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

Quality Assurance

Report 2016

Content

Foreword

Fellow members

Time flies! We have reached the tenth anniversary of our revised practice review programme. This year, in addition to presenting you our report on the work carried out under the practice review and professional standards monitoring programmes in 2016, we also set out in this report a summary of the major events that occurred in the past decade in relation to practice review activities.

In 2016, we again achieved our targets for both on-site visits and desktop reviews. Over the past 10 years, we have increased the number of reviews from five in 2007 to 262 in 2016, covering more than 1,500 practices. Up to 2016, we have covered almost all practices with listed and/or other public interest clients, which are given priority for review in our programme. With the implementation of a number of new initiatives to encourage practices to take proactive steps to enhance audit quality in the past few years, we started to see an increase in direct closed cases to above 50% from 2015. Practice reviews resulting in complaints are also on a rise although they remain at less than 5% of all reviews carried out. In general, we consider practices are now better prepared for a practice review and are better at addressing deficiencies as soon as they are identified in a practice review.

To address concerns over the quality of audits of listed companies by smaller practices, we introduced in 2016 additional elements to our selection process to ensure those smaller practices are reviewed in the first year after they signed off their audit reports on their first listed audit clients and those that are the subjects of recent referrals to the FRC and complaints and that with significant or regular changes in the number of their listed audit clients receive an additional interim review within their normal three-year cycle. Practices are therefore advised to make robust assessment of their competency and resources before committing to a new listed engagement.

In 2016, we again referred five cross border engagements to the Mainland MOF for review. We very much appreciate the support given by the MOF and hope to be able to enhance our cooperation arrangements so that both parties can effectively regulate work undertaken by practices under their respective jurisdictions.

2016 was not a particularly exciting year for professional standards monitoring as the shortcomings identified in 2016 were more or less the same as in previous years. However, preparers and auditors should get themselves prepared for more exciting times when the new standards on revenue, leases and financial instruments take effect in or after 2018.

Following the public consultation exercise in 2014 and release of consultation conclusions in 2015, the Hong Kong government is preparing draft legislation in relation to the audit regulatory reform, including the proposed transfer of the practice review of listed engagements from the Institute to the FRC. We shall monitor the progress and participate in the law drafting process when needed. However, this will not disturb our current role in maintaining the quality of the work of the audit profession.

Finally, I would like to thank members for their support and cooperation over our quality assurance programmes in the past ten years. I hope our programmes will continue to receive support and serve their purposes well in the next ten years.

Elsa Ho
Director, Quality Assurance
March 2017

Oversight of our work

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

The responsibility for oversight of QAD activities rested with the Standards and Quality Accountability Board ("the SQAB") until the end of 2016. From January 2017, the function and role of the SQAB have been taken over by the Regulatory Oversight Board ("ROB") formed to oversee all the regulatory functions of the Institute.

The SQAB and, subsequently, the ROB serves to ensure that QAD activities are carried out in accordance with strategies and policies determined by the Council of the Institute and in the public interest. The oversight work includes receiving and reviewing annual work plans and budgets and regular progress reports from management and reporting to the Council on observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB in 2016.

Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all the Institute's practising certificate holders who engage in the provision of audit and other related assurance services. The Professional Accountants Ordinance ("PAO") has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards and is regularly amended to maintain best practice.

The Practice Review Committee ("the PRC") is a statutory committee responsible for exercising the powers and duties given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. The QAD reports to the PRC which makes decisions on the results of practice reviews. Section 32A of the PAO stipulates that at least two thirds of the PRC members must hold practising certificates. The practising members of the PRC are drawn from the full spectrum of audit firms, representing smaller practices through to the Big Four. The composition of the PRC is reviewed by the Nomination Committee of the Institute every year to ensure a balanced composition. Please refer to Annex for members of the PRC.

Our work

The practice review process can be divided into three stages:

Stage 1 – Preparation

- Select practice for review
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents including, if applicable, the completed audit health screening checklist

Stage 2 – On-site visit / inhouse desktop review

- Opening meeting *
- Conduct interviews *
- Review compliance with HKSQC1 and review selected audit files
- Summarize findings and recommendations
- Exit meeting *

** These procedures are carried out by telephone for desktop reviews*

Stage 3 – Reporting

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

Selection of practices for review is based on their risk profiles, developed using information obtained from the electronic self-assessment questionnaire ("the EQS") and other relevant sources. The frequency of reviews of each type of practices is set out below:

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

Note:

1. This recognizes the significance of listed and other public interest entities in Big 4 client portfolios.

2. Practices with 20 or more listed clients will receive an interim review in addition to a full review every three years.

3. The three-year review cycle is in line with international best practice. In order to address concerns over the quality of audits of listed companies by smaller practices, the following new elements were added to the selection process to increase the frequency of practice reviews of practices with less than 20 listed clients ("relevant practices") in 2016:

   a) Relevant practices that take on their first listed audit client will receive a practice review within a year of the date of the first audit report issued on that listed client.

   b) Relevant practices that have more than one listed engagement and have been the subject of a referral to the Financial Reporting Council ("the FRC") by the PRC or a complaint raised by the PRC or the FRC will receive an interim review within the next normal three year cycle.

   c) Relevant practices that have significant or regular changes in the number of listed engagements will receive an interim review within the normal three year cycle.

4. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers are given priority for reviews. A number of practices are selected for reviews on a random basis to ensure that all practices will have a chance of being selected. Practices with few audit clients and without any predetermined risk factors ("small practices") are selected for desktop reviews.

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

In late 2014, desktop reviews were introduced for small practices. Desktop reviews take place at the Institute's office and comprise a review of the latest monitoring report and one audit engagement.

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 decisions. The PRC having regard to the report and any response by the practice to the matters raised in the report may act under the power given by the PAO, to:

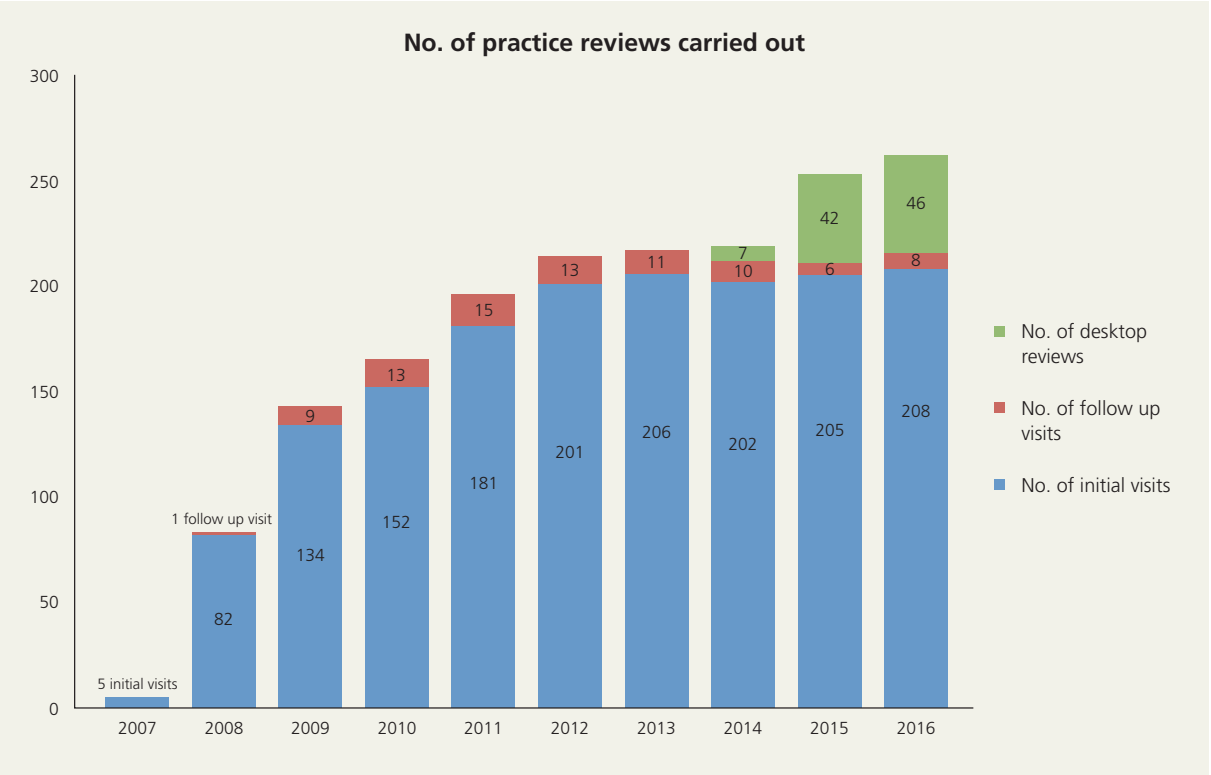
- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct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

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

If an auditing, reporting or relevant irregularity is identified in respect of a listed company, the PRC may, via the Council of the Institute, refer the case to the FRC for investigation.

Our review outcomes

The number of reviews carried out each year has increased from 83 in 2008 to 262 in 2016. The increase in the number of reviews in 2015 was mainly due to a whole year of desktop reviews, which were introduced in late 2014, and there was a slight increase in the number of desktop reviews in 2016.

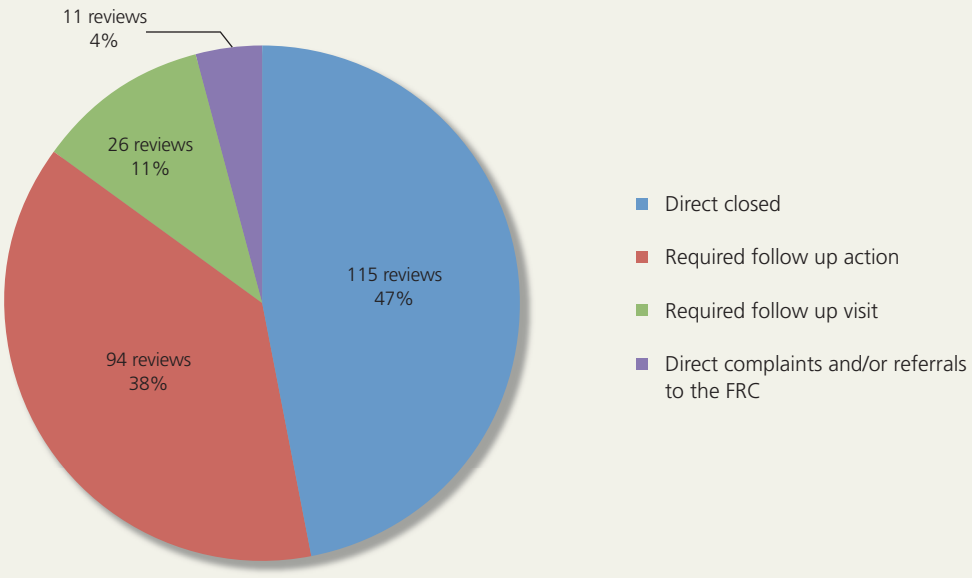


In 2016, the QAD carried out 23 visits on practices with listed clients. We referred five cross border engagements to the Ministry of Finance ("MOF") in Mainland China for review under the current arrangement. The MOF's review reports and the responses from the practices formed part of the practice review reports on the practices. The Institute will continue to work with the MOF to enhance cooperation and coordination of review work on cross border engagements.

Since the launch of the revised practice review programme in 2007 up to December 2016, the QAD has performed 246 reviews of practices with listed clients covering 92 individual practices. For practices with listed clients where significant findings were identified, the PRC directed the QAD to conduct follow up actions or visits to ensure that findings had been properly addressed. The PRC has a policy to consider referral of significant findings identified in an audit engagement of a listed client to the FRC. In the case that there is sufficient evidence of a significant audit failure, the PRC will consider raising a direct complaint as well.

Up to December 2016, a total of twelve cases from eleven reviews of practices with listed clients have been referred to the FRC for investigation. Five investigations resulted in complaints and disciplinary actions against the relevant practices as a result of serious non-compliance with professional standards and serious technical failings. Four cases are still under investigation by the FRC. The remaining three cases are under consideration by the Institute for further regulatory action following the FRC investigations.

Reviews of practices with listed clients since 2007



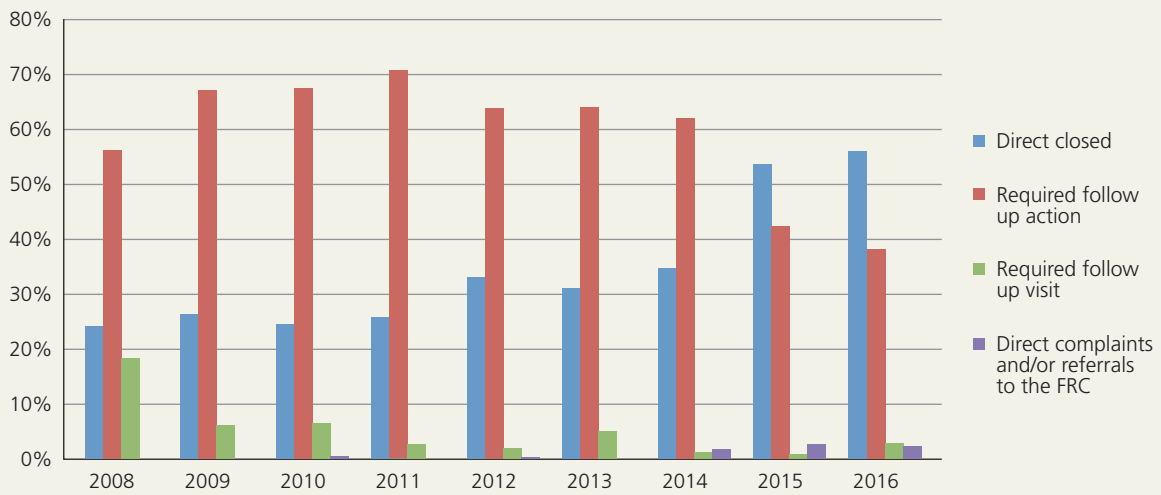
The PRC met on eleven occasions in 2016 and considered 256 practice review reports. The PRC concluded that 143 initial visits should be closed without requiring any follow up actions. For 99 initial visits, practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Eight reviews required a follow up visit to assess the effectiveness of remedial actions taken. Six reviews including one practice with listed clients proceeded to complaints and / or referrals to the FRC.

