost”. This treatment does not comply with HKFRS 3 (2008) paragraph 58 which states that *“Contingent consideration classified as an asset or a liability that (i) is a financial instrument and is within the scope of HKAS 39 shall be measured at **fair value**, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with that HKFRS”* (bold and underline added). Therefore the promissory note should have been accounted for at fair value with subsequent fair value changes recognized in profit or loss (as they do not qualify as measurement period adjustments).

Following the issue of HKFRS 13, the definition of fair value in HKFRS 3 (2008) Appendix A has been amended. Therefore the fair value of contingent consideration will be measured in accordance with HKFRS 13.

3. Earnings per share

Issues on earnings per share have been reported in previous years. The following are some issues identified in 2014 reviews.

a. Mandatorily convertible instruments

A reporting entity disclosed that the basic loss per share for the year was calculated based on the loss for the year attributable to the owners of the reporting entity and the

weighted average number of ordinary shares in issue during the year. The reporting entity issued zero-coupon mandatorily convertible bonds in prior years and the bonds remained outstanding at the end of the reporting period. The reporting entity did not include the convertible bonds which would be mandatorily converted at the maturity date in the calculation of earnings per share.

HKAS 33 *Earnings per share* paragraph 23 states that *“Ordinary shares that will be issued upon the conversion of a mandatorily convertible instrument are included in the calculation of basic earnings per share from the date the contract is entered into”* (underline added).

Accordingly to comply with HKAS 33 paragraph 23, the management of the reporting entity should include the number of ordinary shares that are issuable upon conversion from the date the contract was entered into when determining the denominator for the “basic” earnings per share calculation. This is because the ordinary shares will certainly be issued in the future when the bonds are mandatorily converted.

Mandatorily convertible bonds should be differentiated from a case where the bonds are convertible at the option of the holder. In that case, the potential ordinary shares (if dilutive) are only included in the calculation of “diluted” earnings per share as it is uncertain that these shares will be issued until the conversion option is actually exercised.

b. Potential ordinary shares issued by subsidiaries

The consolidated financial statements of a reporting entity with a listed subsidiary showed that basic and diluted earnings per share were the same. However, the basic and diluted earnings per share of the listed subsidiary were different because of the dilutive effects of share options issued by the listed subsidiary. This information raised a question whether the share options issued by the listed subsidiary had been properly taken into account in the calculation of earnings per share of the reporting entity.

HKAS 33 paragraph A11 states that *“Potential ordinary shares of a subsidiary, joint venture or associate convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent, or investors with joint control of, or significant influence (the reporting entity) over, the investee are included in the calculation of diluted earnings per share as follows: (a) instruments issued by a subsidiary, joint venture or associate that enable their holders to obtain ordinary shares of the subsidiary, joint venture or associate are included in calculating the diluted earnings per share data of the subsidiary, joint venture or associate. Those earnings per share are then included in the reporting entity’s earnings per share calculations based on the reporting entity’s holding of the instruments of the subsidiary, joint venture or associate”* (underline added).

In the above example, the management of the reporting entity in its diluted earnings per share calculation should include the reporting entity’s proportionate interest in the subsidiary’s earnings attributable to the share options held by the reporting entity.

Example 10 of HKAS 33 gives more information on application of this Standard.

For situations in which (1) instruments issued by a subsidiary, joint venture or associate are convertible into the reporting entity’s ordinary shares; and (2) instruments issued by a reporting entity are convertible into ordinary shares of a subsidiary, joint venture or associate, HKAS 33 paragraphs A11(b) and A12 respectively give details of the earnings per share calculation requirements.

c. Inappropriate determination of denominator

Management of some reporting entities do not exercise sufficient due care in calculating earnings per share. An example arising from our review is that the denominator used in the calculation of earnings per share was significantly more than the weighted average number of shares in issue during the period. Therefore the denominator was clearly wrong.

Earnings per share is important information which enables readers to make financial performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Therefore as long as the

reporting entity falls within the scope of HKAS 33 (HKAS 33 paragraphs 2 to 4A), earnings per share have to be correctly calculated and disclosed in accordance with the requirements of HKAS 33 or otherwise the view given by the financial statements might be materially affected.

4. Consideration of estimated useful lives of intangible assets

Estimation of the useful life of an intangible asset involves judgment. However in some findings raised questions about the appropriateness of the judgement made.

In the prior year, a reporting entity acquired a subsidiary which had an intangible asset. The management of the reporting entity determined that the intangible asset had a finite useful life and therefore would be amortized on a straight-line basis over its estimated useful life. In the current year, the reporting entity carried out a reassessment of the useful life of the intangible asset held by the subsidiary and concluded that the useful life should be indefinite. The entity accounted for the change as a change in accounting estimates during the current year. We questioned how the change of the useful life from "finite" in the prior year to "indefinite" in the current year was justifiable and why the change was not accounted for as a "correction of prior errors".

Below is an extract from the relevant paragraphs of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* that give guidance on determining the accounting treatment for the change in useful life of an intangible asset:

HKAS 8 paragraph 5 states that "Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (a) was available when financial statements for those periods were authorised for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud" (underline added).

