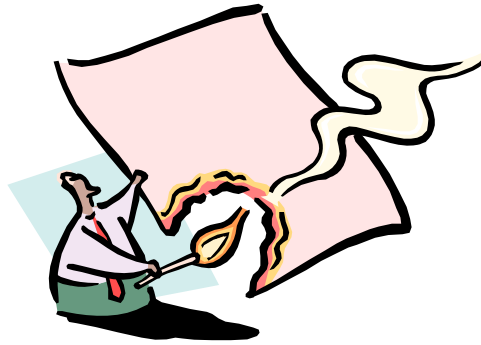


Overview of Auditing Standards – Recap and Update

7 August 2009



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What is Your Expectation?



Per your flyer

- Overview on HKSQC 1 and the critical HKSA's
- Recap of risk assessment standards
 - Including HKSA 315 and 330
- Update of the international clarity project on the ISA and the resulting effects on HKSA

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Today's Agenda



Simple but
Comprehensive

Critical and New
Issues

Templates and
Examples

Overview

HKSQC 1 and Critical HKSA's

Risk Assessment and Response to
Assessed Risks (incl. Assertions)

Update (ISA Clarity Project in HK)

Today's Agenda



Overview

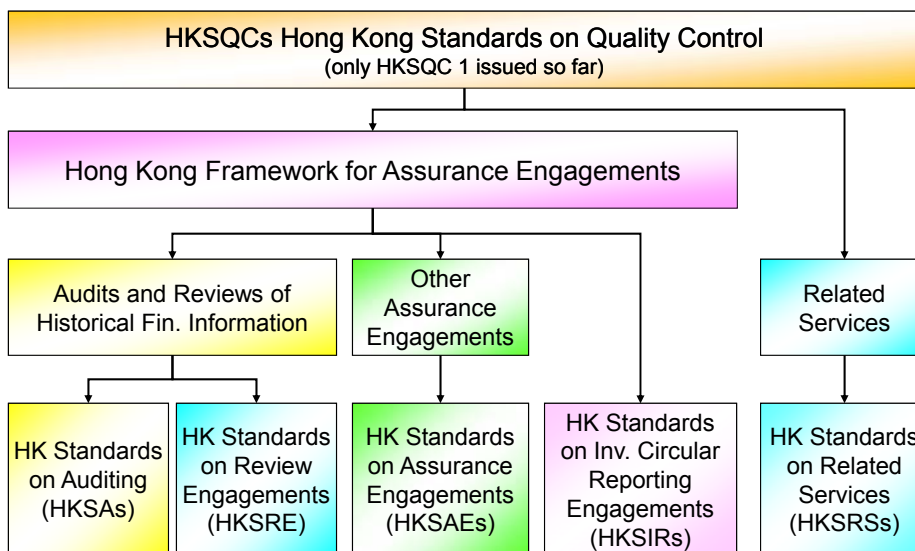
Overview

- Auditing standards have been re-structured since 2004
 - Become part of the standards under standards on quality control, auditing, assurance and related services
 - Standards on quality control apply on a firm-wide basis
 - HKSQC 1 was issued in 2004 and become effective as of 15 June 2005
 - HKSA and other standards aligned with ISAs and other international standards
 - All SASs are being replaced by HKSA