In addition to the 256 initial practice reviews, 5 follow up visits were reported to the PRC in 2016. One follow up visit was closed on the basis that adequate remedial actions had been taken, two required further follow up actions and, two proceeded to complaints.

Initial practice reviews reported to the PRC, which were directly closed, increased from 53% in 2015 to 56% in 2016. The improving results were mainly due to the steps that were implemented in the past few years to encourage practices to improve their audit quality and better prepare for a practice review.

Initiatives included e-Seminar "Improve audit quality – Practice review and common findings" and an Audit Health Screening Checklist to help practices identify common deficiencies and take appropriate actions to address those deficiencies. Practices that are identified to have a certain extent of common deficiencies by the Audit Health Screening process are notified that robust actions will be taken against them if the level of improvement is assessed to be unsatisfactory in the practice review. The e-Seminar is currently available for subscription at the Institute's website: http://www.hkicpa.org.hk/en/cpd-and-specialization/cpd/cpd-and-learning-resource-centre/online-courses/e-seminars/available-courses/.

Practice review cases reported to PRC (all practices)



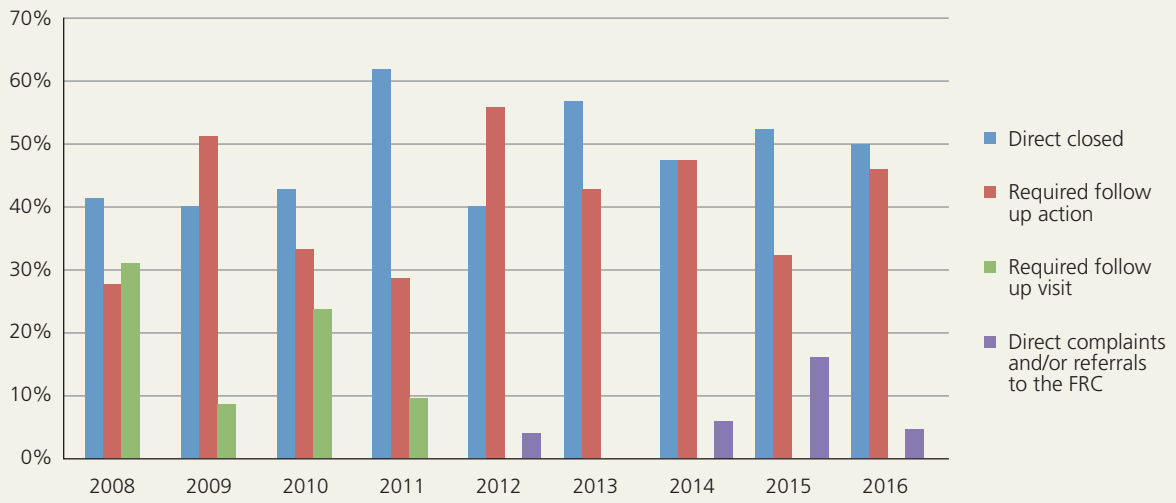
The PRC considered practice review reports on 22 practices with listed clients in 2016. Directly closed reviews have slightly decreased from 52% in 2015 to 50% in 2016 while reviews requiring follow up action have increased from 32% in 2015 to 45% in 2016. In 2016, one practice with listed clients proceeded to a complaint and related significant findings on two listed entity audits were also referred to the FRC.

The increasing number of reviews requiring follow up action raised concerns over the quality of firms auditing listed companies, in particular those smaller firms with less than 20 listed clients. Except for one practice, all of this group have previously been reviewed at least once. Although these practices generally improved on their quality control policies and procedures, the most recent reviews of some practices continued to identify some findings in audit engagements requiring the practices to take follow up actions.

Because of the concerns over the quality of audits of listed clients by smaller practices, new elements were added to the practice review selection process in 2016 to increase the frequency of visits to those practices. This means that a closer watch will be kept on the audit quality of smaller practices and ensure that they meet the standards required for a listed company auditor.

As practices with listed clients are reviewed at least every three years, and often more frequently, the PRC has not directed any follow up visits in the last few years but relied on monitoring of improvement at the next practice reviews.

Practice review cases reported to PRC (Practices with listed clients)

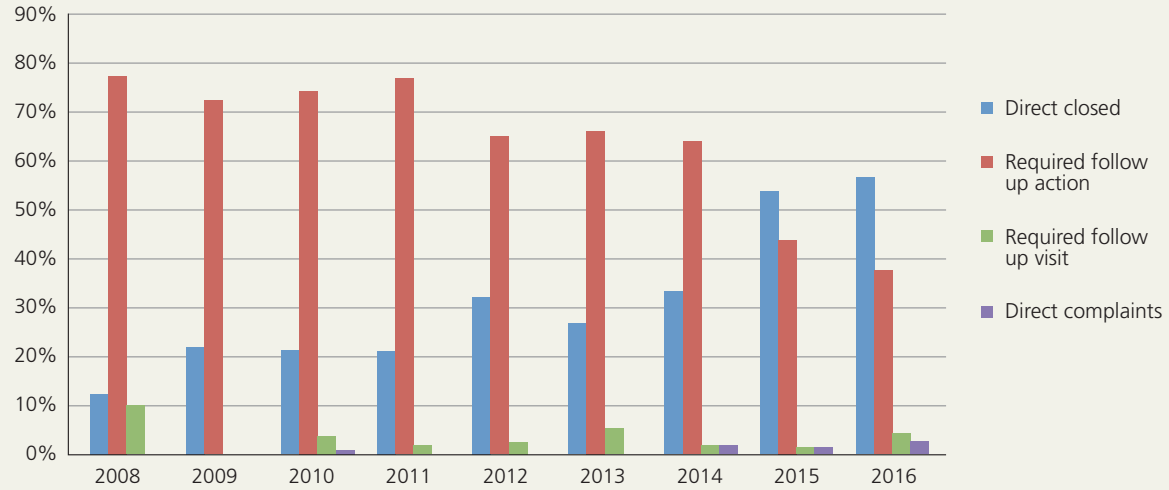


56% of the reviews of other practices (without listed clients) were directly closed in 2016, representing an increase of 2% from 2015. The reviews that required follow up action have decreased from 44% in 2015 to 38% in 2016. The improving results, which reflect the outcomes of the new initiatives introduced in the recent few years, are encouraging.

In 2014, a letter was sent to all practices setting out the PRC's decision to take stronger action against the top 5 findings (details provided later in the report). If a practice review finds that practices have made no or little attempt to avoid those common findings, the non-compliance will be regarded as serious professional misconduct and may result in disciplinary action, even for a first time review.

Where findings identified in a first time review amount to serious professional misconduct or in subsequent reviews 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. In 2016 seven reviews of other practices resulted in complaints being raised by the PRC for action under the Institute's disciplinary process. Of the seven reviews, five were first time reviews. In addition to making complaints against the practicing members, the PRC also made a referral to the Registrar of the Institute for him to consider raising a complaint against one practice given the seriousness of the findings identified.

Practice review cases reported to PRC (other practices)



Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory financial statements review programme set up in 1988 with the objective 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 to identify if there are any matters that indicate possible non-compliance with professional standards. Enquiry letters are issued to members (primarily auditors of the listed companies) for the matters identified. Matters raised primarily focus on financial reporting but the QAD also looks into audit matters if significant issues are identified. The QAD determines if follow up action is required on the issues raised with the auditor based on the reviews of the auditors' replies to our enquiry letters. Follow up actions include issuing further enquiry letters and letters with comments to advise members of areas for future improvement. If the issues identified indicate significant potential non-compliance with professional standards that constitutes a "Relevant Irregularity" or "Relevant Non-compliance", the financial statements, and our concerns, will be referred to the Financial Reporting Council ("FRC") for investigation.

Changes are often made to the subsequent financial statements in light of our comment letters. To ensure that members benefit from our programme so as to enhance the quality of financial reporting in Hong Kong, the QAD communicates common weaknesses identified from the reviews to members through different channels such as annual joint financial reporting forums, technical article published in the Institute's publication (A-Plus) and our annual report.

The programme is supported by the Professional Standards Monitoring Expert Panel ("Expert Panel") and independent external reviewers ("Independent Reviewers"). The Expert Panel is an advisory panel that gives advice to the QAD on the appropriate course of actions on significant, complex or controversial issues. The Expert Panel in 2016 comprised representatives from the Big Four firms, medium-sized practising firms and Hong Kong Exchanges and Clearing Limited ("HKEX"). Please refer to Annex for composition of the Expert Panel.

The Independent Reviewers as well as the QAD involved in conducting initial reviews of financial statements. The QAD assesses the observations identified from initial reviews and determines whether an enquiry should be raised.

The Institute regularly communicates with the FRC and the HKEX which have similar financial reporting review programmes to avoid duplication of reviews.

Our work

The review process comprises three stages:

Stage 1 – Initial review

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

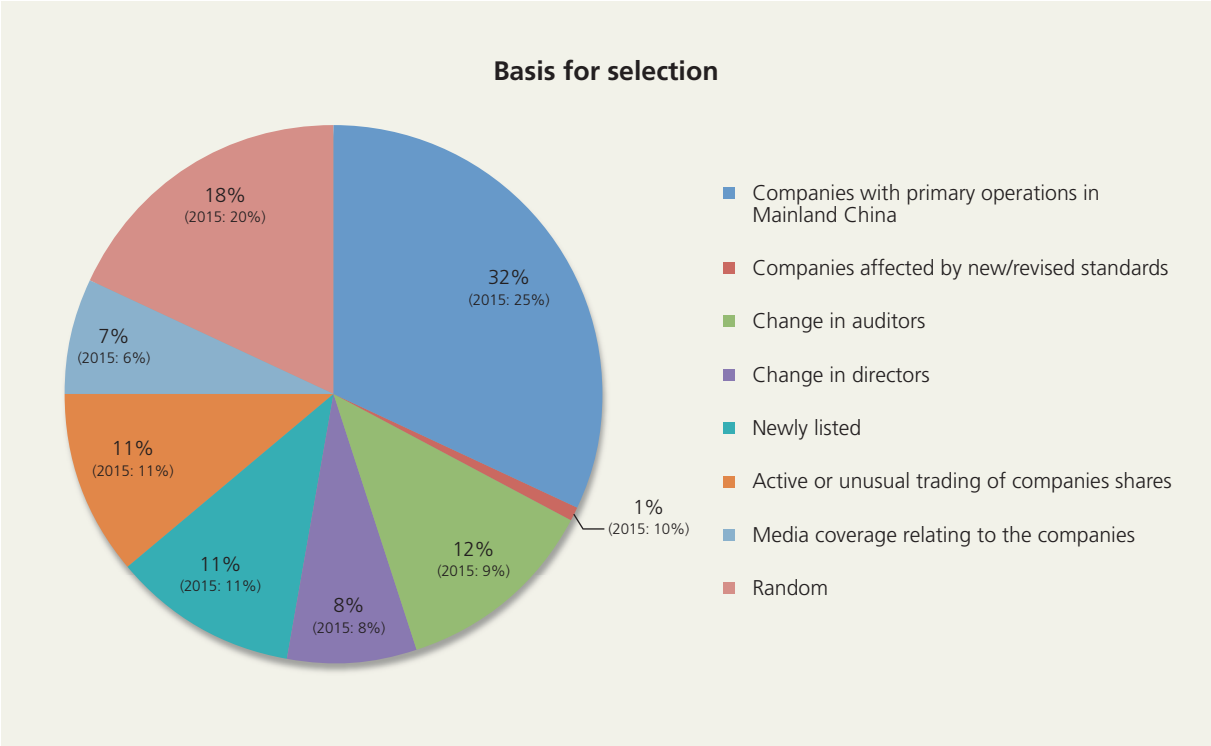
Stage 2 – QAD review

- The QAD reviews observations identified in initial reviews and issues enquiry letters to members when necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