HKAS 8 paragraph 34 "An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error" (underline added).

In response to our enquiry, the auditor advised that new information had been obtained by management in the current year that supported the change in estimate of the intangible asset's useful life. This should have been disclosed to ensure sufficient information was provided to explain the change in accounting estimates when the financial impact is significant (HKAS 8 paragraphs 39 and 40).

In another example, the reporting entity determined that the copyright of a movie that it owned had an indefinite useful life. In view of the nature of copyright of a movie, it was unclear how an indefinite useful life could be justified. However, there was no disclosure of the reasons supporting the assessment of an indefinite useful

life as required by HKAS 38 paragraph 122(a), including describing the factor(s) that played a significant role in determining that the asset has an indefinite useful life. An assessment of whether events and circumstances continue to support an indefinite useful life should also have been made as required by HKAS 38 paragraph 109.

Section III – Common disclosure deficiencies

A number of disclosure deficiencies identified in previous years continued to be found in 2014. Although the deficiencies discussed in this section might not be new, they are repeatedly identified and it is worthwhile highlighting them again.

1. HKFRS 7 *Financial Instruments: Disclosures*

The following disclosures were often missing from financial statements:

- a sensitivity analysis for each foreign currency to which the reporting entity has significant exposure;
- a sensitivity analysis of each type of market risk to which the reporting entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in relevant risk variables that were reasonably possible at that date;
- a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities;
- a description of how the reporting entity manages the liquidity risk inherent in the remaining contractual maturities for those

derivative or non-derivative financial liabilities due within one year or on demand;

- information about concentration of credit risk the reporting entity is exposed to, for example in cases where sales to the five largest customers represented a significant percentage of the total sales;
- an analysis of the age of financial assets that are past due at the year end but not impaired;
- the carrying amount of financial assets that the reporting entity has pledged as collateral for liabilities or contingent liabilities, and the terms and conditions relating to its pledge; and
- for an investment in equity instruments that do not have a quoted market price in an active market for an identical instrument (i.e. a Level 1 input) that is measured at cost because its fair value cannot otherwise be measured reliably, information about the market for the instruments and information about whether and how the entity intends to dispose of the financial instruments.

HKFRS 7 paragraph BC45 states that *“The Board’s view is that financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial instruments”*. To enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period, the disclosures of sensitivity analysis of various risk(s) arising from financial instruments is necessary.

2. HKFRS 8 *Operating Segments*

The following disclosures were often missing from financial statements:

- revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed;
- total amount of revenues from each customer and the identity of the segment or segments reporting the revenues from transactions with a single external customer that amount to 10 per cent or more of the reporting entity's revenues;
- items required by HKFRS 8 paragraph 23 in respect of each reportable segment (e.g. depreciation and amortisation, income tax expense or income and material non-cash items, etc.) if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker ("CODM"); or are otherwise regularly provided to the CODM; even if not included in the measure of the segment profit or loss;
- non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately; and

- all material reconciling items that are to be separately identified and described.

Regarding identification of operating segment(s), HKFRS 8 paragraph 6 states that *"Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments"*. In some examples reporting entities identified "corporate activities" as an operating segment or included significant "corporate assets" and "corporate liabilities" in operating segments where the related corporate headquarters or functional departments do not earn revenues directly or incidentally.

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

The following disclosures were often missing or incomplete:

- for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from profit or loss, other comprehensive income and transactions with owners in their capacity as owners;
- the name of the parent and the ultimate parent of the group and any change in that information from the end of the preceding reporting period;

- summary quantitative data about what the reporting entity manages as capital;
- disclosure in either the statement of financial position or in the notes, further sub-classifications of the line items presented, classified in a manner appropriate to the reporting entity's operations;
- information about the assumptions the reporting entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year;
- comparative information in respect of the preceding period for all amounts reported in the current period's financial statements;
- for each class of share capital disclosure of the number of shares authorised, the number of shares issued and fully paid, issued but not fully paid, par value per share, or that the shares have no par value; and
- additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense for a reporting entity that classifies its expenses by function.

4. HKAS 24 (Revised) *Related Party Disclosures*

The following disclosures were often missing or incomplete:

- if the exemption of paragraph 25 (Government-related entities) was applied, disclosure of (a) the name of the government; (b) the nature and amount of each individually significant transaction; and (c) for other transactions that are collectively, but not individually, significant a qualitative or quantitative indication of their extent;
- key management personnel compensation in total and for each of the categories of (a) short-term employee benefits; (b) post-employment benefits; (c) other long-term benefits; (d) termination benefits; and (e) share-based payment; and
- the nature of the related party relationship as well as information about transactions and outstanding balances, including commitments necessary for an understanding of the potential effect of the relationship on the financial statements.

For one reporting entity key management personnel compensation paid by a significant listed subsidiary was not included in the relevant disclosure in the consolidated financial statements of the reporting entity. HKAS 24 (Revised) paragraph 9 defines key management

personnel as *“those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity”*. Consideration should have been given to assess whether key management personnel of the significant listed entity are regarded as key management personnel of the reporting entity under HKAS 24 (Revised) paragraph 9 and if so, they should have been included in the key management personnel compensation disclosure of the reporting entity.

