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

Quality Assurance Department

Activities Report 2008

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Introduction

The Quality Assurance Department ("QAD") of the Institute is responsible for ensuring practising members of the Institute observe, maintain and apply professional standards such that the quality of their work is maintained or enhanced. Its main functions are to conduct reviews of quality control systems and assurance engagements of practices ("Practice Review") and to review audited financial statements of listed companies ("Professional Standards Monitoring").

This is a report on the 2008 activities carried out under the programmes of Practice Review and Professional Standards Monitoring and also addresses what the Institute and QAD are doing in the further development of quality assurance and audit regulation. In addition, the report provides a summary of common issues and educational points that have been identified in the course of QAD activities which have been communicated to members throughout the year by way of articles, circulars and forums.

Both programmes are on-going and will remain a critical part of the Institute's role to support members and serve the wider public interest of Hong Kong by ensuring that the quality of auditing and financial reporting is maintained and enhanced.

The period covered by this report is from January 2008 to December 2008.

Part I – Practice Review Programme

1. Introduction

1.1 The Institute has operated a programme of Practice Review since 1992 with the objective of enhancing the quality of work of Institute members engaged in audit and related assurance activities. In 2006, a revised programme was launched that took into account international developments in professional standards and auditor regulation.

1.2 The Practice Review programme is kept under constant review to ensure that it addresses the Institute's statutory responsibilities and is comparable to auditor monitoring programmes in other major jurisdictions.

2. Role of the Practice Review Committee ("PRC") and Practice Review Oversight Board ("PROB")

2.1 The PRC is a committee of the Institute with responsibility to Council for exercising the statutory powers and duties given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the Professional Accountants Ordinance. The PRC is therefore a crucial element in enabling the Institute to operate a robust but fair system of auditor regulation that meets the expectations of local and international stakeholders.

2.2 The membership of the PRC is made up primarily of practising members (by law at least two thirds of the committee must hold practising certificates). The inclusion of non-practising members demonstrates the Institute's commitment to ensuring the impartiality of committee decisions on the quality of work carried out by firms subject to Practice Review. The practising members of the committee are drawn from the full spectrum of audit firms, representing small practices through to the Big Four firms. Please refer to Annex for the composition of the PRC.

2.3 The activities and operations of the PRC are subject to scrutiny by Council and the PROB. The PROB was established in 2005 to introduce a further level of independent oversight in the Institute's Practice Review programme.

2.4 The Institute recognizes that the successful operation of the Practice Review programme requires the participation of a number of member and non-member volunteers on the PRC and the PROB. The Institute is most grateful for the contributions of time and experience that have been received.

2.5 From January 2009, the function and role of the PROB has been taken over by the Standards & Quality Accountability Board ("SQAB"). The SQAB has been created

as part of the overhaul of the Institute's governance and operational structure and will ensure that QAD activities are being carried out in accordance with strategies and policies determined by Council and in the public interest.

3. The Practice Review Team

3.1 The Institute has built up a QAD team of nine reviewers by the end of 2008.

3.2 The team members all have a strong audit background and have been engaged in learning and development activities to keep them up to date with professional standards and to enhance their skills in dealing with practices in a fair and sensitive manner.

4. Practice Review Activities

The review process

4.1 The general outline of the review process has been well publicized. Depending on the size of the practices and the types of engagements being selected for review, the period of time for site visit can vary from one or two days to several weeks. To facilitate the efficient use of QAD resources, practices are reminded that the information requested in the notification letter and a full client list should be made available to reviewers two weeks before the commencement of the Practice Review visit.

4.2 Practices selected for Practice Review visits are normally advised of the proposed visit date several weeks in advance. QAD received many requests asking for the change of the site visit date especially timing around tax deadlines. The Institute and QAD understand the pressure on practices around tax deadlines every year and will try to accommodate requests for changes to visit dates. However, the Practice Review team will not be able to set aside significant periods of time during the year when no on-site review activities are taking place.

4.3 At a high level the scope of each review includes:

(a) Obtaining an understanding of the practice's system of quality control;

(b) Assessing the effectiveness of the system of quality control in achieving compliance with HKSQC 1; and

(c) Assessing compliance with professional standards in the operation of quality control policies and procedures and the conduct of audit work.

4.4 The detail and extent of review work that reviewers will need to carry out varies from practice to practice depending on a number of factors including the size of the practice and the nature of the client base. However, the work typically carried out during the site visit, will include:

(a) Interviewing different levels of personnel to assess the practice's culture and commitment to quality;

(b) Reviewing the documented quality control procedures and checking how they are applied in practice;

(c) Reviewing audit methodology and procedures to ensure they are up to date and include reference to current professional standards and relevant application guidance for staff;

(d) Reviewing selected engagement files to evaluate the application of audit procedures, the design and selection of audit work in response to assessed risk, the basis for key audit judgments and conclusions, and the adequacy of audit evidence and documentation;

(e) Communication of QAD findings to the practice; and

(f) Providing practical advice to the practice on possible improvements in efficiency of the audit process and to address weaknesses that have been identified by the reviewers.

4.5 To fully understand the quality control system and the audit work of the practice, reviewers have to enquire and discuss findings with the practice in respect of matters identified through the course of the review. Practices are encouraged to try and make sure that issues are addressed and questions responded to as fully as possible at the point that they are raised by the reviewers. This does help reviewers refine their findings as reviewers work through the review process and ensures that the exit meeting is more a formal presentation of the significant matters, which have already been discussed in detail during the course of the review.

4.6 After the exit meeting, QAD sends each practice a draft report that communicates the findings and conclusion of the review. At this stage, the practice is asked to provide a formal written response to the matters raised in the draft report. QAD is responsible for making recommendations to the PRC for consideration. The PRC sends each practice a formal notification of its decision that may include specific request to ensure that appropriate steps are taken by the practice to address weaknesses and shortcomings that have been identified by the review.

4.7 One of the key messages delivered with the roll out of the revised Practice Review programme is that recommendations are intended to be constructive and relevant and assist practices take appropriate actions to rectify any weaknesses identified. To achieve this objective, QAD gives thorough consideration to the practice responses to review findings and provide recommendations to the PRC that are relevant and appropriate to the issues identified and consistent where there are common features.

4.8 It was noted that all of the recommendations in the PRC decision letters have been acknowledged and are being implemented by practices which were subject to Practice Review in 2008. In addition, feedback so far has been very positive from all practices as well as the PRC. It is pleasing to see that practices and members recognize that Practice Review is a constructive and helpful exercise as well as a necessary regulatory function.

Practice review cases

4.9 The Institute's records show that at 31 December 2008, there were approximately 3,250 registered practice units comprising 1,200 firms, 250 corporate practices and 1,800 practising certificate holders practising in his or her own name. Of the total number of practice units eligible to act as auditors information we obtained through the electronic self-assessment questionnaire identified 696 not actively engaged in audit work and a further 648 with five or less audit clients.

4.10 In 2008, the Practice Review programme progressed at an excellent pace. QAD carried out 82 Practice Reviews including reviews of all of the Big Four, 54 other practices that audit listed and other public interest entities and a number of other small and medium sized practices.

4.11 During the year, the PRC held 9 meetings and reviewed 69 Practice Review reports. In 23 cases, the PRC had concluded that the cases should be closed. In 40 cases the practices were required to submit a status report to QAD on the actions taken in response to the findings within a requested period of time. In 6 cases the PRC decided to schedule a follow up visit to the practices to assess the effectiveness of the remedial action taken by the practices. The first follow up visit to a practice that was first reviewed in early 2007 took place in December 2008. Evidence of significant improvement was noted and the PRC concluded that the review was completed.