Stage 3 – Follow up

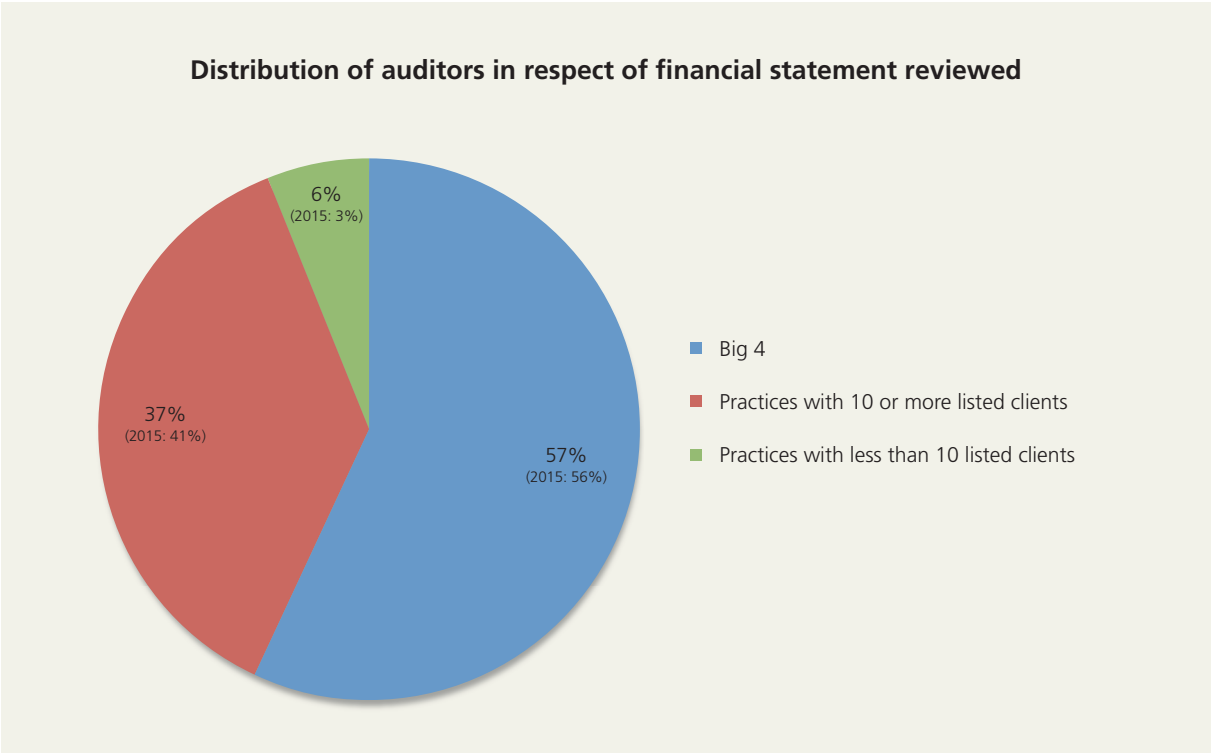
- In cases where enquiry letters are issued, the QAD reviews reply letters from members and decides whether further enquiry or other appropriate action is necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

The programme uses a risk-based approach to select financial statements for review. The following chart shows the basis of selection of financial statements reviewed in 2016.



As compared to 2015, a smaller portion of financial statements reviewed were for "Companies affected by new/revised standards" as only a few revised financial reporting standards became effective in the financial periods beginning on or after 1 January 2015 and the impact on the majority of financial statements was minimal. Some of the financial statements for "Companies with primary operations in China" were prepared under China Accounting Standards for Business Enterprises.

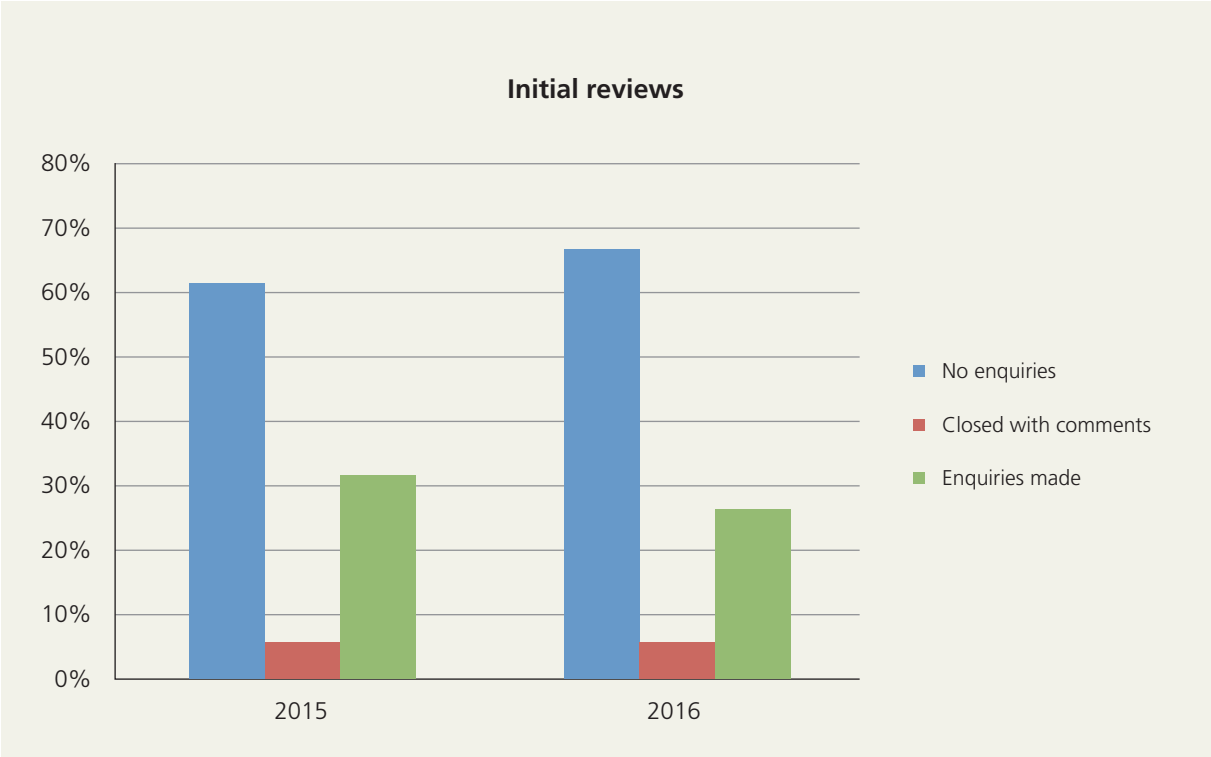
The following chart shows the distribution of auditors of the financial statements reviewed in 2016:



Our review outcomes

In 2016, the QAD achieved its review target with a total of 88 sets of financial statements reviewed (2015: 88). The QAD also followed up 20 cases brought forward from the previous year. During the year, the QAD issued 54 letters enquiring about matters identified from reviews or making recommendations on improvements in presentation and disclosures. The QAD handled a total of 32 responses from auditors during the year. There were 85 cases closed during the year, of which 72 related to financial statements reviewed during 2016 and 13 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 2016.



Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. Since 2010, a total of 12 cases have been referred to the FRC of which two cases were referred in 2016.

Major events

The Institute has operated a programme of practice review since 1992 with the objective of enhancing the quality of work of practising members engaged in audit and related assurance activities. In 2004, the Council of the Institute took the decision to revise the practice review programme in light of international developments and increasing expectations of regulation and monitoring of auditors.

The revised practice review programme started to run in 2007. It places greater emphasis on addressing areas of significant public interest, including the audits of public listed companies and all practices with listed company clients are inspected at least every three years. A risk based approach has been adopted for selection of practices without listed clients for practice review. The revised programme meets the requirements of the PAO and the Statement of Membership Obligations (SMO) 1 on Quality Assurance issued by the International Federation of Accountants, of which the Institute is a member.

This report is the tenth report on the practice review work carried by the QAD and therefore marks a key milestone in the revised practice review programme. To mark the tenth anniversary of the revised programme, this report gives a summary of the major events that have occurred in the past decade in relation to practice review activities on the next few pages.

2007

- From July 2007, the QAD started to carry out reviews of the Big 4 and other practices with listed clients. All listed company auditors are inspected at least once every three years, in accordance with international best practice.

- The QAD rolled out the first EQS to collect information from practices.

2008

- The QAD implemented the risk based approach for selection of practices without listed clients. 82 practices were reviewed in the first full year of the practice review programme.

2009

- The QAD completed the first cycle of practice review of listed company auditors, well within the three-year target. The QAD also reviewed auditors of regulated entities. This confirmed the QAD's commitment to give priority to reviews of auditors of listed and regulated entities.

2010

- The PRC raised the first complaint against a practising member of a practice without listed clients under the revised practice review programme.

2011

- The PRC raised the first complaint against a practicising member of a practice with listed clients under the revised practice review programme. Pursuant to the memorandum of understanding between the FRC and the Institute, the PRC, via the Council of the Institute, also referred this case to the FRC for further investigation.

- Interim reviews within the normal three-year cycle were introduced for practices with 20 or more listed clients. This new element of the practice review programme demonstrated the QAD's commitment to focus on areas of higher public interest.

2012

- The QAD completed the second review cycle of all practices with listed clients.

2013

- The QAD made the first referrals of cross border engagements to the MoF in Mainland China for review under the arrangements between the MoF and the Institute.

- The QAD started to classify review findings into significant findings and other points for attention in order to draw focus of the readers of our review reports to the former. The QAD also started to highlight the top 5 (most frequent) practice review findings in publications and communications to alert practices to areas that may need urgent attention.

2014

- The QAD sent a letter to all practices drawing their attention to the top 5 findings in practice reviews and requesting them to take immediate remedial actions to rectify those deficiencies if they exist in their practices. Failure to do so would be regarded as amounting to serious professional misconduct and consideration would be given to raising a complaint against the practice. Towards the end of 2014, a few cases that featured top 5 findings were referred for disciplinary actions.

- The QAD introduced desktop reviews for small practices without any pre-determined risk factors. The QAD started to develop new initiatives to help practices improve audit quality and better prepare for a practice review in order to bring down the overall number of practice review cases requiring follow up actions that continued to remain at around 70%.

- The PRC raised the first complaint based on the findings of a first time review of a practice without listed clients on the grounds of serious professional misconduct.

2015

- The QAD launched an e-Seminar "Improve audit quality – Practice review and common findings" and introduced the use of an Audit Health Screening Checklist to help practices identify common deficiencies and take appropriate actions to address those deficiencies. Practices that are identified to have a certain extent of common deficiencies by the Audit Health Screening process are notified that robust actions will be taken against them if the level of improvement is assessed to be unsatisfactory in the practice review.

- The PRC issued disapproval letters to a handful of practices that reported that they had not performed a monitoring review in the 2014 EQS and did not confirm to the QAD that they had done so by end of March 2015.

- The PRC referred a practice review case for the first time under the revised practice review programme to the Registrar of the Institute for him to consider raising a complaint against a practice given the seriousness of the findings identified.

- Following the implementation of new initiatives, the number of direct closed cases rose to above 50% for the first time.

- The QAD completed the third review cycle of all practices with listed clients.

2016

- In order to address concerns over the quality of audits of listed companies by smaller practices, the PRC agreed to add new elements to the selection process for practices with less than 20 listed clients. Practices will receive a review within a year after signing off their report on their first listed client. Those that are the subjects of recent referrals to the FRC or complaints and that have significant and/or regular changes in the number of listed clients will receive an additional interim review within the normal three-year cycle.

Our findings

Practice review programme

This is the tenth annual report on our revised practice review programme. Every year, we use the annual report to communicate common findings identified in practice reviews. We achieved our target of practice reviews for 2016, having carried out 216 on-site and 46 desktop reviews, including 8 follow up visits. Most practices were cooperative and willing to make improvements to their systems, policies and processes to address deficiencies identified in their practice reviews.

Although common findings identified in 2016 are similar to those in previous years, improvements have been made in terms of the significance of the findings and efforts made by practices to address the findings before the practice review cases were concluded. Some key factors that caused audit deficiencies over the past ten years are summarized below:

1) Developments in business, regulation and user expectations in the past decade have driven changes in financial reporting and auditing standards. Practices have had to deal with more requirements and new standards that are more detailed and comprehensive. Providing up-to-date training on practical application of professional standards to audit staff members is important given the rapid pace of changes of standards. Without adequate training support, audit staff members would not be sufficiently competent and capable of identifying and addressing key audit risk areas and complex issues, which often resulted in deficiencies in audit work and poor audit quality.

2) Listed entities are often involved in complex business transactions that give rise to significant accounting issues, e.g. business combinations, recognition and impairment of intangible assets and goodwill, issuance and accounting for financial instruments, valuation of assets and revenue recognition. However, not all practices have been able to handle the demands that listed audit engagements placed on their audit processes and procedures and resources and have underestimated the technical knowledge and resources required for carrying out a listed company audit. Findings quite often result from there being no or insufficient evidence in audit files to demonstrate that the audit teams had a clear understanding of the complex transactions undertaken and had made a proper evaluation of the appropriateness of accounting treatments adopted by their clients.

3) Some practices, particularly smaller practices, subcontract elements of audit work to other practices or individuals when they have limited internal resources. In many cases, the use of incompetent subcontractors who were not conversant with current accounting standards and lack of proper involvement and control by the practices in subcontracted engagements had led to poor performance of audit engagements.

Starting from April 2013, we have categorized our review findings into significant findings and other points for attention in order to draw focus of the practices and Practice Review Committee ("PRC"), to the former. Significant findings are findings that may have a more direct or material impact on the quality control system or audit opinion and therefore require special attention of the practices. This change in reporting style does not affect the number of findings reported in our review reports.

In late April 2014, we issued a letter to all practising members alerting them to the Top 5 findings, which are the most frequently found deficiencies in practice reviews. We requested practices to take pro-active actions to remediate those deficiencies if they existed in their processes and procedures. 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. A number of cases with these top 5 findings have been referred for disciplinary action, including some first time review cases.