5. HKAS 36 *Impairment of Assets*

The following disclosures were omitted or incomplete:

- discount rate(s) used in the current and previous estimates, if the recoverable amount is based on value in use;
- events and circumstances that led to recognition or reversal of impairment losses;
- description of management’s approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information; and
- the amount of the impairment loss recognized or reversed by class of assets and, if the entity reports segment information in accordance with HKFRS 8, by reportable segment.

Communication with members

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

- The QAD hosted two forums, in July and September 2014, that attracted a combined audience of approximately 530. The forums covered common findings from practice reviews and addressed group audits, inventories and revenue as special topics. A webcast of the forum is available at the Institute's website for subscription until 15 February 2016.
- The Director of the QAD ("the DQA") was invited by the Society of Chinese Accountants and Auditors to present in a seminar on the same topics covered in the Quality Assurance

Forum in October 2014. The seminar attracted approximately 270 attendees.

- In November 2014, the QAD organized a joint forum with the FRC and HKEx which drew approximately 300 attendees. Common issues identified by the reviews of financial statements of Hong Kong listed companies carried out by the three bodies were presented. A webcast of the forum is available at the Institute's website for view until 15 February 2016.
- The DQA participated in the practice review session of the 2014 SMP Symposium in November 2014 which attracted approximately 300 attendees.

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

Members of the Standards & Quality Accountability Board in 2014

Name	Position	Company
Ms. BROWN, Melissa (Appointed 21 January 2014)	Chairman	Daobridge Capital
Ms. CHEUNG, Sau Lan, Susanna (Appointed 21 January 2014, resigned 22 May 2014)	Member	The Treasury, HKSAR
Ms. CHUNG, Lai Ling, Ada	Member	Companies Registry, HKSAR
Mr. GRIEVE, Charles Ramsay	Member	Securities & Futures Commission
Mr. KENNEDY, Paul	Member	Hong Kong Exchanges and Clearing Limited
Mrs. SENG SZE, Ka Mee, Natalia (Appointed 21 January 2014)	Member	Tricor Services Ltd
Mr. TONG, Eric	Member	Deloitte Touche Tohmatsu
Ms. WANG, Esther (Appointed 9 June 2014)	Member	The Treasury, HKSAR
Mr. WONG, Tat-cheong, Frederick	Member	Audit Commission, HKSAR

Members of the Practice Review Committee in 2014

Name	Position	Company
Mr. GEORGE, Richard John Weir	Chairman	Deloitte Touche Tohmatsu
Miss CHAN, Mei Bo, Mabel	Deputy Chairman	Mabel Chan & Co.
Mr. CHAN, Shu Kin, Albert	Member	Ting Ho Kwan & Chan
Miss CHAN, Wai Ching	Member	PricewaterhouseCoopers
Mr. FAN, Chun Wah, Andrew	Member	C.W. Fan & Co.
Mr. HEBDITCH, Paul Donald (Appointed 21 January 2014)	Member	Ernst & Young
Mr. HON, Koon Fai, Alex	Member	HLB Hodgson Impey Cheng Ltd.
Mr. KWONG, Kam Wing, Kelvin (Appointed 21 January 2014)	Member	Grant Thornton
Mr. LIU, Eugene	Member	RSM Nelson Wheeler
Mr. NG, Kar Ling, Johnny	Member	KPMG
Mr. OR, Ming Chiu	Member	Mazars CPA Limited
Mr. POON, Tsun Wah, Gary	Member	Poon & Co.
Miss TANG, Kwan Lai, Amingo	Member	SHINEWING (HK) CPA Limited
Mr. TSUI, Hon Man	Member	Crowe Horwath (HK) CPA Limited
Ms. YAM, Hoi Yin, Cecilia	Member	BDO Limited
Mr. YAU, Yin Kwun, Joseph	Member	C K Yau & Partners CPA Limited

Members of the Professional Standards Monitoring Expert Panel in 2014

Name	Position	Company
Mr. CHENG, Chung Ching, Raymond	Member	HLB Hodgson Impey Cheng
Ms. CHEUNG, Sau Ying, Olivia	Member	Hong Kong Exchanges and Clearing Limited
Mr. CHOW, Siu Lui, Jack	Member	VMS Investment Group
Mr. DEALY, Nigel Derrick	Member	PricewaterhouseCoopers
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Mr. HO, Che Kong, John	Member	Leighton Asia Limited
Miss HSIANG, Yuet Ming, Fanny (Appointed 21 January 2014)	Member	BDO Limited
Mrs. MORLEY, Catherine Susanna	Member	KPMG
Mr. PANG, Wai Hang, Arthur	Member	SHINEWING (HK) CPA Limited
Mr. TAYLOR, Stephen	Member	Deloitte Touche Tohmatsu
Mr. YAN, Yiu Kwong, Eddy	Member	Crowe Horwath (HK) CPA Limited

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

