Alert

Updates on financial reporting, auditing and ethics

Issue 38 (April 2021)

Dear members,

Commitment to ensuring audit quality

Introduction

The Institute issued its Quality Assurance Department Report 2020 on 21 April 2021. As in previous years the report sets out the most commonly occurring findings identified by the Institute's practice review programme, highlighting audit areas that appear to be most challenging to auditors. The report explains how this has resulted in failures to comply with auditing standards, and suggests how auditors should prepare to address such deficiencies. The report also highlights areas where auditors should pay more attention when conducting audits as a result of increased audit risks or challenges to the effective conduct of audits arising from the consequences of the COVID-19 pandemic. Audit practitioners are strongly recommended to read through the report and consider its findings.

It is a timely opportunity for the Auditing and Assurance Standards Committee and the Standard Setting Department to provide their own reminders to practitioners of important topical matters: the purpose and value of an audit, the current audit environment and certain key areas that might need extra focus.

This Alert is intended as general information and includes topics that are of interest to both professional accountants in practice and in business. It should not be relied upon as being authoritative or all-inclusive, or a substitute for reading and complying with the standards.

Purpose and value of audit

When performing an assurance engagement, a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against agreed criteria.

An audit is a form of assurance engagement giving reasonable assurance on the financial statements. It provides reasonable assurance that the financial statements prepared by management give a 'true and fair' view of an entity's financial performance and position as well as its cash flows. In an audit, it is not possible to provide absolute assurance due to a number of factors such as:

- the use of selective testing
- the inherent limitations of internal control
- the fact that most of the evidence available is persuasive rather than conclusive

- the use of professional judgement in gathering and evaluating evidence and forming conclusions based on that evidence

An audit underpins the trust and obligation of stewardship between the owners and management of the entity. Audited financial statements are also used by other stakeholders such as potential investors and banks. *Audits of financial statements* play a critical role in enhancing confidence of these users.

Though an audit is mandatory under the Companies Ordinance in Hong Kong, it should not be viewed as a compliance burden. It offers the entity an opportunity to review its operations and consider improvements. For example, the audit involves the external review of an entity's internal control systems by the auditor. Even though no opinion is expressed on the effectiveness of the entity's internal control in the auditor's report, the auditor can share their insights on the internal control systems with those charged with governance and management. Such communications can add value to the entity and enhance the overall quality of its business processes.

Audit environment

Auditors need to keep abreast of changes in the economic environment that impact the audited entity's operations and financial reporting. For example, in the current COVID-19 situation, there may be changes in the entity's internal control systems and this may increase the level of risks affecting the business. This also affects the way the audit is conducted. The auditor must consider how external environments impact their audit risk assessments and whether any revision is needed to their planned audit procedures or whether to perform additional procedures in response, as required under Hong Kong Standard on Auditing (HKSA) 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Fraud risks

Under s379 of the Companies Ordinance, directors of entities, except those meeting exemptions, are required to prepare financial statements for each financial year that give a true and fair view of the financial position as at the year end date and the financial performance for the year.

As set out in paragraph 4 of HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, "[t]he primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management of the entity. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment." The paragraph continues that this involves a commitment to creating a culture of honesty and ethical behaviour, which can be reinforced by an active oversight by those charged with governance. Oversight includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

An auditor conducting an audit is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs.

Given the continued disruption caused by COVID-19, there is increased inherent risk of fraud in all business sectors. It is critical that management revisit their fraud risk assessments to ensure that they remain fit for purpose.

Likewise for auditors, identifying and assessing risks may be more challenging due to these uncertainties. The auditor's assessment of the risks of material misstatement, including fraud risks, continues throughout the audit, and may change over time. For example, there may be new risks identified as responses to COVID-19 evolve.

Auditors are reminded to exercise professional skepticism – to have an attitude of a questioning mind and critical assessment – when gathering audit evidence.

Going concern

As a result of the uncertainty caused by COVID-19, going concern is one of the challenging areas for both management and auditors. It is the responsibility of management to assess whether the going concern basis for accounting is appropriate.

Auditors are required under HKSA 570 (Revised) *Going Concern* to obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern basis of accounting in the preparation of financial statements. They must also conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

The Quality Assurance Department Report 2020 highlights that due to the impact of COVID-19 and resulting uncertainty in the business and wider economic environments, auditors may need to perform additional procedures to evaluate the appropriateness of management's assessment of the entity's ability to continue as a going concern and assess asset impairment. Consideration should be given to the scenarios and assumptions that management used in their assessment and the nature of material uncertainties.

Auditors are also reminded that if based on their judgement, management's use of the going concern basis of accounting is inappropriate, they should consider the implications on the auditor's report and/or the audit opinion.

Conclusion

Although the way that auditors interact with clients may have changed recently, auditing standards have not. Auditors need to maintain their focus on enhancing audit quality that will drive our profession forward.

Auditors must continue to comply with the required standards, which may necessitate different and enhanced considerations given the current circumstances. Auditors may also need to consider developing alternative procedures to gather sufficient appropriate audit evidence to support their audit opinion, or to modify the audit opinion.

The Institute will continue to support the profession through these challenging times. We are aware of the additional pressure COVID-19 has put on our members to try and maintain their working routines and continue to provide quality service to clients. During the past year we have issued guidance on audit related matters, and collated guidance from others on the COVID-19 – CPA Information Centre. Members should review these guidance, which they may find helpful.

The Institute expects to see evidence of improvements in overall audit quality in the results of practice reviews in 2021 and subsequent years. Practices are encouraged to take note of the key findings in the Quality Assurance Department Report 2020 and make appropriate changes to enhance effectiveness of their quality control and audit systems to prevent these deficiencies from occurring in their future audits.

Sincere regards,

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