This section summarizes the top 5 findings and other common findings identified from our 2016 practice reviews with indications of the extent of improvements made to address the related deficiencies by practices over the years. We will continue to focus on how practices addressing common deficiencies in 2017 and expect practices to continue to pay attention to the common findings as described below and to take actions to prevent those deficiencies occurring in their policies, processes and procedures.

No or insufficient quality control policies and procedures (Top 5)

A few years back, we often found that smaller practices did not have any quality control policies and procedures to address the requirements of HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. In recent years most if not all practices have their quality control manual ready for our review at the start of the practice review although a small number of them might have introduced it just prior to the practice review. Many smaller practices adopt example quality control manuals from the Institute's publication, A Guide to Quality Control, but some do not tailor the manuals to suit their own circumstances. Inconsistencies between policies and procedures set out in the Practice's quality control manual and those actually applied in practice are also identified.

We recommend practices take steps to appropriately tailor the example manual before adopting it as their quality control manual. In particular, they should carefully read the content of the example manual and consider whether the policies and procedures are relevant to their size and operating characteristics. They should make appropriate changes to the example manual before introducing it as their quality control manual. Care should be taken to ensure the changes do not result in policies and procedures not fulfilling the requirements of HKSQC 1.

No or ineffective monitoring (Top 5)

HKSQC 1 requires practices to set up a monitoring function to ensure their quality control systems are relevant, adequate, and operating effectively. When HKSQC 1 was initially introduced, many practitioners found this key element of HKSQC 1 challenging to meet or misunderstood the requirements, for example:

a) Many small practitioners believed that no monitoring review was required if they had a client base that consisted of only small and uncomplicated entities;

b) Some practices had documented policies for their monitoring function but no monitoring activity had ever taken place;

c) Some practitioners were not aware that a firm-wide monitoring review should be performed annually and it is only the review of a completed engagement file of a director/partner that can be performed on a cycle of no more than three years; and

d) Some smaller practices confused a monitoring review (which is often referred as a "cold review" as it is done after the audit report is signed) with an engagement quality control review ("EQC review") (which is often referred as a "hot review" as it is done before the audit report is signed).

Over the years, we have emphasized the importance of monitoring and suggested a number of possible ways that practices can meet their monitoring responsibilities. In 2014, the PRC started taking stronger actions against practices that have not performed a monitoring review. Disapproval letters were issued to a number of practices that reported that they had not carried out a monitoring review in their submitted 2014 EQS and did not subsequently confirm that they had done so by March 2015. Two reviews in 2015 where practices were found not to have performed a monitoring review resulted in complaints being raised by the PRC and consequently actions taken against the practices under the Institute's disciplinary system.

Practices now generally have their monitoring reports ready for our review at the time of practice review. However, we still found the following shortcomings in the monitoring functions of some practices during our 2016 practice reviews:

a) The engagement reviews only covered simple or dormant engagements even where there were high-risk engagements e.g. listed and regulated clients, within the practices' client portfolios;

b) There was no or limited documentation to evidence the monitoring procedures performed;

c) Deficiencies identified by the monitoring review were significantly less than those that were found by the practice review; and

d) Practices did not develop a plan to address the issues identified by the monitor nor assess whether the recommendations made by the monitor had been properly addressed. In some cases, the findings identified were not communicated to the audit team and other audit staff, resulting in the issues not being addressed in subsequent or other applicable audits.

These findings raised questions about the effectiveness and robustness of the monitoring review process and issues need to be effectively addressed without delay. When weaknesses are identified from monitoring reviews, practices should take them seriously and discuss remedial actions with the monitors.

Unsatisfactory subcontracting arrangements (Top 5)

Unsatisfactory subcontracting arrangements have been a key concern of practice review over many years. As emphasized in previous reports and forums, practitioners need to bear in mind that subcontracting work in an audit does not reduce the responsibility of the practice for its audit opinion on the financial statements. Nevertheless, we continued to identify practices that did not retain their subcontractor's audit work papers, did not have sufficient audit evidence in their own files to support their audit opinion, did not know the extent of audit procedures performed by their subcontractor and did not exercise adequate control and review to ensure their subcontractor's work was sufficient and appropriate before issue of audit opinions.

In such cases, practices are unable to exercise proper control over their subcontractor(s) and their work. These arrangements often lead to poor audit work being carried out and audit opinions not being supported by sufficient adequate audit evidence. Actions taken against practices that were involved in these arrangements included requesting them to terminate the subcontracting arrangements and, in serious cases, raising a complaint.

Inappropriate audit methodology (Top 5)

The Institute publishes an Audit Practice Manual ("APM") to provide a tool to facilitate consistency in the quality of engagement performance in an audit. Many practices, particularly smaller practices, use the APM as their manual. However, the following deficiencies were identified in the usage of the APM:

a) Some smaller practices wrongly believed that acquiring the APM is imperative to meet our expectations but they failed to make appropriate use of the APM guidelines and programmes when carrying out their audits.

b) Some practices selectively used only a few of the APM audit programmes particularly for planning and completion. As a result, a number of requirements of auditing standards, including the following, were commonly not fully or adequately addressed in their engagements:

- Audit plan and audit strategy (HKSA 300)
- Understanding of client's business, including key controls and evaluation of design and implementation of controls (HKSA 315)
- Audit risk assessment (HKSA 315) and response to assessed risks (HKSA 330)
- Fraud risk assessment (HKSA 240)
- Calculation and application of audit materiality, including performance materiality (HKSA 320)
- Preliminary analytical reviews to identify risk areas (HKSA 315) and final analytical procedures to review and conclude on consistencies between financial statements and auditors' understanding (HKSA 520)
- Consideration of laws and regulations (HKSA 250)
- Subsequent event review (HKSA 560)
- Consideration of going concern assumption (HKSA 570)

c) Some practices simply used the basic "Flat Holdings Limited" example from the APM to reproduce documentation for every audit engagement, resulting in documentation often not being specific to each individual client.

Some practices had developed sophisticated audit programmes and checklists to help audit teams carry out audit procedures to meet requirements of standards. However, they often did not take adequate steps to ensure that audit teams understood the programmes and checklists and how they should be applied. This situation could result in audit teams having spent hours working through the programmes and checklists but still not attaining the objectives that the programmes and checklists were intended to achieve.

Practices should not represent compliance with auditing standards in their audit reports unless they have complied with the requirements of all auditing standards relevant to the audits. Departure from a relevant requirement in an auditing standard is allowed only in exceptional circumstances and alternative audit procedures should be performed to achieve the aim of that requirement.

Practices should provide appropriate training to their staff members so that they have adequate knowledge about application of programmes and checklists to ensure that audits are carried out in accordance with the requirements of relevant auditing standards.

Misuse of modified opinion (Top 5)

Practices might be faced with pressures, which led them to compromising audit quality. Some practices misused modified opinions to circumvent necessary audit procedures as they believed that this approach would still allow them to properly discharge their responsibility as auditor. Some practices adopted this approach due to pressures from clients to minimize audit costs. The following are common examples:

a) Time constraints

Practices disclaimed all significant balances in the financial statements because of time constraints, for example, as a result of tax deadlines and audit teams being unable to complete all necessary audit work to issue a clean opinion. Lack of time is not an acceptable reason to disclaim an opinion.

b) Non-attendance at client's stock-take

Practices issued modified opinions year after year because clients have not "invited" them to attend inventory counts. No steps were taken to understand why they were not invited. If the reasons were that the inventories were located outside Hong Kong or the clients were at peak season at the year-end date, they should instead consider, for example, engaging another auditor or a suitably qualified person as their representative to attend the inventory count; or arranging inventory counts with clients on dates other than the year-end date.

Practices are reminded that stock-take attendance is an important and necessary audit procedure. It serves not only to confirm the existence of stock, but also to evaluate physical controls over stock and identify damaged, slow moving or obsolete stock which are critical audit procedures.

Practices should use best endeavours to obtain sufficient, relevant and reliable audit evidence to enable them to express an unqualified opinion. It is not acceptable to issue a qualified opinion where practicable audit procedures are available but have not been carried out. When no steps have been taken to resolve the circumstances that give rise to a scope limitation, this would beg a question whether there is really a limitation or whether it is simply an arrangement of convenience for client and auditor. A review in 2016 that found the practice had qualified its reports on nearly all its engagements due to work limitations on a number of similar areas resulted in a complaint being raised by the PRC.

Engagement quality control review

HKSQC 1 makes it mandatory for a listed entity audit to be subject to an engagement quality control ("EQC") review, and requires practices to establish criteria against which all other assurance engagements are to be assessed for the need for an EQC review. Criteria for an EQC review could be, for example, regulated entities and special engagements which are considered higher risks or subjected to compliance with additional rules and requirements of other regulatory bodies. Common issues identified in respect of EQC reviews are as follows:

a) Practices viewed an EQC review primarily as a compliance task and did not devote sufficient time to the review;

b) Practices retained little evidence of EQC review on audit files, including documentation and time records to reflect the extent of participation of the EQC reviewers in the audits;

c) EQC reviewers were involved only in the completion stage of the audits and therefore could not have shared their views on critical issues earlier; and

d) EQC reviewers were junior staff members who did not have sufficient experience to perform an effective review or authority to challenge engagement directors/partners when they encountered issues.

EQC review is a pre-issuance review that aims to provide an objective evaluation, before the date of the auditor's report, of the audit team's significant judgments and the conclusions they reached in formulating the auditor's opinion. Therefore, it is important to conduct the EQC review properly and in a timely manner at appropriate stages during the engagement and prior to the issuance of the audit report. Practices should clearly communicate to EQC reviewers their role and scope of work and EQC reviewers should adhere to relevant policies and procedures.

To reduce familiarity and self-interest threats to an acceptable level, the revised Code of Ethics for Professional Accountants ("revised Code") requires key audit partners, including the engagement partner and EQC reviewer, of a listed client to be rotated after seven years and not to be a member of the audit team for two years following the rotation. During the cool-off period, the individual should not participate in any other ways in the audit or provide consultation in relation to quality control or technical matters for the listed client. Practices are advised to bear in mind the above rotation requirements from the very start of a client relationship to ensure they have sufficient resources to implement a partner rotation policy and have personnel with sufficient technical expertise and experience to carry out an effective EQC review.

Although the engagement partner has the prime responsibility for the audit, the EQC reviewer has an important role to ensure audit quality is of an acceptable standard. EQC reviewers have been penalized in disciplinary cases for their lack of due care as the EQC reviews carried out were not effective as they failed to identify critical issues or effectively challenge the audit team's judgements on critical areas, in addition to actions taken against engagement partners.

Practices are advised to take steps to evaluate the effectiveness of their EQC reviews, including the competence and capabilities of EQC reviewers and quality of their reviews.

Fee dependence

Fee dependence is often an issue to smaller practices with one or a few listed clients as the total fees from their listed clients may represent a large proportion of the practices' total fees. Dependence on a client or client group can lead to concerns about the possibility of losing the client and this may create a threat to independence. The revised Code states that if the total fee income from a listed client and its related entities represents more than 15% of the total fees received by a practice for two consecutive years, the practice should disclose this fact to those charged with governance of the listed client and apply appropriate safeguards to reduce the threat to an acceptable level. Safeguards required by the Code are either an external pre-issuance review or a post-issuance review or both on the audit engagement. If no safeguard can be implemented, the practice should terminate the audit relationship.

In the early days of the implementation of the revised Code, smaller practices often ignored or misunderstood the additional requirements e.g. they did not realize that the 15% threshold was for two consecutive years, conducted an "internal" instead of "external" pre-issuance review as a safeguard and did not disclose the fact on fee dependence and safeguards applied to those charged with governance.

Through practice reviews and our regular publications, practices are now more familiar with these requirements although we still found a number of cases that failed to disclose the safeguards applied to those charged with governance in our 2016 practice reviews.

Other independence issues

It is common for smaller practices to provide non-assurance services such as accounting and bookkeeping services to their audit clients. Not all practices go through the "threats and safeguards" process to ensure that threats are identified and reduced to an acceptable level by applying safeguards when needed as required by the revised Code.

Under the revised Code, practices are not restricted in providing non-assurance services to their audit clients that are not public interest entities, as long as they are mindful of the threats to independence and introduce appropriate safeguards to reduce such threats to an acceptable level when needed. To give an example, it is well understood that preparation of journal entries may create a self-review threat if practices subsequently audit their own work. However, when the journal entries are simple in nature e.g. those for recording depreciation, or recurring transactions e.g. electricity and water charges for which amounts are easily determinable from source documents such as an utility bill where the client has approved the appropriate account classification, the self-review threat would be insignificant as these entries do not involve the application of complex accounting standards. As a result, no safeguards would be required.

However, when a client's transactions involve accounting issues which require significant judgment e.g. bad debt and inventory provision, the self-review threat would be significant and practices would need to document their assessment and conclusion on safeguards required (e.g. to arrange personnel who is not a member of the audit team to do / review the work) to eliminate the threat or reduce it to an acceptable level on audit files.

However, it is important to remember that the revised Code allows provision of 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. In a recent case the practice issued a proposal to its listed audit client for providing some internal audit services which would involve a review of a significant part of internal controls over financial reporting. The practice overlooked that such work is prohibited under the revised Code. During the time of our on-site visit, the practice reassessed the potential threats that might arise from the work and subsequently informed the client that they could not offer the services.