4.12 None of the reviews that took place in 2008 were pursued with disciplinary action. This was in line with the PRC's intention to give practices time to improve on identified weaknesses in procedures and conduct of audit work except in the most serious cases. Disciplinary actions will be a "last resort" rightly reserved for those practices that have "serious" Practice Review findings of non-compliance with professional standards or "serious" levels of incompetence.

4.13 Big Four reviews

The Big Four firms are subject to Practice Review on an annual basis. This recognizes the predominance of listed and other public interest entities in the client portfolios of these firms. The focus and extent of the work undertaken during the Big Four reviews is agreed annually by the PRC.

4.14 Reviews of practices with listed clients

Practices with listed companies will be subject to review at least every three years. As for the Big Four firms this recognizes the public interest that exists in relation to listed entities and is in line with international best practice.

4.15 Reviews of other practices

The information provided in the electronic questionnaires submitted by practices is used to assist in the risk based selection of other practices for review. Practices with other public interest clients are always given priority for site visit reviews. A number of practices are selected for site visit reviews on a random basis to ensure that all practices will have a reasonable chance of being selected.

Electronic self-assessment questionnaire ("EQS")

4.16 The first electronic questionnaire was rolled out in 2007. The questionnaire was made available to approximately 3,000 practices in two batches from August 2007 and December 2007 respectively. By the submission deadlines of 14 December 2007 and 31 March 2008, only about 100 practices failed to complete the questionnaire or file a declaration that they no longer audit. By mid of 2008, all practices had completed and submitted the EQS. This is an excellent result and reflects Institute members' professionalism and commitment.

4.17 The preparation of the revised version of the questionnaire is underway and targeted to go to all practices for online completion and submission in the second half of 2009. QAD received a good deal of feedback on the content and format of the EQS that has been taken into account in the development of a simpler and shorter questionnaire, aiming to make the task of completing it as straightforward as possible. Before this stage is reached there will be further communication and discussion with practices and their representative groups to ensure that all ideas are properly considered in the development of the revised EQS.

Communications

4.18 The Institute has endeavoured to keep members informed about progress of the Practice Review programme and is confident that the initiatives set out below have enhanced the transparency of the process and proved valuable feedback to members. The Institute is committed to keeping members up to date with the principles of the review programme.

The actions that have been taken in this respect included:

(a) An article by the Director, Quality Assurance in APlus advising the progress made with the Practice Review programme in early 2008.

(b) An article by the Director, Quality Assurance in the e-circular addressing some matters coming to our attention that may have relevance to a number of practices.

(c) QAD hosted two forums in November and December 2008 that drew more than 400 members. The forums covered the Practice Review programme's progress so far and some of the common issues identified by the reviewers. The forums also looked at some practical ways in which practices can address the challenges of complying with professional standards, and provided suggestions in respect of the improvements of quality control policies and procedures.

(d) Findings from the reviews have also been used by the Institute's technical team in providing relevant support for members through the ongoing TUE technical update programme.

(e) The quality assurance team has answered over 2,000 phone calls from practices and replied to over 1,000 emails after the launch of the revised Practice Review programme and the EQS.

(f) The participation of the Chairman of the PRC and the Director, Quality Assurance in various small and medium practitioner forums.

5. The Future

5.1 The progress that has been made in implementing the Practice Review programme over the past two years is encouraging. The target of 80 visits for 2008 was met and 120 visits are planned to be carried out in 2009. By the end of 2009, we will also have completed reviews of all practices that audit listed entities which is some six months ahead of timeframe we had committed to when commencing the Practice Review programme in 2007. International benchmarks set three years as the maximum interval between reviews of auditors of listed entities.

5.2 Our future plan is to steadily increase the number of practices to be reviewed each year to bring the overall volume of reviews up to a level that bears comparison with other jurisdictions in major capital markets. Our policies, procedures and documentation will continue to be reviewed and, if necessary, revised in the light of experience gained in conducting and recording reviews.

5.3 The Institute is fully committed to maintaining an effective auditor regulatory mechanism and through QAD, the PRC and the SQAB will ensure that appropriate steps are taken to ensure that the programme continues to operate robustly and effectively.

6. Findings and Educational Points from Reviews

This section presents the findings that were most often noted during the course of reviews carried out in the period covered by the report. The following matters should be of interest to all practices involved in auditing and may assist them in revising their audit approach and procedures where they recognize the situations as potentially applying to them. **We strongly recommend practitioners to carefully read this section.**

6.1 HKSQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

It has been a few years since the introduction of HKSQC 1. There is evidence that most of the practices have taken time and effort to improve their quality control procedures to address the requirements of the standards and we have seen an increasing number of practices adopting quality control procedures. Nevertheless, certain matters were noted during QAD reviews that are causing difficulties for many firms: -

- Tailoring of quality control manual

A number of smaller firms tend to adopt "A Guide to Quality Control" issued by the Institute without considering how it should be specifically applied to their circumstances. From discussions with these practices, it seems that some practices are still assuming that "adopting" the guide will be sufficient to meet all the requirements of HKSQC 1. This suggests that there are two issues that need to be better understood. Firstly, the guide is not a mandatory document that has to be applied word for word. Secondly, in all cases, the policies and procedures adopted need to be appropriate to the size and operating characteristics of the practice, while still retaining the principles of HKSQC 1. QAD assess and review a practice against the requirements of HKSQC 1, not the guide.

We believe that it is possible, and acceptable, to apply the requirements of HKSQC 1 in a way that is relevant and appropriate to each individual practice. Documented policies and procedures do not have to be complicated and extensive for small practices with few staff and a straightforward client base.

- Monitoring function

There are three areas related to monitoring that are still causing difficulties for some practices.

Firstly, some smaller practices are confusing the functions of engagement quality control review ("EQC review") and monitoring review which in fact have quite different objectives. EQC review is an additional review (sometimes called a second partner review or independent review) at

engagement level carried out before signing the audit report and applies to identified higher risk clients. Monitoring is a periodic firm level review of quality control policies and procedures that includes a review of a sample of completed engagement files.

Secondly, certain practices have documented their policies for the monitoring function but no monitoring activity had ever taken place. Some believe that no monitoring review is required if they have a client base that is typically small and uncomplicated entities. Others find it difficult to carry out the monitoring function as a result of limited internal resources. We recognize the characteristics of small practices and the challenges they often face in terms of resources. However, HKSQC 1 applies to all practices, there is no exemption on the grounds of size or nature of client base.

Practices should entrust the monitoring responsibility to a partner or other persons, either internally or externally, with sufficient and appropriate experience and authority to assume that role as soon as practicable. HKSQC 1 refers to the possibility of appointing independent external monitors but we accept that this is not a resource that is yet readily available in Hong Kong and would therefore suggest that sole practitioners and smaller firms consider pooling resources and knowledge with others in similar position. When there is no other alternative, self-monitoring by sole practitioners may be possible if they can manage to perform the monitor role objectively. There are clear limitations in the effectiveness of self-review but we would rather see firms recognize and seek to apply the principles of HKSQC 1 rather than ignore such an important element of the standard.

Thirdly, monitoring sometimes only extends to the cold review of engagement files. In addition monitoring should cover the implementation and application of all quality control procedures that are required by HKSQC 1. As the Practice Review approach focuses on a practice's own approach to quality control, it is crucial that monitoring programmes are fully comprehensive.

Practices are also reminded that taking actions on findings identified by the monitor is as important as the monitoring process.

- Acceptance and continuance

Most practices adopt a checklist approach to this task. However, practices should, as always, be alert to the dangers of completing a checklist in a mechanistic manner without giving the issues proper consideration. In particular for engagements of public interest such as IPO, listed or regulated entities where there is a higher risk to the firm in the way of potential consequences or exposure, additional knowledge and resources may needed to provide the necessary standard of audit work. Extra caution must be

exercised at client acceptance when there are qualified audit opinions or a regular change of auditors for these entities as such circumstances could be indicative of disagreements between auditor and client.