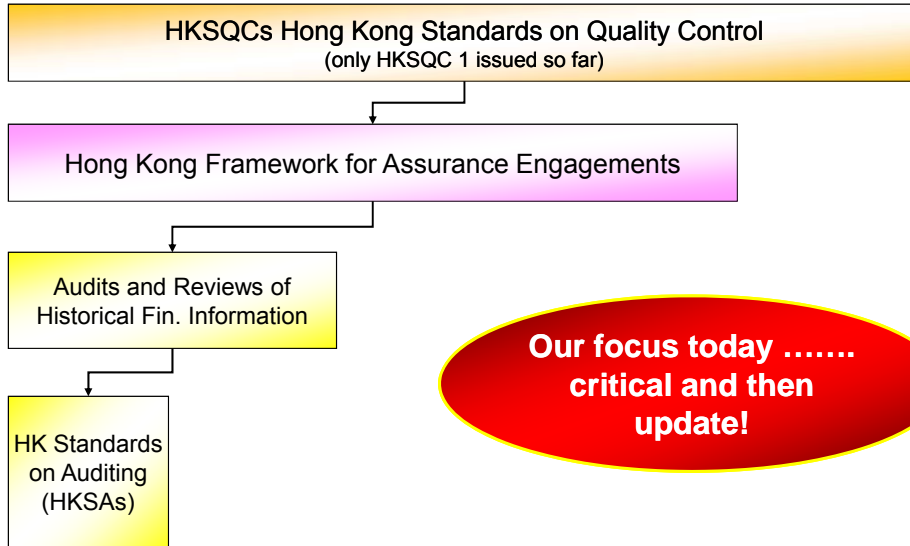
- IAASB has finalised its clarity project on its ISAs in early 2009.....



Overview



Overview



Today's Agenda



HK SQC 1 and Critical HK SAs

HKSQC 1

HKSQCs Hong Kong Standards on Quality Control
(only HKSQC 1 issued so far)

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

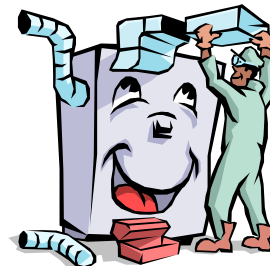
- to establish basic principles and essential procedures and to provide guidance
 - regarding a firm's responsibilities for its system of quality control
 - for audits and reviews of historical financial information, and
 - for other assurance and related services engagements.



HKSQC 1

HKSQC 1 requires:

- The firm should establish a system of quality control designed to provide it with reasonable assurance
 - that the firm and its personnel comply with professional standards and regulatory and legal requirements, and
 - that reports issued by the firm or engagement partners are appropriate in the circumstances.



HKSQC 1

HKSQC 1 requires:

- The firm's system of quality control should include policies and procedures addressing each of the following elements:
 - a) Leadership responsibilities for quality within the firm
 - Quality Manual
 - Promote internal culture
 - CEO or Managing partner(s) assume ultimate responsibility
 - b) Ethical requirements
 - Integrity of the client
 - Competent to perform the job
 - Comply with ethical requirement
 - c) Acceptance and continuance of client relationships and specific engagements
 - Sufficient and competent personnel committed to ethics
 - Each job with appropriate staff
 - d) Human resources
 - e) Engagement performance
 - f) Monitoring
 - Significant new requirements

HKSQC 1 – Engagement Performance

- The firm's policies and procedures on engagement performance should include:

Consultation

Engagement Quality Control Review

Documentation

- Consultation policies and procedures should be established and designed to provide it with reasonable assurance that:
 - a) Appropriate consultation takes place on difficult or contentious matters;
 - b) Sufficient resources are available to enable appropriate consultation to take place;
 - c) The nature and scope of such consultations are documented; and
 - d) Conclusions resulting from consultations are documented and implemented.



HKSQC 1 – Engagement Performance

- The firm's policies and procedures on engagement performance should include:

Engagement Quality Control Review

- The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review
 - that provides an objective evaluation of
 - the significant judgments made by the engagement team and
 - the conclusions reached in formulating the report.

HKSQC 1 – Engagement Performance

- The firm's policies and procedures on engagement performance should include:

Engagement Quality Control Review

- Require an EQC Reviewer
- Similar to a 2nd partner to have 2nd review
- For all audits of financial statements of **listed entities** (set criteria for other audits)
- **Not to issue** auditor's report until the completion of EQC Review

- Such policies & procedures should:
 - a) Require an engagement quality control review for all audits of financial statements of listed entities;
 - b) Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and
 - c) Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).

HKSQC 1 – Engagement Performance

- The firm's policies and procedures on engagement performance should include:

Engagement Quality Control Review

- The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:
 - a) The technical qualifications required to perform the role, including the necessary experience and authority; and
 - b) The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.