Fraud risk assessment

HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires auditors to consider fraud risk in an audit and adopt a more critical and skeptical mind-set particularly during audit planning and evaluation of audit evidence, to identify, assess and appropriately respond to fraud risk. However, we continue to identify the following common deficiencies in practice reviews:

a) Insufficient work on journal entry testing to address fraud risks arising from management override of controls

   Many smaller practices misunderstood the requirement to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

The test should be performed in every audit, irrespective of the results of the assessment of the risk of management override of controls as this risk is present in all entities and due to the unpredictable way in which such an override could occur, it is a risk which requires special audit consideration.

Many small practitioners believed that scrutinizing the general ledger could fully address the risk of management override of controls. We would like to remind practices that, HKSA 240 specifically requires practices to select journal entries and other adjustments made at the year-end (for example, non-routine entries, entries/adjustments made by personnel who typically do not make journal entries, entries contain round numbers or consistent ending numbers) and consider the need to test journals and other adjustments throughout the year. This procedure is necessary as material misstatement of financial statements due to fraud often involves manipulation of the financial reporting process by:

- Use of inappropriate or unauthorized journal entries which may occur throughout the year or at period end, or
- Use of adjustments to change amounts reported in the financial statements that are not reflected in routine journal entries e.g. consolidating adjustments and reclassifications.

Practices should ensure that appropriate procedures to address risk of management override of controls is adequately covered as part of the audit planning procedures and details of procedures performed e.g. criteria used to identify significant and unusual journal entries.

b) Practices did not consider additional fraud risk factors relevant to audits of regulated clients as set out in PN 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries*.

Misappropriation of customer assets can occur in a number of ways, such as falsifying customer account statements, withdrawing or transferring funds out of customer accounts without authorization, and transmitting customer funds to another account not designated by the customer. Due to the nature of their business, some regulated clients, for example, licensed corporations might be more susceptible to these risks. Therefore, it is important for practices to take additional steps to assess fraud risks including considering the additional fraud risk factors as set out in PN 820 for licensed corporations and appropriately respond to those risks.

c) There was no evidence that audit teams discussed susceptibility of clients' financial statements to material misstatement due to fraud.

HKSA 240 and HKSA 315 require audit teams to have discussions about susceptibility of the entity's financial statements to material misstatements due to fraud. In planning an audit, the engagement partner/ director or manager should communicate with members of the audit team regarding potential for material misstatements due to fraud. Practices should document the discussion with team members on how and where the entity might be susceptible to fraud to ensure appropriate level of professional skepticism is maintained on those specific areas.

d) There was no inquiry of management on fraud when gaining an understanding of the client.

Practices should inquire of management about its knowledge of fraud. In particular for listed entities, they should also understand controls and programmes that management has established to mitigate specific risk factors and assess how well management monitors those controls and programmes. Those charged with governance in the entity, such as the board of directors and the audit committee, should assume an active role in oversight of the assessment of the risk of fraud. Audit teams should obtain an understanding of how the board of directors exercises its oversight activities. When the client has an internal audit function, the audit team should also inquire of the internal audit team about their assessment of fraud risk, including whether the management has satisfactorily responded to internal audit findings during the year.

Communication with audit committee

Practices with listed company audits are generally well aware of the requirements to communicate with management and those charged with governance. However, we found that some practices still needed to improve their documentation of communications and some did not communicate all required matters, including the following, to audit committees at an appropriate time:

a) The planned scope and timing of the audit;

b) Auditor's independence;

c) Plans to address the significant risks of material misstatements due to fraud or errors;

d) Approach to internal controls relevant to the audit;

e) Application of the concept of materiality in the context of the audit; and

f) Significant audit matters and respective written representations obtained from management.

Practices are reminded that the audit committee, which provides an oversight function over internal controls and financial reporting, plays a very important role in the audit process. Effective and timely communication between the audit committee and auditor avoids misunderstanding and last minute surprises between auditor, management and those charged with governance, and is beneficial to the overall conduct of the audit.

Practices should keep an adequate record of the matters communicated verbally to the audit committee e.g. nature of the matters raised, and when and to whom it is communicated. Where matters were communicated in writing, practices should retain a copy of the communication as part of their audit documentation. Templates of communication can be useful to assist audit teams to document their communication with management and audit committees and to achieve compliance with HKSA 260 *Communication with Those Charged with Governance*.

Practices should also communicate with the client's management and the audit committee by way of a management letter when significant deficiencies in internal control are identified as required by HKSA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* to ensure that management is made aware of deficiencies which merit their attention and action.

Professional skepticism

We continued to have concerns about whether practices have appropriately applied professional skepticism in the course of their audits on areas such as impairment of goodwill and other intangible assets and going concern assessment. We sometimes found that the level of challenge made by audit teams on key assumptions adopted by clients was not rigorous enough to support their conclusions.

a) Asset impairment

Impairment reviews of goodwill and other intangible assets remain a challenge for practices. We would expect there to be audit evidence to review the reasonableness of the key assumptions in a discounted cash flow projection used for impairment assessment, including the forecast revenue and costs, discount rate and growth rate used.

Instances were found where there was insufficient audit work and explanations as to why no impairment loss was provided when there were indications of possible impairment of a significant asset. Common issues identified during our review included that practices:

- did not assess reasonableness of assumptions underlying the client's decisions with reference to historical outcomes e.g. appropriateness of growth rates used by the client which appeared to be unrealistically high;
- obtained audit evidence that corroborated rather than challenged clients' judgment e.g. taking a macro view and general economic outlook optimistically to support the client's best estimates;
- failed to obtain appropriate third party audit evidence since most of the evidence supporting the impairment assessment was prepared and provided by management or related parties; and
- did not consider whether evidence available on other parts of the audit files was consistent with the work on impairment e.g. source data used by the client in the discount cash flows projection.

In general, practices should heighten the level of professional skepticism when assessing evidence in areas that involve significant estimates or judgment by clients. Persuasive audit evidence should be obtained on these areas. Practices should ensure the sufficiency of audit evidence on file to reduce the risk of being challenged by external reviewers or regulators in relation to their audit procedures performed or conclusions reached on asset impairment. Appropriate training should be provided to improve staff understanding of the accounting requirements of HKAS 36 *Impairment of Assets*.

b) Going concern evaluation

When there were indications of potential going concern issues, some practices relied solely on management representations to support their conclusion that the use of the going concern basis was still appropriate. Practices should obtain sufficient audit evidence such as cash flow forecasts to support the going concern assumption. Work should involve reviewing the appropriateness of underlying bases and assumptions and applying professional skepticism to challenge the appropriateness of the forecasts, such as whether the sales projection was too optimistic.

Some practices completed standard checklists without giving any thoughts to the sufficiency and appropriateness of audit evidence gathered. For example, a going concern checklist was completed which highlighted that the client had net current liabilities and incurred significant losses over a few years but there was no further evidence on file to show that these going concern indicators were properly considered before the audit report was issued. In some cases, there was a lack of evidence that the audit teams had appropriately challenged the information provided by the clients to support their assumption that the entity was a going concern. For example, some practices accepted the client's estimates of future cash flows without critically assessing the underlying assumptions.

Practices should be mindful that HKSA 570 *Going Concern* requires practices to undertake specific procedures when events or conditions that may cast significant doubt on client's ability to continue as a going concern have been identified.

c) Related party transactions

In some engagements, related entities of the clients had undertaken some significant and/or unusual transactions during the reporting period which resulted in inflated asset values, but the audit teams failed to identify them as significant risk items and obtain an adequate understanding of their nature. Practices should carry out procedures in addition to standard audit procedures to specifically address the additional risks arising from significant and/or unusual transactions. Audit teams should maintain and appropriately update the list of related parties through, for example, making inquiries of management regarding the existence of related party transactions and confirming with the counter-parties of material or unusual client transactions whether a relationship exists between the counter-party and the client or its management. Once the audit team becomes aware of a related-party transaction, they should closely examine the transaction with proper supporting documents to ensure that it has occurred, is appropriately valued and properly disclosed.

Group audit arrangements

HKSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* sets out specific guidelines and requirements for group auditors when they plan audits. For example, group auditors are required to determine group materiality and the type of work to be performed on the financial information of components and communication with both management and component auditors about the group audit process. Group auditors are expected to pay more attention to where audit risks lie within the group and have involvement in the audits of components.

In 2013, we issued an audit alert which summarized challenges and provided guidance on the application of HKSA 600 in the following areas:

- Restrictions on involvement of group auditors in the work of component auditors
- Group auditors' lack of understanding of component auditors and failure to evaluate their work
- Group audit planning, communication with component auditors and documentation

However, we continue to identify issues in group audits, including:

a) Some smaller practices only obtained audited financial statements from component auditors for group audit purposes. This approach is not sufficient to satisfy requirements of HKSA 600, which requires in particular, involvement of the group auditor in risk assessment and development of risk responses;

b) Practices failed to evaluate professional competence and independence of component auditors, determine group and component materiality, perform analyses to identify significant components and determine the scope of work for components;

c) Some practices used templates to prepare group instructions without appropriate tailoring to cover issues specific to client's circumstances and, as a result, potential problems were not followed up with component auditors;

d) Practices did not undertake work to assess whether appropriate adjustments had been made to reflect activities undertaken in the period between the component and the group's year-ends when they were not the same; and

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

Limiting the work in a group audit to receiving documents (e.g. audit questionnaires and clearance) from component auditors without adequate involvement by group auditors is not sufficient to meet the requirements of HKSA 600. 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 adequately document their involvement.

Audit confirmations

We identified a number of instances where confirmation requests were arranged by client personnel e.g. allowing clients to mail confirmation requests. When performing confirmation procedures, practices should ensure their audit teams adequately control the confirmation process e.g. sending out the confirmation requests themselves and requesting replies to be sent directly to them. When replies are in the form of a fax or other electronic means, practices should perform all reasonable steps to verify the identity of the sender as required by HKSA 505 *External Confirmations*.

In some cases, a circularization was carried out but there was no proper follow up action, for example on assessment of potential implications of information other than bank balances disclosed in bank confirmations and returned confirmations with material exceptions, and carrying out sufficient appropriate alternative audit procedures when confirmations were not returned.

Over-reliance on experts' work

In previous reports, we emphasized the need to properly assess the work of experts if practices intend to rely on their work. As in prior years, we continued to identify cases showing insufficient efforts had been made to meet the relevant requirements of HKSA 500 *Audit Evidence* and HKSA 620 *Using the Work of an Auditor's Expert*.

The common explanation from practitioners was that the expert was a known expert for valuations in related industries so they did not feel able to challenge the professional competence of that expert. In some cases, practitioners argued that they did not possess the same expertise and knowledge so that they were unable to challenge the expert's assumptions and methods used.

Practices are reminded that they have the sole responsibility for the audit opinion expressed and that responsibility is not reduced by using the work of management's experts or the practices' own experts. The valuation reports provided by experts might vary significantly in scope and the extent of the expert's work on reliability of data used in the valuation might also vary significantly. Reports of experts may also contain disclaimers that affect the reliability of the report. Auditing standards require that before relying on expert's work, auditors should perform the following work:

a) Evaluate competence, capabilities and objectivity of the expert;

b) Obtain an understanding of the expert's work; and

c) Evaluate the appropriateness of the expert's work, including:

- Reviewing the appropriateness of key assumptions and valuation methods;
- Reviewing or testing of data used by the expert; and
- Assessing the relevance and reasonableness of the expert's findings or conclusions, and their consistency with other audit evidence.

Audit teams should also properly document their evaluation work in the audit work papers.

Audit of inventories

Inventories are often a major item in financial statements. Issues on auditing inventories have been covered in previous reports and forums but keep recurring year on year.

In some engagements reviewed, documentation showed that the practices did not perform appropriate audit work on inventories e.g. attending physical inventory counting at a date other than the year end but not performing audit procedures to test transactions during the intervening period. Another common finding was that where inventories were held in different locations, only one location with a small proportion of inventories held was selected for stock-take attendance but there was no justification documented on file for the basis of selection.

There were also some cases where there were inventories held under the custody and control of a third party and practices arranged audit confirmation requests to confirm the quantities and conditions of inventories held on behalf of the client. However, they did not follow up non-replied audit confirmations and did not perform alternative procedures to verify the inventories held.

In some cases, practices did not assess the appropriateness of costing methods used. For example, testing of costing of inventory items was limited to checking the latest supplier invoice without considering whether the costing method was properly applied. Practices need to understand costing methods, e.g. first-in-first-out or weighted average, used by clients and design appropriate audit procedures to test whether costs of inventories are properly determined. Instances were also found where materials, labour and overheads were incurred in producing goods but only material costs but not labour and overheads were absorbed into work-in-progress and finished goods. Practices are reminded to perform sufficient audit work to ensure processing charges are properly accrued and absorbed into inventory costs.

In some other cases, practices assessed adequacy of the inventories provision only through identifying damaged or obsolete inventories during stocktake attendance. They did not evaluate the clients' inventory provision policies for damaged and obsolete inventories nor assess the appropriateness of the policies based on reliable operational or accounting information such as product life cycle and inventory aging. In some cases, they did not perform adequate audit procedures to test net realizable values of inventory items as they only checked items with insignificant values or performed a general review of overall gross profit ratio without checking the subsequent market prices of specific items.

Practices might recognize that some of the shortcomings set out in this report also exist in their own quality control systems and/ or audit methodology. Practices are strongly advised to take appropriate actions to address the shortcomings relevant to them. Practices are also advised to evaluate their own quality control systems to ensure policies and procedures emphasize the importance of proper audit planning, supervision and review, including timely involvement by engagement partners / directors and EQC reviewer, and require coverage of technical accounting topics and industry-specific requirements in firm-sponsored training courses to equip audit teams with sufficient knowledge to handle complex issues.