- Subcontractors

  QAD reviewers have identified that some practices subcontract elements of the audit work to other practices or individuals either in or outside Hong Kong. There is nothing wrong with this in principle if it addresses gaps in resources or skills that would otherwise exist. However, subcontracting an audit does not reduce the responsibility of the practice for the audited financial statements and the opinion it contained. The practice retains full responsibility for all aspects of the audit and must ensure control and management of the audit process. The practice should ensure the subcontractor understands and complies with all policies and procedures of the practice. In such circumstances a formal engagement letter is usually a good starting point. We would make a clear distinction between a legitimate and properly controlled sub-contract arrangement and a situation where the member simply signs an audit report where the audit has been done by another party and our member has had no input to or control over the audit process. The latter situation is clearly unacceptable and will be severely dealt with if identified.

6.2 Audit methodology and procedures

QAD reviewers noted that some practices still have not updated their audit procedures to fully embrace the changes that came in with the adoption of International Standard on Auditing as Hong Kong Standards on Auditing with effect for accounting periods beginning on or after 15 December 2004. It is important that a firm's audit approach and procedures address all current professional standards. Standard audit programs and checklists are tools to facilitate consistency in the quality of engagement performance and assist in ensuring the application of the requirement of standards. The practice should update their audit programmes and checklists without delay to embrace the requirements of the current standards. When this involves the introduction of new procedures and documentation, firms are advised to carry out staff training on how to adopt the revised procedures to avoid any misunderstandings or inconsistencies in the application of the new materials.

- **HKSA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement and HKSA 330 The Auditor's Procedures in Response to Assessed Risks**

  HKSA 315 requires auditors to understand their clients' business and control environment, and to identify key controls. Auditors need to assess the design and implementation of key controls and to test

the operational effectiveness of any such controls that are to be relied on to provide audit assurance. However, for some small and medium sized firms, QAD reviewers have observed that there was no clear documentation on understanding the entity and its control environment, assessment of the risk of material misstatement, or design and implementation testing of key controls.

There is also often no documentation to evidence how the practices determined the overall responses and audit procedures to address the risk of material misstatement, as required under HKSA 330. Although most of these practitioners were able to persuasively explain their knowledge and understanding of their clients' business, they need to document such understanding in their work papers. Some practitioners are still under the impression that immediate default to a "substantive" audit approach for a small company with simple operations is possible and do not go through the process of the risk assessment. The current standards require this process to be undertaken regardless of the size and complexity of their clients but the documentation required for a small client can be relatively simple.

- HKSA 230 Audit Documentation

The sufficiency of audit documentation remains a constant theme. Auditors need to ensure that they have sufficient relevant documentation to evidence the work carried out and conclusions reached. Practitioners should promote a disciplined approach to documentation among their staff. QAD reviewers have observed that certain practices did not document their work or complete and retain their audit documentation in a manner consistent with HKSA 230. Senior management within the practices should deliver a clear message to all audit staff about the importance of audit documentation and that poor audit documentation is unacceptable. Common weaknesses in documentation include:

(a) Insufficient or lack of documentation on major judgments and conclusions for resolution of key issues e.g. adequacy of bad debt provision or provision for inventories, accounting treatment on complex transactions;

(b) Documentation regarding changes in audit plan or scope e.g. document the thought process on the subsequent change in audit approach which is different from the approach set out at the planning stage;

(c) Identification of key risk areas and their conclusions e.g. treatment of on-going or possible litigation and claims;

(d) Qualified or non-standard opinions e.g. document the thought process and discussions held to reach

conclusions on qualified or modified opinions which usually involve extensive consultation, discussion with management and potentially additional audit work; and

(e) Documentation on asset valuation and assessment of asset impairment e.g. audit documentation should clearly explain the work done, thought process and conclusion reached for assessment of items such as write-downs of property, plant and equipment. When there is a need to use the work of a specialist e.g. property valuers or actuaries, the auditors must assess the competence and objectivity of the expert and the scope of work before placing reliance on their work.

- **HKSA 240 The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements**

  HKSA 240 brought in a number of specific requirements related to how the impact of potential fraud should be addressed by the auditor. Some practices continue to use the same audit approach as in the past and as a result have not picked up the changes to audit approach that are necessary in applying this standard. We have also seen that some practitioners did not carry out a fraud risk assessment as they believe that this is not required when the size of the client is small. Being a small entity does not mean that the audit falls outside the scope of this standard.

  When a fraud risk assessment is carried out we often question the sufficiency of documentation of the work performed in that assessment, for example:-

  (a) Enquiries of management are not always documented;

  (b) It is not always clear that discussions with management have really focused on the potential for fraud; and

  (c) Simply stating that no fraud was identified during the audit.

  QAD expects auditors to document the assessment and any work they have carried out in reaching their conclusion.

  There should be a continued alertness to potential fraud throughout the course of the audit. Also, as HKSA 240 includes a presumption of a potential for fraud related to revenue recognition, when auditors conclude that the risk is not applicable in the circumstances of the engagement, they are required to document the reason for that conclusion.

- **Management representations**

  QAD reviewers found some practitioners tend to over rely on management representation. Throughout the

audit, management makes many representations to auditors. When these representations relate to matters which are material to the financial statements, auditors should, if possible, obtain further audit evidence and evaluate whether the representations made by the management appear to be reasonable and consistent with the audit evidence obtained. Practitioners should remember management representations cannot be a substitute for other audit evidence that the auditors could reasonably expect to be available. If management representations are judged to be the only appropriate audit evidence the auditor should make a clear record of why that is the case and why he is prepared to rely on that evidence in forming his opinion.

In some cases, QAD reviewers noticed that standard representation letters were used and had not been tailored to the client's situation such as written representation on significant assumptions used to prepare discounted cash flow produced by the management. Therefore, practitioners are reminded that they should make sure the wordings in the representation letter are relevant to the client's situation.

- Circularisations

Where circularisations (of debtors or creditors) are carried out as a relevant audit procedure, the auditor must make sure that non-replies are properly followed up by sending out second reminders and/or performing alternative audit procedures. Auditors must have control over the process of sample selection, should send out the confirmation requests by themselves, not by the client, and take all reasonable steps to ensure all replies must be sent directly to the auditors.

6.3 Useful sources of information and guidance

The key issues that were identified in the course of QAD reviews were used as source topics to our Institute's TUE programmes and as content for our QA forums held in November and December in 2008.

Within the Institute there are a number of useful sources of information, guidance and support:

- A Guide to Quality Control
- Audit Practice Manual
- Financial Reporting and Auditing Alerts
- Technical enquiry helpline
- SMP and SME Resource Centre (http://www.hkicpa.org.hk/professionaltechnical/SSRC/Images/SSRC_Banner.jpg)

As similar issues are faced by auditors in other parts of the world, it is also worth considering sources of information available from other bodies including:

IFAC

- Guide to Using International Standards on Auditing in the Audit of Small- and Medium-sized Entities published by the International Federation of Accountants

  (http://www.ifac.org/Members/DownLoads/ISA_Audit_Guide.pdf)

APB

- Practice Note 26: Guidance on Smaller Entity Audit Documentation published by the Auditing Practices Board

  (http://www.apb.org.uk/images/uploaded/documents/PN26%20Web%20Sep%2020071.pdf)

Part II – Professional Standards Monitoring Review Programme

1. Introduction

1.1 The second area of responsibility of the QAD is the continuous review of published financial statements, primarily listed companies, in Hong Kong. The objective of the review is to monitor the compliance with professional standards of members engaged in the preparation or audit of financial statements and to enhance the quality of application of professional standards in Hong Kong. The Professional Standards Monitoring review programme has been in operation since 1988 and remains a vital part of the Institute's role in promoting and maintaining compliance with professional standards.