HKSQC 1 – Engagement Performance

- The firm's policies and procedures on engagement performance should include:

Documentation

- To complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized
 - Observe local laws and regulations
 - In or audit, **no more than 60 days** after the date of auditor's report
- For the retention of documentation for a period sufficient to meet the needs of the firm or as required by law or regulation
 - the retention period ordinarily is **no shorter than 5 years** from the date of the auditor's report, or, if later, the date of the group auditor's report

HKSQC 1 – Monitoring

- Policies and procedures for monitoring should include
 - an ongoing consideration and evaluation of the firm's system of quality control, including
 - a periodic inspection of a selection of completed engagements.

Ongoing Evaluation

Quality Assurance Review (QAR)



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HKSQC 1 – Monitoring

- Periodic inspection of a selection of completed engagement
 - Termed as Quality Assurance Review (QAR) in Practice Review Self-assessment Questionnaire
 - Ordinarily performed on a cyclical basis
 - Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years
 - Includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team
 - Those inspecting the engagements (“the monitor”) are not involved in performing the engagement or the engagement quality control review (EQCR)

- Small firm may wish to use a qualified external person or another firm to carry out that QAR

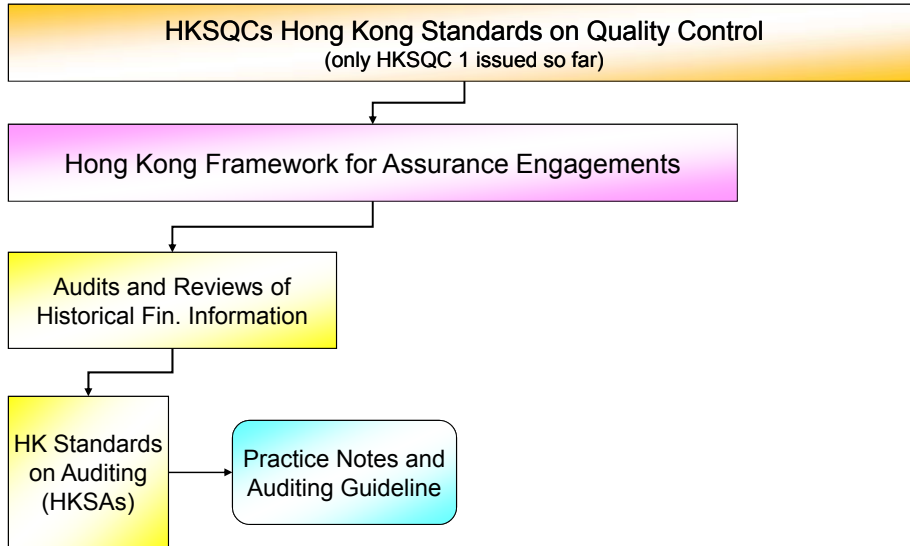
Quality Assurance Review (QAR)



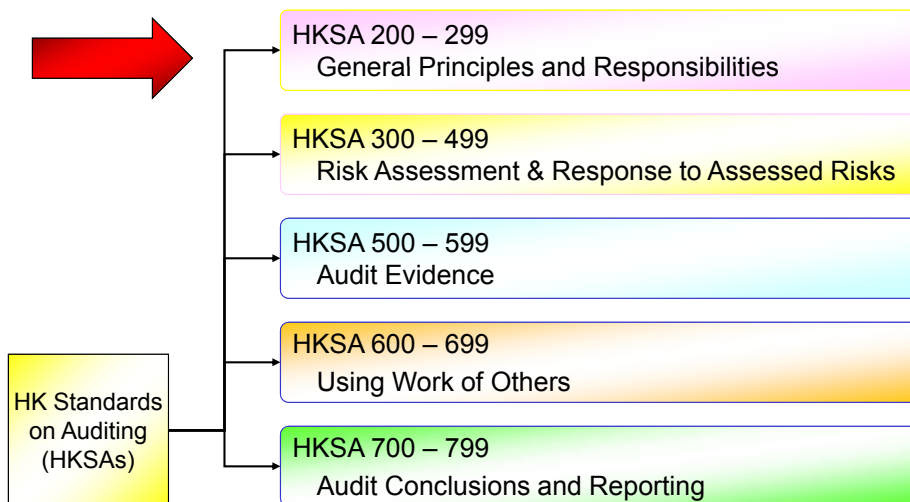
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HKSQC and HKSA