Expectation

Increased complexity is an inescapable feature of the audit profession. Practices are facing new challenges every year, e.g. the recently revised Companies Ordinance and new requirements for long form audit reports for listed entities. Regular updates on the requirements of professional standards and provision of sufficient training for audit staff are crucial for maintaining technical knowledge in the ever-changing environment of the audit profession. Practitioners and other audit team members should maintain questioning minds with an appropriate level of professional skepticism, obtain sufficient evidence, and not be over-reliant on management's and experts' information without performing appropriate audit procedures. "Tone at the top" should clearly communicate to staff members the importance of audit quality in training programs and annual performance reviews.

Our findings

Professional standards monitoring programme

Each year, we share with members a summary of the more significant or commonly identified findings from our programme. We hope that, through this exercise, members can take on board our comments if similar issues arise when they prepare or audit financial statements.

In our past reports, deficiencies had been repeatedly identified in the application of several Hong Kong Financial Reporting Standards ("HKFRSs") including HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement*, HKAS 36 *Impairment of Assets* and HKFRS 3 (Revised) *Business Combinations*. In our 2016 reviews, the issues identified mainly relate to the application of existing HKFRSs as there were no new and only a few revised standards that had come into effect for financial statements with a year-end date in 2015. We still identified a number of instances that the above named HKFRSs were not appropriately applied.

In this section, we will first cover the more significant or commonly identified findings on the above HKFRSs. In the second part of this section, we will discuss the deficiencies identified in the application of HKAS 12 *Income Taxes*. In the last part of this section, we will give you an overview of common disclosure deficiencies identified from our 2016 reviews.

Section I – Common or significant findings on application of HKFRSs

1. HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement*

   At present, there are three Standards that deal with accounting for financial instruments, namely HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 7 *Financial Instruments: Disclosures*.

   HKFRS 9 *Financial Instruments* will come into effect for accounting periods beginning on or after 1 January 2018 with early adoption permitted. We expect that many entities will continue to apply the existing accounting requirements for their financial instruments before HKFRS 9 replaces HKAS 39 in its entirety.

In the modern world, it is very common for entities to engage in transactions that use innovative and complex financial products for specific purposes (e.g. raising funds by issuing convertible bonds). Innovative and complex financial products may mean that the accounting for these financial instruments is more complicated and requires a well thought through evaluation of their substance. A detailed analysis of the terms and conditions included in the underlying contracts of the financial instruments is necessary. A number of areas concerning financial instruments including accounting for discounted bills, financial guarantee contracts and early redemption options embedded in a convertible instrument and impairment assessment of available-for-sale equity investments have been covered in our previous reports. Members may access our previous reports through the link below:

http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/publications-reference/

This year, we would like to highlight some areas that we consider worth drawing to members' attention again.

a. Measuring fair value of a hybrid/compound financial instrument

A convertible bond is a common hybrid/compound financial instrument that in its simplest form usually comprises a debt component (i.e. the bond) and an option that allows holders to convert the bond into the underlying entity's equity at a certain time or during a certain period of the bond's life (i.e. the conversion option). How the conversion option should be classified will depend on whether the convertible bond is a compound or a hybrid financial instrument.

HKAS 32 paragraph 29 explains that a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a "compound financial instrument" because it contains a component that creates a financial liability (i.e. a contractual obligation to deliver cash or another financial asset) to the entity and an equity instrument (i.e. a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity and thereby meeting the "fixed-for-fixed" criterion[1]). The relevant accounting guidance on a compound financial instrument is provided in HKAS 32 paragraphs 28 to 32 and AG30 to AG35.

Conversely, if the conversion option embedded in a convertible bond does not meet the "fixed-for-fixed" criterion (i.e. not an equity component) under HKAS 32, it would be treated as an embedded derivative and the convertible bond as a whole would be referred to as a "hybrid instrument" (see HKAS 39 paragraph 10). The accounting treatment of a hybrid instrument shall follow the relevant guidance provided in HKAS 39.

[1] A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash (in its functional currency) (HKAS 32 paragraph 22).

When a convertible bond is determined to contain a debt component and an embedded equity conversion feature (i.e. a compound instrument), the carrying amount of the debt component should be determined first by measuring the fair value of a similar liability that does not have an associated equity component (e.g. using a present value technique that discounts the contractual stream of future cash flows using the market interest rate that would apply to a comparable debt instrument with similar credit status and substantially the same cash flows but without the conversion feature). The equity component is assigned the residual amount, by deducting the amount calculated for the debt component from the fair value of the convertible bond as a whole (HKAS 32 paragraphs 32 and AG31(a)).

Conversely, when the conversion feature does not qualify for an equity classification, it should be classified as a derivative. The fair value of the embedded derivative feature would be determined first and the residual value is assigned to the debt component (HKAS 39 paragraph AG28).

The recognition and measurement of convertible instruments, particularly their valuation methodology and key assumptions used in measuring fair value of their individual components, very often catch our attention in our reviews.

In a set of financial statements reviewed, the reporting entity disclosed that it had issued three convertible notes ("CNs") in the year. The entire instrument of each of the CNs was considered as a hybrid instrument that comprised a "debt component" and a "derivative component". On initial recognition, the proceeds received from issuing the CNs were considered to be the same as the "fair values" of the entire CNs. The fair values of the derivative components were determined by using the binomial option pricing model. The excesses of the proceeds received over the amounts initially recognized for the derivative components were recognized as the fair values of the debt components. The effective interest rate ("EIR") derived for the debt components as disclosed in the financial statements ranged from 10% to 55%.

Given that the three CNs were issued in the same year, it was questionable as to why there were significant differences in respect of the EIR determined for each of the debt components, in particular, with one that was unusually high (i.e. 55%). The above indicated that the key assumptions used in measuring their fair values might not be appropriate. This begs the question of whether (i) the fair values of the embedded derivatives were properly determined, or (ii) the proceeds received actually reflected the fair values of the entire instruments, and thus there might be unidentifiable goods or services that could take the whole transactions within the scope of HKFRS 2 *Share-based Payment* and out of HKAS 39.

On the assumption that the transactions were in the scope of HKAS 39 not HKFRS 2, the critical issues should be on fair value measurement on which the following guidance should be relevant:

HKAS 39 paragraph 43 states that "*When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability*".

Paragraph 43A further states that "*However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph AG76*" (underline added).

Paragraph AG76 then continues to state that "*The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also HKFRS 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 43A, the entity shall account for that instrument at that date as follows: (a) at the measurement required by paragraph 43 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss. (b) in all other cases, at the measurement required by paragraph 43, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise the deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability*" (underline added).

Guidance on measuring fair value at initial recognition is also provided in HKFRS 13 *Fair Value Measurement* paragraph 64 which states that "*If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. Calibration ensures that the valuation technique reflects current market conditions, and it helps an entity to determine whether an adjustment to the valuation technique is necessary…..*" (underline added).

In the above case, consideration should have been given to the above guidance on fair value measurement before fixing the fair values of the CNs and each of their components at initial recognition.

In October 2016, the QAD published an article in the Institute's publication, A-Plus, on the application of HKAS 39 paragraphs 43, 43A and AG76 and HKFRS 13 paragraph 64 in accounting for rights to subscribe for convertible bonds when those rights fall within the scope of HKAS 39. Members may access the article through the following link:

http://aplusmagazine.realviewdigital.com/?iid=147813#folio=50

As disclosed in another set of financial statements, the reporting entity entered into an acquisition transaction to acquire the entire share capital of another entity during the year. The consideration was to be satisfied by way of issuance of three CNs within three years.

The first CN was issued in 2015 and was a compound instrument that contained a liability component and an equity component. The second and third CNs would be issued in 2016 and 2017 and were recognized as "deferred consideration" by the reporting entity in its 2015 financial statements.

In respect of the above CNs, their fair values measured at the date of the acquisition were significantly higher than their principal amounts and the differences were almost 80%. We again had significant concerns over the valuation methodology and key assumptions used by the reporting entity in arriving at the fair values. However, in the reporting entity's financial statements, there was no disclosure of the valuation methodology and key assumptions used in determining the CNs.

In respect of the 2016 and 2017 CNs, the reporting entity's consolidated statement of financial position showed that the carrying amounts of the "deferred consideration" were the same as the amounts that were initially recognized on the acquisition date. However, according to the reporting entity's accounting policy as disclosed in its financial statements, deferred consideration would be subsequently measured at amortised cost using the effective interest method. Therefore, the accounting for the deferred consideration does not appear to have followed the accounting policy.

The above case clearly illustrated that adequate disclosures of the accounting policy as well as the valuation technique and key assumptions used in the measurement are important for readers of financial statements to understand how a reporting entity had accounted for its financial instruments, particularly those complex financial instruments, and whether the accounting was in accordance with the entity's accounting policies and the relevant Standards.

b. Accounting for derivative instruments

Early redemption option

In addition to the debt component and the conversion option, a convertible bond may also contain other (non-equity) derivatives, such as options for either the issuer or the holder to opt for an early repayment. HKAS 32 paragraph 31 requires that "*The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component*" (underline added). It should however be noted that, those derivative features are further subject to the requirements of HKAS 39 applicable to embedded derivatives and therefore they would be accounted for separately if they are not considered to be closely related to the host contract (HKAS 39 paragraphs 11, 11A, 12 and AG30).

A set of financial statements disclosed that the reporting entity issued a convertible bond ("CB") during the year. The CB might be redeemed by the reporting entity at 105% of the outstanding principal amount at any time from the date of issue to the maturity date. The disclosure therefore suggested that the CB had an issuer's early redemption option. However, there was no information disclosed in the financial statements to explain how the reporting entity had accounted for such early redemption option in its financial statements. In response to our enquiry, the auditor explained that the management of the reporting entity allocated the initial carrying amount of the CB to its equity and liability components and the value of the early redemption option was included in the liability component according to HKAS 32 paragraph 31 but without specifying whether a further assessment was performed to support the conclusion that the issuer's redemption option had not needed to be accounted for separately from the liability component under HKAS 39.

Under HKAS 39, if there is more than one element in the liability component (after separating the other (non-equity) derivatives embedded in the compound financial instrument from the equity component), there is always a need to carry out a further assessment. This is to check whether the other elements (e.g. an early redemption option) are/are not closely related to the liability component of the CB, based on the requirements set out in HKAS 39, in order to consider whether those elements need to be accounted for separately.

Forward foreign currency exchange contracts

Another reporting entity disclosed in its financial statements that it had some outstanding forward foreign currency exchange contracts at the year end. Instead of recognizing those contracts in its financial statements at fair value, the reporting entity disclosed them as contingent liabilities.

As forward contracts are derivative instruments, they should be accounted for as derivatives at fair value through profit or loss in accordance with HKAS 39.

c. Impairment assessment of financial assets

HKAS 39 paragraph 58 requires that "*An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss*" (underline added).

HKAS 39 paragraph 59 then sets out the events, which, if they occur, would be considered as objective evidence of impairment of a financial asset or a group of financial assets. These events include significant financial difficulty of the issuer, a breach of the contract, probable bankruptcy of the borrower, disappearance of an active market and an observable decrease in estimated future cash flows from the asset. In addition, objective evidence of impairment for an investment in an equity instrument includes a significant or prolonged decline in its fair value below its cost (HKAS 39 paragraph 61). When any of the above events occurs, a detailed impairment assessment, as required by HKAS 39, should be carried out to determine the amount of impairment loss.

In one set of financial statements, we noted that the net assets of the reporting entity itself exceeded the consolidated net assets of its group. According to the response from the auditor to our enquiry, the investment costs of all subsidiaries were immaterial and the remainder of the interest was in the form of "amount due from subsidiaries". The shortfall indicated that the amounts due from subsidiaries at the holding company level might be impaired. The auditor also stated that management of the reporting entity had assessed the recoverable amount of the "amount due from subsidiaries" by comparing their estimated recoverable amounts with the "net liabilities" of the respective subsidiaries.

HKAS 39 paragraph 63 states that "*If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss*" (underline added).

Given the impairment assessment was performed on the "amount due from subsidiaries" (i.e. receivables), the reporting entity should apply HKAS 39 paragraph 63 to determine the amount of impairment to be recognized. It is obvious that comparing the estimated recoverable amounts of the holding company's receivables from its subsidiaries with the "net liabilities" of those subsidiaries was inappropriate and did not meet the above requirement.

Another reporting entity granted two significant entrusted loans to two companies established in Mainland China. The financial statements disclosed that the entrusted loans were lent to the two companies through a lending agent (a commercial bank in Mainland China) in the previous year. Following on from their failure to settle the agreed principals and related interest of the above entrusted loans, the two companies filed for voluntary bankruptcy at the District Court in their respective provinces. However, no impairment loss was recognized by the reporting entity in respect of the entrusted loan receivables despite the filing of bankruptcy notices by the two companies.

We would like to remind members that when objective evidence of impairment exists, a detailed impairment assessment should be performed to determine whether an impairment loss is required to be recognized. Furthermore, sufficient details should be provided about management's judgments on how the impairment assessment was performed and what facts and circumstances management had taken into account, particularly for individually significant items e.g. the significant entrusted loan receivables mentioned above, as required by HKFRS 7 paragraph 37(b).

d. Transaction costs (listing expenses)

For many years, Hong Kong as an international financial centre has attracted companies from around the world to raise funds through initial public offerings ("IPOs"). In an IPO exercise, it is inevitable that different types of expenses e.g. underwriting fees and listing fees will be incurred. How should these expenses be accounted for in the financial statements? HKAS 32 paragraph 37 states that "*The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided*[2]*. The costs of an equity transaction that is abandoned are recognised as an expense*".