1.2 For the period covered by this report this function was overseen by the Professional Standards Monitoring Committee ("PSMC"). Regular meetings of the PSMC were held for discussion of significant matters identified from the initial reviews of financial statements.

1.3 To ensure unbiased and balanced views on the selected financial statements, the PSMC comprised members with in-depth knowledge of accounting and auditing standards who have extensive practical experience in auditing or preparing financial statements of listed companies as well as representative from other regulatory body. It therefore consists of members from Big Four firms, medium-sized practitioners, non-practising members working in listed and unlisted companies and representative of Hong Kong Exchanges and Clearing Limited. Please refer to Annex for the composition of the PSMC.

2. Review process

2.1 In 2008, the selection of published financial statements of listed entities comprised:

(a) A random sample of financial statements of companies listed on Hong Kong Stock Exchange (both Main Board and Growth Enterprise Market issuers) which included newly listed companies and companies with changing auditors).

(b) Some selections were made on the basis of publicly available information e.g. newspaper reports that drew attention to potential accounting issues.

2.2 In July 2008, the Financial Reporting Council ("FRC"), an independent statutory body responsible for investigation and enquiry into potential auditing and accounting irregularities in listed entities, announced that it would with immediate effect undertake reviews of all financial statements of listed companies in Hong Kong which

had a modified auditor's report. From that point, financial statements on which qualified/modified audit reports were issued were excluded from the Professional Standards Monitoring review programme, to avoid duplication of the review programme of the FRC.

2.3 The review process was carried out in the following way:

(a) QAD selected the financial statements for review based on the criteria set out above and distributed to external monitors for review. The external monitors are representatives nominated by a number of practising firms which have listed audit clients.

(b) For each set of financial statements, two monitors carried out initial reviews to assess compliance of the financial statements with relevant financial reporting standards.

(c) The monitors provide their findings ("Monitors' Reports") to QAD.

(d) After receiving the Monitors' Reports, QAD then reviews and assesses all the findings and educational points noted by the monitors. QAD sorts out the major findings and makes recommendations to the PSMC ("QAD recommendations") on matters that appear to need explanation or clarification from members involved in the preparation or audit of the financial statements.

(e) The PSMC considers QAD recommendations and decides the specific matters that need information and explanation. Enquiry letters are then issued by QAD to members concerned. The PSMC has no powers of investigation and therefore relies on the goodwill and co-operation of members in dealing with the enquiries that are made.

(f) Upon receipt and consideration of the responses from members concerned, a decision will be made by the PSMC on whether the response addresses the concerns, in which case the enquiries are concluded, or whether further information or another appropriate course of the action should be taken.

2.4 In writing the letters, QAD and the PSMC tried not to ask questions on the financial statements that were related to judgements of audit professionals and/or management. The enquiries raised in the letters were mainly to obtain clarification on the facts and circumstances with regard to certain specific events and transactions observed from the financial statements, and to seek explanations from members on matters where the PSMC had concerns over compliance with professional standards. The overall review process is interactive and is not a unilateral check of the quality of financial reporting.

2.5 Certain matters, such as improving disclosures and presentation of financial statements, were sometimes included in

the letters to members for "educational purposes". Such matters are also put into a database for communication to the wider membership through training events, forums and other media, including this report.

2.6 Most of the written replies from members provided clear explanations in response to the matters raised and in most cases the enquiries were concluded after minimal exchanges of correspondence.

2.7 If there is a reasonable suspicion and belief that a member is in breach of professional standards, or, in exceptional cases, if there is a prima facie case that the subject member has breached professional standards, the case would be referred to the Professional Conduct Committee of the Institute for consideration of appropriate regulatory actions.

2.8 The success and smooth running of the review process relies on the support of monitors and PSMC members and cooperation of Institute members. The Institute is most grateful the enormous contributions of all monitors and PSMC members in assisting and providing advice to the Institute in reviewing listed entities' financial statements as well as the full co-operation of all Institute members in answering PSMC's enquiries.

3. Achievements

3.1 There were 10 PSMC meetings held in 2008. A total of 160 reviews of financial statements of listed entities were conducted in 2008, with priority given to cases brought forward from prior years. All but six brought forward cases were discussed in 2008 meetings. Most of the financial statements reviewed were for financial years ended 31 December 2007 or 31 March 2008.

3.2 Over 110 letters were issued to members (primarily the auditors concerned). There were over 75 cases closed in 2008.

3.3 Two cases of more significant departures from relevant accounting standards with material impact on the financial statements were referred to the Compliance Department of the Institute in 2008 for consideration by the Professional Conduct Committee.

3.4 To make the common findings from reviews available to the Institute's members generally, QAD held two forums in November and December 2008 in addition to the publication of Operations Report in May 2008. The Forums covered the key application issues identified from reviews of financial statements of listed companies and suggestions on how to cope with the issues. QAD also had on-going communication with Standard Setting Department of the Institute to bring common issues on applications of various professional standards to members' attention for their inclusion in the TUE technical update programme.

4. The Future

4.1 The Institute's current programme for reviewing published financial statements is generally recognized as a valuable and well-established function for monitoring the quality of application of financial reporting standards in Hong Kong. Through correspondence with members, the Institute is made aware of difficulties experienced by them in interpreting and applying the standards. Letters issued to members highlight matters for their attention in respect of the appropriate application of standards to avoid the same shortcomings in future financial statements.

4.2 In view of the perceived value of the programme, it will continue, with plans in hand to further enhance its effectiveness in 2009. More resources will be allocated to the operation of this programme and therefore it is expected that the number of reviews to be taken in 2009 will be increased.

4.3 The Institute will also continue to communicate with the FRC and ensure no duplications with the FRC review programme.

5. Findings and Educational Points from Reviews

This section sets out the significant findings and educational points identified from reviews of the selected financial statements of listed entities in 2008. The reviews of published financial statements were carried out with reference to financial reporting and auditing standards that were effective during the relevant financial reporting periods. **QAD strongly recommends members, as auditors or preparers of financial statements, to carefully read this section and pay attention to the common deficiencies addressed in the section which are helpful references for audit and/or preparation of financial statements.**

5.1 Functional currency

- Determination of functional currency of an entity

  Many companies listed in Hong Kong are primarily investment holding companies with no or minimal operating activities of their own. These investment holding companies have obtained equity and loan financing in Hong Kong and have invested in subsidiaries in Mainland China. From reviews of the financial statements of this kind of listed entities, it is commonly noted that investment holding companies (the entities listed in Hong Kong Stock Exchange) have chosen the Hong Kong dollar as their functional currency although they had not undertaken any material operating activities in Hong Kong and its sources of income are primarily its subsidiaries in Mainland China.

  In view of the frequency with which issues were raised on the determination of

functional currency, the PSMC considered that the choice of functional currency was a recurring issue that has particular relevance in Hong Kong.

Paragraph 8 of HKAS 21 The Effects of Changes in Foreign Exchange Rates, defines functional currency as the currency of the primary economic environment in which the entity operates (i.e. the one which the entity normally generates and expends cash), which is the core principle of determination of functional currency. Paragraphs 9 to 14 of HKAS 21 give further guidance on the determination of functional currency.

The first key matter is that the functional currency of an investment holding entity shall represent the economic effects of the underlying transactions and conditions, that is, the holding of investments in subsidiaries to generate returns for its owners. The second key matter that preparers should be aware of is the "hierarchy" of determining factors which is addressed in paragraph 12 of HKAS 21. In other words, the entity needs to consider the primary factors stated in paragraph 9 of HKAS 21, before going down to the indicators stated in other paragraphs of HKAS 21. Paragraphs 10 to 11 of HKAS 21 provide further guidelines on the additional supporting evidence that an entity can consider when determining the functional currency.

In many responses received from members the focus seems to have been on paragraphs 10 to 11 rather than paragraph 9 of HKAS 21 in determining functional currency. It is probably because the companies and auditors concerned either are not aware of or have overlooked the "hierarchy" in HKAS 21.

An example of the responses received is that the focus had been placed on considering the currencies of funds from financing and investing activities (such as currencies of share capital, dividend received, loans borrowed) and the currencies in which receipts from operating activities are usually retained rather than considering the primary economic environment that the entity operates in.

It is worth highlighting that the primary source of cash inflow of an investment holding entity are dividends from its subsidiaries and its ability to service debts and make distributions owners are heavily dependent on the economic environment in which the subsidiaries operate. It is therefore not appropriate to regard the currency in which dividends are received by the investment holding company to be the conclusive factor in determining the functional currency given that the investors may demand dividends to be paid in the currency they request. Similarly, it was also not appropriate to

determine the functional currency solely based on the currency of the funds being invested in the subsidiaries.

It is also noted that there is some confusion caused by the requirement that the determination of functional currency should be at an "entity" level and not a "group" basis. Because of this misunderstanding, there has been no consideration of the economies in which the subsidiaries operate, which directly affect the ability of the subsidiaries to generate returns on the capital invested by the holding company. The PSMC is of the view that the "entity" cannot ignore the underlying economies of subsidiaries, which frequently are the major, or sometimes the only, assets of the entity.

The following example on determination of functional currency was included in the TUE programme organized by the Institute. QAD considers the example is helpful:

- Scenario:

  "My company is an investment holding company ("the holding company") located in Hong Kong and has 3 subsidiaries in the Mainland China. The holding company obtains equity and loan financing and invests in the Mainland China through its subsidiaries. It pools cash from all group entities, invests excess cash and obtains external financing according to the Group's needs. The majority of its financing is drawn in Hong Kong dollar and all of its assets are denominated in HKD. Most of the holding company's staff usually station in Hong Kong, except for certain directors who travel frequently between Hong Kong and the Mainland."

- Suggested answer provided in TUE:

  " - Functional currency of the holding company is RMB;

  - Reflects the economic substance of the underlying economic events;

  - All subsidiaries are operating in Mainland China and the primary source of income of the holding company is from the Mainland China;

  - The ability to service debts and pay dividends to shareholders is dependent on the Mainland's economy."

The conclusion is that the determination of the functional currency of an investment holding company depends on the specific facts and circumstances.

The PSMC also noted a related issue on accounting treatment for convertible instruments. The PSMC observed that companies that had incorrectly determined the functional currency as Hong Kong dollars may be reluctant to change because changing to a functional currency other than Hong Kong dollars would

have an impact to the recognition and measurement of convertible instruments in the financial statements. If this resulted in fixed-for-fixed conditions no longer being met, all elements of convertible instruments previously recognized as equity would need to be reclassified as liabilities.

- Disclosure deficiencies

  There were also a few financial statements which did not disclose the functional currency of the entity. Members are advised to pay attention to paragraph 53 of HKAS 21 which states that "When the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a different presentation currency". Therefore, if the entity's functional currency is not disclosed, it would be presumed that the functional currency is the same as the presentation currency.

5.2 Impairment of assets including goodwill

- Assessment of impairment and related recognition of impairment loss

  Based on the observations of specific events or transactions disclosed in the reviewed financial statements (e.g. reportable segments showing segment losses for several years), a number of enquiries were raised with auditors on how they were satisfied with the adequacy of impairment provision made by management.

  In a few cases reviewed there were indications that the discount rates used for impairment assessment were not appropriate, as a result of a lack of attention to paragraph 55 of HKAS 36 Impairment of Assets which states that "The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of (a) the time value of money; and (b) the risks specific to the asset for which the future cash flow estimates have not been adjusted". Members are also advised to refer to Appendix A to HKAS 36, an integral part of the standard, which provides detailed guidance on the use of present value techniques in measuring value in use when carrying out an impairment assessment of assets.

  Questions are often raised because of apparent inconsistencies and contradictions between the company level balance sheet and the consolidated balance sheet. Enquiries are made as to whether there was impairment for the investments in subsidiaries at company level when the balance of net asset value at company level was significantly greater than consolidated net asset value. There was an instance noted by the PSMC whereby the auditor did not carry out any audit work on the balance sheet at company level as the auditor considered that it only gave opinion on the group's financial statements and that the impairment assessment on the

company's investment in subsidiaries was not applicable to the group's financial statements. However, the PSMC was of the view that the note which disclosed company level balance sheet had formed part of the financial statements. The auditor therefore had responsibility to carry out sufficient audit procedures to ensure the consistency of information disclosed in the audited financial statements.

There was also a disclosure in one set of financial statements which mentioned the management's assessment of "reversal of goodwill". Members are reminded that reversal of impairment made for goodwill was prohibited under paragraph 124 of HKAS 36 which states that "An impairment loss recognized for goodwill shall not be reversed in a subsequent period".

Auditors should also bear in mind that management, as preparers of financial statements, has the responsibility of undertaking the impairment assessment of assets, and the auditors, to avoid any reduction in independence, should not perform the assessment on behalf of management.

- Disclosure deficiencies

As reported in last year's report, there is continued room for members to improve the quality of the financial statements in the area of disclosures on impairment of assets (such as intangible assets and goodwill) recognized. There are many cases of deficiencies in complying with the disclosure requirements under HKAS 36. The disclosures that were often omitted include the events and circumstances that led to the recognition or reversal of the impairment loss (paragraph 130(a) of HKAS 36), description on the key assumptions on which management bases its cash flow projections (paragraph 134(d) of HKAS 36), sensitivity analysis of how possible changes in key assumptions would impact the recoverable amounts (paragraph 134(f) of HKAS 36) and other disclosure requirements under paragraphs 126, 134 and 135 of HKAS 36.

5.3 Business combinations

- Application of HKFRS 3 to account for business combinations

In the light of the regular comments made in the reviews of financial statements, a number of enquiries were raised on the topic of business combinations. Members (primarily auditors), in most cases, were able to provide clear responses and demonstrate their assessments and knowledge of HKFRS 3 to substantiate their conclusions that the transactions were properly accounted for in accordance with HKFRS 3 Business Combinations.

However, QAD would like to highlight a few key matters for members' attention in the application of HKFRS 3.

(a) Recognition of intangible assets on acquisition of subsidiaries (paragraphs 37, 45 and 47 of HKFRS 3)

Consideration should be given to the recognition of intangible assets such as customer relationship, brandname, in-process research and development projects and contingent liabilities upon acquisition of subsidiaries. In particular, it is important to assess whether there is any intangible asset acquired that has to be separated from goodwill on acquisition. There were a number of queries raised noting that there was significant amount of goodwill recognized on the acquisition of a business but no intangible assets were shown in the balance sheet, and questioning whether there were in fact any intangible assets that should have been accounted for separately on acquisition.

(b) Measurement of identifiable assets and liabilities acquired in the business combinations (paragraph 24, 27, 36 of HKFRS 3)

Identifiable assets and liabilities acquired and consideration paid in the business combinations should be measured at fair value. Auditors are reminded to carry out sufficient audit procedures and obtain adequate audit evidence to substantiate their conclusion of fair value measurement on the acquired assets and liabilities and the cost of business combination. In respect of the fair value measurement of cost of business combination (i.e. consideration), if consideration is satisfied by issuance of quoted shares, the published price of quoted shares at the date of exchange of control would be the best evidence of fair value of consideration (paragraph 27 of HKFRS 3). It will generally not be appropriate to assume the agreement price to be the fair value of the cost of business combination.