HKAS 32 paragraph 38 also explains that "*Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions*".

[2] See also IFRIC Update – September 2008: IAS 32 Financial Instruments: Presentation - Transaction costs to be deducted from equity

Instances were identified in our financial statement reviews where some reporting entities did not appropriately account for listing expenses according to their nature. One reporting entity had listed on the Hong Kong Stock Exchange through issuing new shares after its reorganization and had recognized all its listing expenses (which were material) in its income statement without any deductions from equity in respect of the incremental transaction costs directly attributable to the issue of the new shares in the IPO. Given there was also no disclosure of an accounting policy for listing expenses in the reporting entity's financial statements, we questioned whether the accounting treatment of listing expenses complied with the relevant requirements of HKAS 32.

To assist preparers and auditors to distinguish the nature of listing expenses and how to account for the IPO costs incurred during the IPO process, the Institute issued a technical update in June 2014 detailing the background of the issue and relevant accounting treatments compliant with HKAS 32. Members may access the technical update through the link below:

http://app1.hkicpa.org.hk/APLUS/2014/06/pdf/46_Techupdate.pdf

2. HKAS 36 *Impairment of Assets*

HKAS 36 requires an annual impairment test on (i) goodwill acquired in a business combination, (ii) an intangible asset with an indefinite useful life; and (iii) an intangible asset not yet available for use. HKAS 36 also requires an impairment test on any non-financial assets where there is an indicator of impairment. The principle of HKAS 36 is that an asset should not be carried at more than its recoverable amount in the statement of financial position.

Asset impairment is a factor that many entities will address in preparing their financial statements. Various issues were identified with impairment tests performed by entities.

a. A reporting entity allocated goodwill acquired through a business combination to a cash generating unit ("CGU") which essentially represented an operating segment of the reporting entity (i.e. a retail business). In respect of the estimates used to measure the recoverable amount of the CGU containing goodwill, the reporting entity disclosed that the cash flows beyond the five-year period were extrapolated using an estimated growth rate of 8% (prior year: 3%). However, according to the segment disclosure, the revenue from the operating segment to which goodwill was allocated had decreased significantly over the year.

   The above case raised two issues: firstly, the reporting entity should have provided a valid reason to justify the adoption of a higher growth rate in the current year as compared to last year in estimating the cash flows beyond the five-year period.

HKAS 36 paragraph 33 requires that "*In measuring value in use an entity shall:…..(c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified*" (underline added).

Secondly, the reporting entity should also have justified the lack of an impairment charge despite there being significant deterioration in the performance of the segment. In its response to our enquiry, the auditor clarified that the reporting entity had applied a higher growth rate (i.e. 8%) only to estimate the cash flows for the first five years but the same growth rate of 3% (instead of 8%) as the prior year to the cash flows beyond the first five years. The response further explained that the reporting entity expected that the future increase in retail sales in the first five years would be achieved by adopting a new business strategy to expand market coverage by opening a number of new small retail shops in Mainland China each year in addition to selling its products through flagship stores.

HKAS 36 paragraph 44 states that "*Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from: (a) a future restructuring to which an entity is not yet committed; or (b) improving or enhancing the asset's performance*" (underline added).

HKAS 36 paragraph 46 also states that "*A restructuring is a programme that is planned and controlled by management and materially changes either the scope of the business undertaken by an entity or the manner in which the business is conducted*" (underline added).

The auditor's response appears to suggest that the reporting entity had taken into account future cash flows that were expected to be generated from the new small retail shops that would open in future. However, it was unclear whether the business strategy to expand the sales business by opening new smaller retail shops was in fact (i) a future restructuring under HKAS 36 paragraphs 44(a) and 46 (e.g. a future restructuring that was not yet committed and such restructuring was considered as a material change in the manner in which the retail business was conducted) or (ii) an improvement or enhancement of the CGU's performance under HKAS 36 paragraph 44(b). Further enquiries were therefore raised to ask the auditor to provide explanation to respond to the above matters.

A point to note is that as explained in HKAS 36 paragraph 37, "*[w]hen conditions are favourable, competitors are likely to enter the market and restrict growth. Therefore, entities will have difficulty in exceeding the average historical growth rate over the long term (say, twenty years) for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used*" (underline added). This means that, no matter how good the market strategy is, it will be hard for the entity to outperform the market. Accordingly, HKAS 36 paragraph 33 requires that the growth rate to be used to extrapolate the future cash flow projections that are covered by the financial budgets/forecasts shall not exceed the long-term average growth rate for the products, industries, or country in which the entity operates or for the market in which the asset is used, unless a higher rate can be justified.

b. Another reporting entity disclosed that in carrying out an impairment test on the goodwill arising from a business combination, the management measured the value in use by estimating the future cash flows of the respective CGU to which goodwill had been allocated. However, in the auditor's response, it was pointed out that the management had estimated the future cash flows on the assumption that some fund raising activities would take place to enable the Group to achieve better performance in its capital market operations and that the related economic benefits and cash flows from the fund raising would flow to the CGU as part of its future cash flows. This again showed that the impairment assessment had not followed the requirements of HKAS 36.

   HKAS 36 paragraph 31 states that "*Estimating the value in use of an asset involves the following steps: (a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal*....." (underline added).

   Paragraph 50 further states that "*Estimates of future cash flows shall not include: (a) cash inflows or outflows from financing activities; or (b) income tax receipts or payments*" (underline added). In the above case, since the fund raising activities were types of financing activities, they should not have been included in estimating future cash flows of the CGU.

c. Another set of financial statements reviewed showed that the reporting entity performed an impairment test on the carrying amount of its interest in a joint venture. The joint venture mainly held some hotel properties in Mainland China. The discount rate used by the reporting entity in the impairment assessment included a country risk premium representing an additional risk premium for investing in Hong Kong. Given the hotel properties were located in Mainland China and that the economic environment and regulatory systems in Mainland China and Hong Kong are different, the country risk premium for Mainland China rather than for Hong Kong should have been used in the assessment. However, no reason was provided by the auditor in its response to justify the use of the country risk premium for Hong Kong. Members are reminded that the assumptions used in the impairment assessment (such as the discount rate in the above case) should be based on facts and circumstances that are relevant and specific to the assets. Auditors should also bear in mind that, although management might have performed an impairment assessment, they should still perform adequate work to assess whether the assumptions used by management are reasonable and supportable before placing reliance on the management assessment as audit evidence.

3. HKFRS 3 (Revised) *Business Combinations*

In accounting for a business combination using the acquisition method, one shall identify the acquirer, determine the acquisition date, measure and recognize the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree and measure and recognize goodwill or a gain from a bargain purchase as required under HKFRS 3 (Revised) paragraph 5. In our 2016 reviews, we came across instances such as the following that resulted in us raising enquiries to check whether the requirements of HKFRS 3 (Revised) had been complied with:

a. Identification of intangible assets

A reporting entity acquired the entire shareholding of another entity ("acquiree") from an independent third party during the year. The acquiree was mainly engaged in research, production and sales of intelligent home electronic equipment and was the holder of a number of registered patents for such electronic equipment. However, the reporting entity did not recognize any intangible assets in respect of the acquiree's ownership of the patents in the above acquisition.

HKFRS 3 (Revised) paragraph 10 requires that "*As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree*" (underlined added). HKFRS 3 (Revised) paragraph 13 expands on this by saying, "*…the acquirer recognises the acquired identifiable intangible assets, such as a brand name, a patent or a customer relationship, that the acquiree did not recognise .....*" (underline added).

b. Step acquisition of a joint venture

Another set of financial statements reviewed showed an issue related to a step acquisition of a joint venture. The reporting entity acquired the remaining 50% equity interests in a joint venture such that the joint venture became its wholly owned subsidiary during the year. The reporting entity treated the acquisition as an "asset acquisition" instead of a "business combination" given that the joint venture did not constitute a business at the acquisition date.

Although the acquisition transaction was treated by the reporting entity as an "asset acquisition", it recognized a significant fair value gain in its profit or loss. As disclosed in its financial statements, the gain resulted from a remeasurement of the reporting entity's previously held 50% interest in the joint venture by reference to HKFRS 3 (Revised) paragraphs 41 and 42, which provide guidance on the accounting for a business combination achieved in stages.

HKFRS 3 (Revised) paragraph 42 states that "*In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss*".

Given that the reporting entity had clearly disclosed that the above joint venture did not constitute a business and that the transaction was treated as an "asset acquisition", HKFRS 3 (Revised) paragraph 42 was not applicable to the reporting entity's situation. HKFRS 3 (Revised) paragraph 2(b) specifically states that HKFRS 3 (Revised) does not apply to the acquisition of an asset or a group of assets that does not constitute a business and a cost approach should be applied instead. Under a cost approach, an acquirer does not remeasure its ownership interest in the assets it acquires.

c. Recognition of goodwill

Another reporting entity disclosed in its financial statements that it had acquired a controlling interest in a company ("acquiree"). The acquiree's principal asset was an interest in an associate. The financial statements included a note to show the respective fair values of the individual identifiable assets and liabilities of the acquiree at the acquisition date. This suggested that the reporting entity had accounted for the acquisition as a business combination under HKFRS 3 (Revised) paragraph 18 no goodwill was recognized from the above acquisition as the net identifiable assets acquired were attributed the same fair value as the consideration given by the reporting entity. However, it was further noted from the disclosure note on the associate that the carrying amount of that associate included an amount of goodwill.

In response to our enquiry on the accounting treatment of the acquisition, the auditor clarified that the reporting entity had accounted for the transaction as an asset acquisition (not a business combination) and explained how the goodwill included within the carrying amount of the associate was derived.

Purely from reading the disclosures provided in the financial statements, readers might be confused about whether the transaction was accounted for as a business combination or an asset acquisition as well as how the goodwill was derived. We therefore consider it important for the reporting entity to provide appropriate disclosures about the nature and accounting treatment of the transaction in its financial statements to avoid confusion to readers.

d. Bargain purchase gain

A further set of financial statements reviewed disclosed that the reporting entity group had acquired the entire equity interest of a company ("acquiree"). The total fair value of the acquiree's net identifiable assets acquired and liabilities assumed at the date of the acquisition was twice the amount of the cash consideration paid. A significant bargain purchase gain had been recognized.

The reporting entity only disclosed in its financial statements that the significant bargain purchase gain arose because the fair value of the identifiable net assets acquired exceeded the purchase consideration. This disclosure only described how the bargain purchase gain was calculated. It did not specify the circumstance(s) that led to the transaction resulting in the significant bargain gain for the acquirer as required by HKFRS 3 (Revised) paragraph B64(n)(ii). Given the lack of proper disclosure, there were also concerns over whether the reporting entity had properly carried out the steps specified under HKFRS 3 (Revised) paragraph 36 (see below) before recognizing the bargain purchase gain.

HKFRS 3 (Revised) paragraph 36 states that "*Before recognising a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognise any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts this HKFRS requires to be recognised at the acquisition date for all of the following: (a) the identifiable assets acquired and liabilities assumed; (b) the non-controlling interest in the acquiree, if any; (c) for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree; and (d) the consideration transferred*".

Section II – Common or significant findings on other HKFRSs

1. HKAS 12 *Income Taxes*

HKAS 12 sets out specific requirements relating to when deferred tax assets and deferred tax liabilities should be recognized. In our 2016 reviews, we identified instances where reporting entities did not carry out a proper assessment of whether a deferred tax liability/asset should be recognized.

a. Land appreciation tax

Land appreciation tax ("LAT") is levied on income derived from a transfer of state-owned land use rights, buildings and their attached facilities. LAT is determined at a prescribed tax rate on the basis of the appreciation amount derived from the transfer of a real estate. For example, in Mainland China, LAT is imposed at a progressive rate on a gain on disposal of land use rights and the buildings and their attached facilities (collectively "Properties"). Generally, a deferred tax liability is recognized on the appreciated value of the Properties located in countries where taxpayers, either entities or individuals, are subject to LAT.

A set of financial statements reviewed showed that the reporting entity recognized a significant amount of LAT deferred tax expense in respect of its investment properties located in Mainland China. The investment properties were measured at fair value at the year end. The reporting entity disclosed that its management had determined that the investment properties located in Mainland China were held under a business model whose objective was to consume substantially all of the economic benefits embodied in the investment properties over time, rather than through sale. Based on management's intended use of the investment properties (i.e. through use rather than through

sale), management determined that the presumption under HKAS 12 paragraph 51C that the carrying amount of investment properties measured at fair value would be recovered through sale was rebutted.

Given LAT is a tax imposed on the appreciated value arising from the transfer of a property, recognizing a LAT deferred tax liability on the fair value gains of these Mainland China Properties while management had concluded that under its business model those Properties were held for use rather than sale, does not appear to be reasonable. Careful consideration would be needed to decide whether a deferred tax provision based on LAT is appropriate or necessary when the investment properties concerned are not intended to be recovered through sale.

Another instance concerned a reversal of the provision for LAT. A reporting entity disclosed in its financial statements that a significant amount of over-provision for LAT had been reversed and was included in the numerical reconciliation of income tax expenses in the current period. However, there was no further information provided in the financial statements in relation to the reversal.