(c) Recognition of deferred tax assets after initial accounting is complete (paragraph 65 of HKFRS 3, paragraph 68 of HKAS 12)

If the potential benefit of the acquiree's income tax loss carry-forwards or other deferred tax assets did not satisfy the criteria in paragraph 36 of HKFRS 3 for separate recognition when a business combination is initially accounted for but is subsequently realized, the acquirer shall recognize that benefit as income in accordance with HKAS 12. In addition the acquirer shall:

- reduce the carrying amount of goodwill to the amount that would have been recognized if the deferred tax asset had been recognized as an identifiable asset from the acquisition date; and

- Recognize the reduction in the carrying amount of the goodwill as an expense.

The above procedures shall not result in the creation of an excess, nor increase the amount of any gain previously recognized.

To better illustrate the application of the above standard, QAD considers the simple example explained in one of the TUE technical update programme organized by the Institute is relevant and helpful and therefore quoted below.

- Scenario:

  " - Entity A acquires Entity B in 20X5

  - At the date of acquisition, Entity B had tax loss of HK$500,000, if recognized, would result in the recognition of deferred tax asset of HK$100,000.

  - Entity A recognizes deferred tax asset of HK$50,000 with goodwill of HK$100,000.

  - In 20X8, Entity A assesses that the future taxable profit of Entity B would probably be enough to recover all remaining deductible temporary difference."

- Suggested answer provided in TUE:

  " In 20X8, Entity A should:

  - Recognize a deferred tax asset of HK$50,000 and a deferred tax income of HK$50,000 by:

    Dr Deferred tax asset – HK$50,000
    Cr Deferred tax income – HK$50,000

  - Reduce the carrying amount of goodwill by HK$50,000 and recognize an operating expense of HK$50,000.

    Dr Operating expense – HK$50,000
    Cr Goodwill – HK$50,000"

(d) Recognition of deferred tax arising from fair value adjustment to acquired assets and liabilities on business combination and related adjustment to goodwill (paragraphs 19, 26(c), 66 of HKAS 12).

Members should be careful that, when the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference (i.e. difference between carrying amount and tax base) arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.

For example, if the fair value of property was HK$3,000,000 and the tax base remains at cost (e.g. HK$2,000,000) to the previous owner, then the difference of HK$1,000,000 would be the taxable temporary difference and deferred tax liability should be recognized accordingly which then affects goodwill.

(e) Different accounting treatments between acquisition of assets and acquisition of business

If the acquired entity was dormant with no business activities and its balance sheet consisted of specific assets (e.g. property, land use right, other intangible assets and etc), it could be argued that the transaction was in substance an acquisition of assets and not acquisition of business. Members should assess carefully whether the acquisition fulfilled the definition of "business" (Appendix A to HKFRS 3) at the acquisition date and account for the transaction by applying the relevant accounting standards.

It is important to bear in mind that acquisition of an asset or a group of assets that does not constitute a business is not a business combination and does not give rise to goodwill.

HKFRS 3 (Revised) Business Combinations was issued in March 2008, and is applicable for annual periods beginning on or after 1 July 2009. HKFRS 3 (Revised) supersedes HKFRS 3 issued in 2004. Due to the more comprehensive and complex requirements of HKFRS 3 (Revised), members (primarily auditors) are strongly encouraged to put aside some time to understand the revised HKFRS 3 which could have a significant impact on clients' financial statements.

- **Disclosure deficiencies**

  Although there was an improved familiarity with HKFRS 3 there were a number of disclosure deficiencies noted during the course of review of selected financial statements in 2008. The following are the more frequent omissions, many of which were also noted in 2007 reviews:

  (a) information on business combinations effected after the balance sheet date but before the financial statements are authorised for issue (paragraph 66(b) of HKFRS 3);

  (b) factors that led to recognition of goodwill, description of each intangible asset not recognized separately from goodwill, an explanation of why intangible asset's fair value could not be measured reliably or nature of any excess recognized in profit or loss in accordance with (paragraph 67(h) of HKFRS 3);

  (c) revenue and profit or loss of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of that period (paragraph 70 of HKFRS 3); and

  (d) basis for determining the fair value of equity instruments as part of the cost of business combination (paragraph 67(d) of HKFRS 3).

5.4 Application of HKFRS 7 Financial Instruments: Disclosures

HKFRS 7 Financial Instruments: Disclosures came into effect for accounting periods beginning on or after 1 January 2007. HKFRS 7 replaces the disclosure requirements for financial instruments that were previously included in HKAS 32 (which is renamed as HKAS 32 Financial Instruments: Presentation) and supersedes HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions and applies to all entities.

QAD and the PSMC did not find many significant matters on which to ask questions on the appropriateness and sufficiency of disclosures for compliance with HKFRS 7. However, there were a number of points identified from reviews that are worth bringing to members attention, probably because this standard is relatively new.

The following is a summary of the observations on missing or inappropriate disclosures:

(a) sensitivity analysis to each type of market risk (i.e. currency risk, interest rate risk and other price risk) that the entity is exposed to and the potential effect on profit or loss and equity (paragraphs 40 to 42 of HKFRS 7);

(b) methods and key assumptions in the valuation technique applied in determining the fair value of financial instruments (paragraph 27(a) of HKFRS 7). For example, in some cases the disclosure of how the financial assets and financial liabilities were fair valued appears too general. The accounting policies also only disclose that fair valuation techniques have been used to estimate the fair value of these financial assets. More specific and detailed disclosures are needed in order to fully comply with the requirements of HKFRS 7. As stated in paragraph 27(a) of HKFRS 7, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. An example is that in calculating the fair value of unsecured loans, the assumptions applied, such as the prevailing market interest rates for similar loans, should be disclosed in the financial statements;

(c) criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (Appendix B5(f) to HKFRS 7);

(d) carrying amounts of each category of financial instruments (paragraph 8 of HKFRS 7);

(e) terms and conditions relating to the pledging of financial assets (paragraph 14(b) of HKFRS 7);

(f) credit quality of financial assets that are neither past due nor impaired (paragraph 36(c) of HKFRS 7);

(g) aging analysis of financial assets that are past due as at the reporting date but not impaired; an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and for the amounts disclosed, a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value (paragraph 37 of HKFRS 7);

(h) the entity has only one or two major customers but the disclosure mentioned that the entity had no concentration of credit risk (paragraph 34 of HKFRS 7);

(i) maximum risk exposure to credit risk including financial guarantee (paragraph 36(a) of HKFRS 7, Appendix B10 to HKFRS 7); and

(j) maturity analysis for financial liabilities that shows the remaining contractual maturities (paragraph 39(a) of HKFRS 7). The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows (Appendix B14 to HKFRS 7).

5.5 Presentation of financial statements

There were not many questions asked in respect of the presentation of financial statements indicating that there is an improvement in this area. However, following the implementation of Amendment to HKAS 1 Presentation of Financial Statements – Capital Disclosure that became effective for accounting periods beginning on or after 1 January 2007, there were a few cases which showed insufficient disclosures on information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital (paragraphs 124A to C of HKAS 1).

Examples of insufficient disclosures related to:

(a) description of what the Group manages as capital (paragraph 124B(a)(i) of HKAS 1); and

(b) the group's capital risk management policy and how it is meeting the objectives for managing capital (paragraph 124B(a)(iii) of HKAS 1).

QAD would also like to highlight the following required disclosures under HKAS 1 which are often omitted from the financial statements:

(a) nature and purpose of each reserve within equity (e.g. capital reserve and contributed surplus reserve) (paragraph 76(b) of HKAS 1);

(b) the total of income and expenses recognized directly in equity and the total of income and expenses for the period (i.e. the sum of profit or loss and income and expenses recognized directly

in equity) in the statement of changes in equity (paragraphs 96(c) of HKAS 1);

(c) relevant accounting policies and note disclosures (paragraph 108 of HKAS 1). Examples of missing or inappropriate accounting policies include segment reporting, related party, investments, payables and contingent liabilities;

(d) judgments made by management in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements (paragraph 113 of HKAS 1);

(e) key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraph 116 of HKAS 1);

(f) no additional or relevant information disclosed in the notes to the financial statements that helps users obtain an understanding of significant balances presented on the face of financial statements (paragraph 103(c) of HKAS 1);

(g) description of nature of the entity's operations and principal activities (paragraph 126(b) of HKAS 1);

(h) consistency of presentation and classification of information disclosed in the financial statements as compared to previous period (paragraph 27 of HKAS 1);

(i) amount of dividends recognized as distributions to equity holders during the period and the related amount per share (paragraph 95 of HKAS 1); and

(j) inconsistency in information disclosed in more than one note to the financial statements. Members are reminded that notes shall, as far as practicable, be presented in a systematic manner and that each item on the face of the financial statements shall be cross-referenced to any related information in the notes (paragraph 104 of HKAS 1).

In respect of (d) and (e) above, the following are illustrative examples that were encountered during the review indicating matters that should be considered:

- for buildings carried at revalued amounts, whether there are critical estimates involved in the valuations;

- for intangible assets (e.g. know-how), whether there are critical estimates involved in determining their indefinite useful lives; and

- if the entity operates in Mainland China, whether there are any critical accounting estimates involved in determining the provision for tax especially there are significant over/under provision of tax recorded in the year.

Furthermore, in disclosing key sources of estimation uncertainty (i.e. (e) above), sensitivity analysis should be disclosed to help users of financial statements understand the judgments management has made about the future and about other key sources of estimation uncertainty (paragraph 120 of HKAS 1).

QAD would also like to draw members' attention to HKAS 1 (Revised) Presentation of Financial Statements which was issued in December 2007 and is applicable for accounting periods beginning on or after 1 January 2009 and supersedes this HKAS 1. The above mentioned requirements of HKAS 1 are carried over into HKAS 1 (Revised).

5.6 Related party disclosures

It was often noted that related party disclosures were fairly limited. The following are disclosures that are often omitted in the financial statements:

(a) relationships between parents and subsidiaries (irrespective of whether there are transactions between the related parties), name of parent/ultimate controlling party and, if neither the parent nor the ultimate controlling party produces financial statements available for public use, the next most senior parent that produces financial statements available for public use (paragraph 12 of HKAS 24, paragraph 126(c) of HKAS 1);

(b) key management personnel compensation in total and divided into certain categories (paragraph 16 of HKAS 24);

(c) for related party transactions, disclosure of the following by categories: nature of related party relationship, amounts of transactions and outstanding balances with terms and guarantees, related provisions and doubtful/bad debts expenses (paragraph 17 of HKAS 24); and

(d) accounting policy for related parties (paragraphs 103(a) & 108(b) of HKAS 1).

In respect of (b) above, it is sometimes noted that there are inconsistencies between the amounts of compensation of key management personnel of the Group and the directors' emoluments disclosed. For example, the amount of key management personnel compensation was smaller than that of directors' remuneration disclosed elsewhere in the financial statements. Members are advised to note that "key management personnel" are defined in paragraph 9 of HKAS 24 which states that "Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity".

5.7 Segment reporting

There were fewer enquiries raised in 2008 with auditors on the disclosure of segment reporting under HKAS 14 Segment Reporting. There appears to be a continued improvement in the quality of disclosures which indicates that members have a better and more thorough understanding of the application of HKAS 14. Nonetheless, there are some cases of which disclosures on segment reporting did not comply with HKAS 14 which are further explained below.

A common deficiency on segment disclosures was where a group, which did not engage in finance business, disclosed a balance of unallocated liabilities smaller than the total balance of the group's borrowings. This suggests that certain borrowings of the group had been allocated to reportable segments. Members are reminded that segment liabilities do not include borrowings, liabilities related to assets that are the subject of finance leases, and other liabilities that are incurred for financing rather than operating purposes unless the segment's operations are primarily of a financial nature. A few financial statements also incorrectly disclosed that the segment assets included assets used for general entity or head office purposes.

There were also instances of inconsistency in the segment disclosure between segment results and segment liabilities. Borrowings were allocated to segment liabilities but finance costs were not allocated to corresponding reporting segments.

Other information such as (i) depreciation and amortization of segment assets that were included in segment result for the period for each reportable segment (paragraph 58 of HKAS 14) and (ii) the total amount of non-cash expenses other than depreciation and amortization that were included in segment expenses (paragraph 61 of HKAS 14) were not disclosed in a few instances.

Some financial statements showed that the group had only one business segment and several geographical segments but still choose business segmentation as its primary reporting format for segment reporting. In this case, the PSMC considered that it may be more appropriate to choose geographical segment as the primary format which focuses on the most significant variations in risks and returns between segments. On the contrary, when the entity has a single geographical segment but several business segments, it may not be appropriate to designate the geographical segment as primary and the business segments as secondary.

Members may find it helpful to refer to paragraphs 9 and 16 of HKAS 14 which set out the definition of business segment, geographical segment, segment revenue, segment expense, segment result, segment assets and segment liabilities.

Members should note that HKAS 14 will be replaced by HKFRS 8 Operating Segments which will become effective for accounting periods beginning on or after 1 January 2009.

5.8 Earnings per share ("EPS")

In many cases, the diluted EPS were presented as "N/A" or even not disclosed on the face of income statement as the entity did not have dilutive potential ordinary shares. However, members are advised to note that diluted EPS are required disclosures under HKAS 33 Earnings per Share and therefore it was not appropriate to present as "N/A". If there are no potential ordinary shares, it means the basic and diluted EPS would be equal and dual presentation can be accomplished in one line on the face of income statement, for example, one single line titled as "Basic and diluted EPS" (paragraphs 66 and 67 of HKAS 33).

5.9 Disclosures required by HKAS 8

It was frequently noted that the omitted disclosures required under HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors were:

(a) regarding the new and revised standards and interpretations adopted during the year, there was no disclosure made to provide information on the change including the title of the standard or interpretation and nature of the change in accounting policy (paragraph 28 of HKAS 8); and

(b) when the entity has not applied the new standards and interpretations which have been issued but are not yet effective, there were insufficient disclosures on the following aspects (paragraphs 30 and 31 of HKAS 8):

- the fact that the entity has not applied the relevant standards and interpretations that are not yet effective;
- known or reasonably estimable information relevant to assessing the possible impact that application of the new standards or interpretations will have on the entity's financial statements in the period of initial application;
- the title of the new standard or interpretation;
- the nature of the impending change or changes in accounting policy;
- the date by which application of the standard or interpretation is required;
- the date as at which it plans to apply the standard or interpretation initially; and
- either:

(i) a discussion of the impact that initial application of the standard or interpretation is expected to have on the entity's financial statements; or

(ii) if that impact is not known or reasonably estimable, a statement to that effect.

5.10 Provisions

There were some instances noted where the accounting policy for provisions and the reconciliation of opening and closing balances of provisions were not disclosed as required by HKAS 37 Provisions, Contingent Liabilities and Contingent Assets,. Provisions here means "liabilities of uncertain timing or amount" as defined in paragraph 10 of HKAS 37. In some countries, the term "provision" is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amount of assets and are not addressed in HKAS 37 (paragraph 7 of HKAS 37).

Members are also reminded the provisions, that meet the definition of "provisions" in HKAS 37, need to be presented on the face of the balance sheet as required by paragraph 68 of HKAS 1.

5.11 Revenue recognition

- **Accounting policy**

  There is a recurring observation that the accounting policies for revenue recognition are often too general. Certain entities only disclose "standardized" revenue recognition policies by copying from accounting policies of illustrative financial statements published by some international organizations and therefore tend towards "boiler-plate", without sufficient reference to specific circumstances of the business activities of the entity. In order to enhance quality of disclosures and transparency of the financial statements requests have been made that auditors advise their clients to make more detailed and specific disclosure in respect of revenue recognition accounting policy when preparing future financial statements.