The reversal of the over-provision for LAT was recognized as a reduction of the current year's income tax expenses without restating the prior period's tax provision. This suggested that the reporting entity had treated such reversal as a change in accounting estimates rather than a correction of an error under HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. No further information was disclosed in the financial statements to explain what changes in circumstances had occurred in the current year such that it was appropriate to account for the reversal of over-provision as a change in accounting estimates.

Members are reminded that it is important to provide sufficient information in the financial statements on critical accounting judgements that management made and on key sources of estimation uncertainty. Without sufficient information e.g. nature and circumstances that caused the significant reversal of the LAT provision, readers could not understand why the management made such a reversal and whether the reversal was appropriate.

b. Undistributed profits of subsidiaries

Another reporting entity disclosed in its financial statements that its directors determined that its group was able to control the timing of reversal of the temporary differences relating to the undistributed profits of its Mainland China subsidiaries and it was probable that such temporary differences would not be reversed in the foreseeable future. Accordingly, the group took advantage of the provision set out in HKAS 12 paragraph 39 and did not recognize any deferred tax liabilities in respect of those undistributed profits. However, we observed from the tax disclosure footnote that the reporting entity had recognized some withholding income tax expenses due to the distribution of dividends by its Mainland China subsidiaries, which seemed inconsistent with management's assertion that the temporary differences would not be reversed in the foreseeable future.

In another case, the financial statements showed that the reporting entity group had retained earnings at the year end whereas the reporting entity at the company level had accumulated losses. This suggested that there were undistributed profits held by the subsidiaries and/or associates of the reporting entity at the year end. Nevertheless, no deferred tax was recognized by the reporting entity in respect of the undistributed profits of its subsidiaries and associates at the year end at the group level.

In the above circumstance, even if no deferred tax needed to be recognized, the aggregate amount of temporary differences associated with investments in subsidiaries and/or associates for which deferred tax liabilities had not been recognized should still be disclosed as required by HKAS 12 paragraph 81(f).

In another case reviewed, the principal places of business of the subsidiaries of the reporting entity included various countries around the world. Given the subsidiaries operated in different jurisdictions, some of them might fall into the circumstances as described in HKAS 12 paragraph 52A.

HKAS 12 paragraph 52A states that "*In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In some other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the entity. In these circumstances, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits*".

Careful consideration and assessment should be performed by management to determine whether and, if so, the amount of deferred taxes should be recognized by the reporting entity in respect of the undistributed profits held by its subsidiaries, particularly if some of them fall into the circumstance(s) set out in HKAS 12 paragraph 52A.

Furthermore, as required by HKAS 12 paragraph 82A, information such as the nature of the potential income tax consequences that would result from a payment of dividends to shareholders should be disclosed in the financial statements if the reporting entity fell into the circumstance(s) described in HKAS 12 paragraph 52A.

Section III – Common disclosure deficiencies

In our 2016 reviews, we continued to identify a number of disclosure deficiencies which have been identified in previous years' reviews. Members are reminded that providing sufficient and clear disclosures is fundamental to a true and fair presentation of the financial statements. This year, we will focus on the disclosure deficiencies that were more frequently identified in our reviews:

1. HKFRS 2 *Share-based Payment*

   The following disclosures were often omitted:

   - information regarding the number of options outstanding at the beginning and end of the period, number of options that were exercised/forfeited/expired during the period (HKFRS 2 paragraph 45); and

   - the significant judgment and key assumptions that the management applied in determining the fair value of the goods or services received or the fair value of the equity instruments granted (HKFRS 2 paragraphs 44 & 46, HKAS 1 (Revised) paragraphs 122 & 125).

2. HKFRS 3 (Revised) *Business Combinations*

   The following disclosures were often incomplete or omitted:

   - information about the nature and financial effect of a business combination (i.e. the information specified in HKFRS 3 paragraph B64 e.g. the acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration) that occurs after the end of the reporting period but before the financial statements are authorized for issue (HKFRS 3 (Revised) paragraph B66);

   - the amount of acquisition-related costs and, separately, the amount of those costs recognized as an expense and the line item or items in the statement of comprehensive income in which those expenses are recognized (HKFRS 3 (Revised) paragraph B64(m));

   - qualitative description of the factors that make up the goodwill recognized (HKFRS 3 (Revised) paragraph B64(e)); and

   - a description of the reasons why the transaction resulted in a bargain purchase gain (HKFRS 3 (Revised) paragraph B64(n)(ii)).

3. HKFRS 7 *Financial Instruments: Disclosures*

The following disclosures were often missing or incomplete:

- information of each type of risk arising from financial instruments specified under paragraphs 33 and 34;
- a sensitivity analysis of each type of market risk (e.g. interest rate risk and other price risk) to which the entity is exposed at the end of the reporting period (HKFRS 7 paragraph 40(a));
- a maturity analysis of the financial guarantee contracts (HKFRS 7 paragraph 39(a));
- an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired (HKFRS 7 paragraph 37(b)); and
- information (e.g. the fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognized financial assets and the undiscounted cash outflows that would or may be required to repurchase derecognized financial assets) when an entity derecognizes transferred financial assets in their entirety but has continuing involvement in them (HKFRS 7 paragraph 42E).

There were instances that when making the disclosure of the other price risk arising from financial instruments as required by HKFRS 7 paragraphs 33 and 34, reporting entities omitted to disclose the equity price risk arising from financial instruments that they held, particularly those measured at fair value through profit or loss as required by the Standard. In some cases they disclosed the risk of fluctuation of prices of the non-financial products that they sold (which is not a disclosure required by HKFRS 7).

There were also instances where some reporting entities, in providing the maturity analysis of their financial liabilities, disclosed the carrying amounts of the financial liabilities. HKFRS 7 paragraph B11D requires the contractual undiscounted cash flows to be disclosed. Disclosing amounts which are the same as the carrying amounts indicates that there were errors in the disclosure.

4. HKFRS 8 *Operating Segments*

   The following disclosures were often omitted:

   - the judgements made by management in applying aggregation criteria as required by the amendments to HKFRS 8 paragraph 22(aa) when the Group had aggregated the operating segments;
   - a measure of profit or loss for each reportable segment; and a measure of total assets and liabilities for each reportable segment if such amounts are regularly provided to the chief operating decision maker (HKFRS 8 paragraph 23);
   - information required under HKFRS 8 paragraph 23 e.g. interest revenue, depreciation and amortization, income tax expense; and
   - the entity-wide information e.g. entity's products and services, geographical areas and major customers (HKFRS 8 paragraphs 31 to 34).

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

   The following disclosures were often omitted:

   - a summarised financial information of each joint venture and associate that is material to the reporting entity (HKFRS 12 paragraph 21(b)(ii));
   - the total commitments that had been made jointly with other investors in relation to the entity's interests in joint ventures (HKFRS 12 paragraphs 23(a) & B18); and
   - the relationship with each of the joint arrangements that is material to the reporting entity by e.g. describing the nature of the activities of the joint arrangement (HKFRS 12 paragraph 21(a)(ii)).

6. HKFRS 13 *Fair Value Measurement*

   The following disclosures were often omitted:

   - information as required by HKFRS 13 paragraph 93 e.g.:
     - the fair value measurement at the end of the reporting period;
     - the level of the fair value hierarchy within which the fair value measurements are categorised in their entirety;
     - a description of the valuation technique and the inputs used, if there has been a change in valuation technique, a description of the change and the reason(s) for making it;
     - 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;
     - a description of the valuation processes used (e.g. how an entity decides its valuation policies and procedures); and
   - the level of the fair value hierarchy within which the fair value measurement of the asset or liability is categorized (HKFRS 13 paragraph 94(b)).

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

   The following disclosures were often omitted:

   - the name of the parent and the ultimate parent of the group (HKAS 1 (Revised) paragraph 138(c));
   - information of the nature and carrying amount of the relevant assets and liabilities at the end of the reporting period for significant assumptions and estimates (HKAS 1 (Revised) paragraph 125);
   - the analysis on each component of equity that an entity present (HKAS 1 (Revised) paragraph 106(d));
   - the accounting policy for significant account balances e.g. convertible bonds issued during the year (HKAS 1 (Revised) paragraph 117); and
   - the amount expected to be recovered or settled after more than twelve months for each asset and liability (e.g. retention receivable and properties under development) (HKAS 1 (Revised) paragraph 61).

We encourage reporting entities to provide additional information for significant matters or account balances (e.g. significant prepayments, other receivables and other payables) presented in the financial statements. As required by HKAS 1 (Revised) paragraph 17(c), an entity shall provide additional disclosures when compliance with the specific requirements in HKFRS is insufficient to enable users to understand the impact of particular transactions. HKAS 1 (Revised) paragraph 112(c) also requires an entity to provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

8. HKAS 12 *Income Taxes*

   The following disclosures were often omitted:

   - the amount of deductible temporary differences and the expiry date of unused tax losses for which no deferred tax asset is recognized in the statement of financial position (HKAS 12 paragraph 81(e)); and

   - information about tax-related contingent liabilities including those from unresolved disputes with taxation authorities (HKAS 12 paragraph 88).

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

   The following disclosures were often omitted:

   - the functional currency of the reporting entity and whether the presentation currency is different from the functional currency (HKAS 21 paragraph 53); and

   - information about how a reporting entity determined its functional currency, especially when a substantial portion of its transactions were denominated in foreign currencies (HKAS 21 paragraphs 9 to11).

10. HKAS 36 *Impairment of Assets*

    The following disclosures were often incomplete:

    - information about the carrying amount of goodwill allocated to the unit (group of units) (HKAS 36 paragraph 134(a)) and the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts. The justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated as required by paragraph 134(d)(iv);

    - information specified in HKAS 36 paragraph 134(d) e.g. each key assumption on which management has based its cash flow projections and a description of management's approach to determining the value(s) assigned to each key assumption; and

    - the recoverable amount of the assets for which impairment loss has been recognized (HKAS 36 paragraph 130(e)).

Communication with members

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

- The QAD hosted two forums, one in June and one in September 2016, which drew a combined total of around 500 attendees. The forums covered common findings from practice reviews and recommended actions that could be taken by practices to enhance audit quality. A webcast of the forum has been available on the Institute's website from January 2017.

- The Director of the QAD ("the DQA") was invited by the Society of Chinese Accountants and Auditors to present in a seminar in October 2016 on the same topics covered in the Quality Assurance Forum. The seminar attracted over 200 attendees.

- On 22 November 2016, the QAD held a joint financial reporting forum with the FRC and HKEX which drew approximately 310 attendees. The representatives of the three bodies shared common or significant observations identified from reviews of financial statements of listed companies. A webcast of the forum has been available on the Institute's website from January 2017.

- The DQA participated in the practice review session of the 2016 SMP Symposium in November 2016 which attracted 350 attendees.

- The QAD issued a number of publications including an annual report, alerts and articles in the Institute's magazine, A-Plus. The publications covered topics such as key issues identified from practice reviews; tips for a smooth practice review; guidelines for IES 8; new elements in the practice review selection process; and accounting for rights to subscribe for convertible bonds.

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 2016

Name	Position	Company
Ms. BROWN, Melissa	Chairman	Daobridge Capital
Ms. CHUNG, Lai Ling, Ada	Member	Companies Registry, HKSAR
Mr. DUIGNAN, Michael (Appointed 10 March 2016)	Member	Securities & Futures Commission
Mr. KENNEDY, Paul	Member	Hong Kong Exchanges and Clearing Limited
Mr. LAW, Cheuk Kin, Stephen	Member	
Mr. LAW, Fu Yuen, Patrick (Appointed 1 February 2016)	Member	Ernst & Young
Mr. LEUNG, Hing Kuen, Alec (Appointed 1 February 2016)	Member	The Treasury, HKSAR
Mr. TEO, Wing On	Member	Audit Commission, HKSAR

Members of the Practice Review Committee in 2016

Name	Position	Company
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Miss CHAN, Mei Bo, Mabel	Deputy Chairman	Grant Thornton Hong Kong Limited
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	Member	Ernst & Young
Mr. LAI, Tak Shing, Jonathan	Member	HLB Hodgson Impey Cheng
Mr. LIU, Eugene	Member	RSM Hong Kong / RSM Nelson Wheeler
Miss NG, Shun Yin (Appointed 1 February 2016)	Member	KPMG
Mr. OR, Ming Chiu	Member	Mazars CPA Limited
Miss TANG, Kwan Lai, Amingo	Member	SHINEWING (HK) CPA Limited
Mr. TSUI, Hon Man	Member	Crowe Horwath (HK) CPA Limited
Mr. WONG, Ho Yuen, Gary (Appointed 1 February 2016)	Member	Confucius International 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 2016

Name	Position	Company
Ms. CHEUNG, Sau Ying, Olivia	Member	Hong Kong Exchanges and Clearing Limited
Mr. DEALY, Nigel Derrick	Member	PricewaterhouseCoopers
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Miss HSIANG, Yuet Ming, Fanny	Member	BDO Limited
Mr. KWONG, Kam Wing, Kelvin (Appointed 1 February 2016)	Member	Grant Thornton
Mr. LAI, Tak Shing, Jonathan	Member	HLB Hodgson Impey Cheng
Mrs. MORLEY, Catherine Susanna	Member	KPMG
Mr. PANG, Wai Hang, Arthur	Member	SHINEWING (HK) CPA Limited
Mr. STEVENSON, Gary (Appointed 1 February 2016)	Member	RSM Hong Kong
Mr. TAYLOR, Stephen	Member	Deloitte Touche Tohmatsu

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

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