- **Net presentation of gain on disposal of financial assets and not "revenue"**

  It was noted that some preparers show sales proceeds from the sale of financial assets as revenue (gross) in the financial statements, while others present gains and losses on disposal net in the income statement. Regarding this inconsistent presentation in the market, the PSMC sought advice from Financial Reporting Standards Committee ("FRSC"). FRSC members agreed that gains and losses arising from the disposal of financial assets must be presented net in accordance with paragraphs 26 and 55 of HKAS 39 Financial Instruments: Recognition and Measurement and paragraph 20(a) of HKFRS 7. FRSC therefore agreed that it was inappropriate to present gross sales proceeds as revenue. However, FRSC also noted that the standards do not preclude an entity providing additional information in the financial statements related to gross sales proceeds provided that they are not described as "revenue".

The relevant meeting summary of FRSC is posted on the Institute's website for members' reference.

5.12 Investments in associates

The following matters are worth highlighting in respect of the application of HKAS 28 Investments in Associates.

(a) If the consideration for acquiring an associate is satisfied by issuance of an entity's listed equity instruments, the published price of the equity shares at the date of exchange is the best evidence of the fair value of the consideration, except in rare circumstances. It is incorrect to measure the consideration by using the agreement price directly. Members should note that according to paragraph 20 of HKAS 28, "the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate". Therefore, paragraph 27 of HKFRS 3 which mentions that consideration that is satisfied by the issue of new shares should be measured at the published price at the date of exchange, except in rare circumstances, is also applicable for the acquisition of associate;

(b) Disclosure on the fair value of investments in associates for which there are published price quotations (paragraph 37(a) of HKAS 28);

(c) Disclosure on the summarized financial information of associates, including the aggregated amounts of assets, liabilities, revenues and profit or loss (paragraph 37(b) of HKAS 28);

(d) Disclosure on the reasons why the presumption that an investor does not have significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting or potential voting power of the investee but concludes that it has significant influence (paragraph 37(c) of HKAS 28);

(e) Disclosure for the reasons why the presumption that an investor has significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting or potential voting power of the investee but concludes that it does not have significant influence (paragraph 37(d) of HKAS 28); and

(f) As goodwill included in the carrying amount of an investment in an associate is not separately recognized, it is not separately tested for impairment. Instead, the entire carrying amount of the investment in the associate is tested under HKAS 36 for impairment, by comparing its recoverable amount with its carrying amount (paragraph 33 of HKAS 28).

5.13 Financial instruments

Application of HKAS 32 Financial Instruments: Presentation and HKAS 39 Financial Instruments: Recognition and Measurement remains a challenging area to members. However, the number of enquiries raised in this year was not many, probably due to members' fuller understanding of the two standards. In response to the enquiries asked, in most cases, the auditors were able to answer the enquiries and provide clear explanations of how they were satisfied that the accounting treatments of relevant financial instruments complied with the standards.

As a reference to members, the following matters came to our attention when reviewing the financial statements:

(a) omission of accounting policy for financial guarantee contracts and how the financial guarantee contracts were properly recognized at fair value at initial recognition;

(b) classification of conversion option of convertible financial instruments and calculation of fair value of the instrument issued as non-cash settlement of a liability;

(c) fair value measurement of early redemption option of convertible instruments; and

(d) accounting treatment for transaction costs that are directly attributable to the acquisition or issue of the financial assets or financial liability.

- **Current developments relating to IAS 39 and HKAS 39**

  In the current global financial crisis, debate has arisen in the market about fair value measures and pressure is being brought to bear from some quarters for scrapping of the fair value model on the basis that (i) it is a contributory cause of the financial crisis and (ii) on the technical level, "fair value" has proved extremely difficult to determine for some complex securitized and derivative instruments.

  The International Accounting Standards Board ("IASB") had made its response to the global financial crisis which is available in the following link:

  http://www.iasb.org/About+Us/About+the+IASB/Response+to+the+credit+crisis.htm

  In connection with the fair value accounting debate and US Financial Accounting Standard Board's recent proposed guidance on fair value measurement and impairments of financial instruments, the G20 in its 2009 meeting called for standard-setters "to reduce the complexity of accounting standards for financial instruments" and to appropriately address issues arising from the global financial crisis such as loan-loss provisioning.

In its press release of 24 April 2009, the IASB announced the timetable for its comprehensive project to undertake the replacement of IAS 39 with a common and globally accepted standard that would address issues arising from the financial crisis in a comprehensive manner. This course of action for replacement of IAS 39 is consistent with the call by the G20 "to reduce the complexity of accounting standards for financial instruments".

As also announced in the press release of 24 April 2009, the IASB had reviewed the Staff Positions of the US Financial Accounting Standards Board (FASB FSP) on fair value measurement in inactive markets and impairments of financial instruments.

(a) Fair value measurement: To ensure ongoing consistency in the application of IFRSs and US GAAP, the IASB will include relevant guidance from the FSP in the IASB's exposure draft on fair value measurement, which has been published in May 2009.

(b) Impairment of financial assets: IASB agreed that it should improve its impairment requirements and would take up the issue of impairment as part of its comprehensive and urgent review of IAS 39. The IASB believes that an immediate response to the recent FSP on impairment is unnecessary. It will work with the FASB as part of its comprehensive project to ensure global consistency in impairment approaches. The IASB will include this in the comprehensive revision of IAS 39.

Members may find it helpful to refer to the following link to the IASB press release to understand the progress of the IASB replacement project of IAS 39 and its conclusion on FASB FSPs:

http://www.iasb.org/News/Press+Releases/IASB+sets+out+timetable+for+IAS+39+replacement+and+its+conclusions+on+FASB+FSPs.htm

With respect to all of the above, members are advised that the Institute has done the following in response to the global financial crisis on financial reporting:

(a) Paper to Hong Kong SAR Government on G20's declaration

The Institute has carefully examined the declaration following the initial G20 meeting in Washington in November 2008 and the useful principles laid down therein. On 27 March 2009, the Institute submitted a paper to Hong Kong SAR Government for the G20 meeting on 2 April in London. The paper outlines a number of issues and concerns, such as its views on fair value accounting and also extends to matters that have

not been covered specifically in the G20 declaration. The paper also included the recommended action to be taken to address those issues and concerns, which were believed, would be of benefit to Hong Kong and G20 members generally.

Electronic copy of the paper is available in the Institute's website at:

http://www.hkicpa.org.hk/correspondence/mail_2009-03-30/G20paper.pdf

(b) Response to Financial Crisis Advisory Group ("FCAG")

The Institute's response to FCAG on 3 April 2009 on the accounting and reporting matters related to the global financial crisis is available at the following link. FCAG is a high level advisory group set up by the IASB and FASB which will consider financial reporting issues arising from the global financial crisis. Results of its work will feed into the work of related projects and additional measures may be undertaken.

http://www.hkicpa.org.hk/professionaltechnical/accounting/submissions/2009/IASB-US_FASB.pdf

(c) Response made to IASB

In connection to the proposed revision of IAS 39, on 24 April 2008, the Institute had also made its responses to IASB Request for views on Proposed FASB Amendments on Fair Value Measurement and Impairment Requirements for Certain Investments in Debt and Equity Securities. The response is available at:

http://www.hkicpa.org.hk/professionaltechnical/accounting/submissions/2009/Sub-Staff_Guidance.pdf

Given that HKFRS has been converged with IFRS since 2005, any changes to IAS 39 would therefore have a direct impact on HKAS 39. Members are requested to keep a close watch on the development of the new IAS 39 which is likely would have an impact on the financial statements prepared under HKFRS.

June 2009

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