HKSQC and HKSA



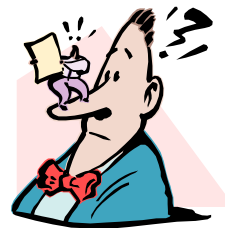
General Principles and Responsibilities

HKSA 200 – 299 General Principles and Responsibilities

- HKSA 200 Objective and General Principles Governing an Audit of Financial Statements
- HKSA 210 Terms of Audit Engagements
- HKSA 220 Quality Control for Audits of Historical Financial Information
- HKSA 230 Audit Documentation
- HKSA 240 The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements
- HKSA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
- HKSA 260 Communication of Audit Matters with Those Charged with Governance

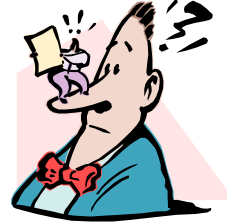
General Principles and Responsibilities

- Generally, HKSAs 200 – 260 set out the general principles and responsibilities for a particular engagement on audit of historical financial information
- In particular, HKSA 220 sets out the quality control on a particular audit engagement
 - Similar to those set out in HKSQC 1
 - While HKSA 220 is tailored to an engagement on audit of historical financial information



General Principles and Responsibilities

- Certain responsibilities must be taken by the engagement partner, including
 - Agree the terms of the engagement (HKSA 210.2)
 - Overall quality of the engagement (HKSA 220.6)
 - Comply with the ethical requirements (HKSA 220.8)
 - Conclude on compliance with independence requirements that apply to the audit engagement (HKSA 220.12)
 - Satisfy appropriate procedures regarding the acceptance and continuance of client relationships followed (HKSA 220.14)
 - Satisfy the engagement team collectively having appropriate capabilities, competence and time to perform the engagement (HKSA 220.19)
 - Take responsibility for the direction, supervision and performance of the audit engagement (HKSA 220.21)
 - Be responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters (HKSA 220.30)

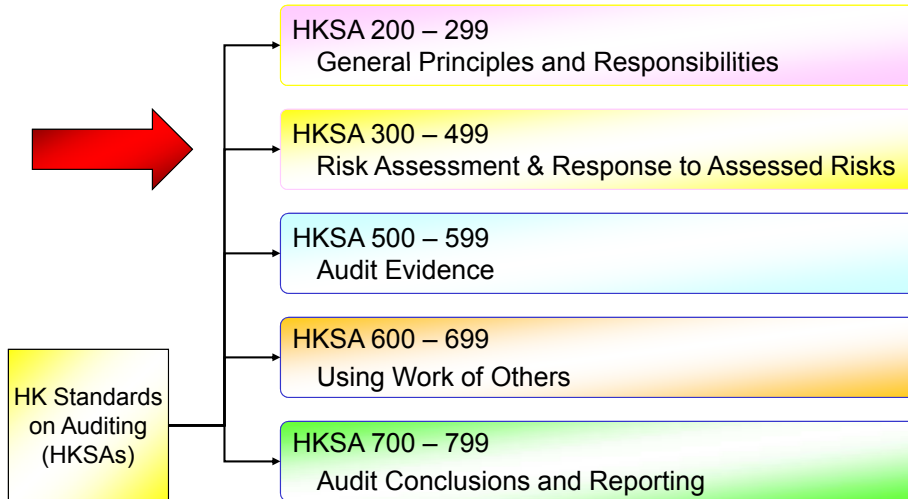


Today's Agenda



Risk Assessment and Response to Assessed Risks (incl. Assertions)

Risk Assessment and Response



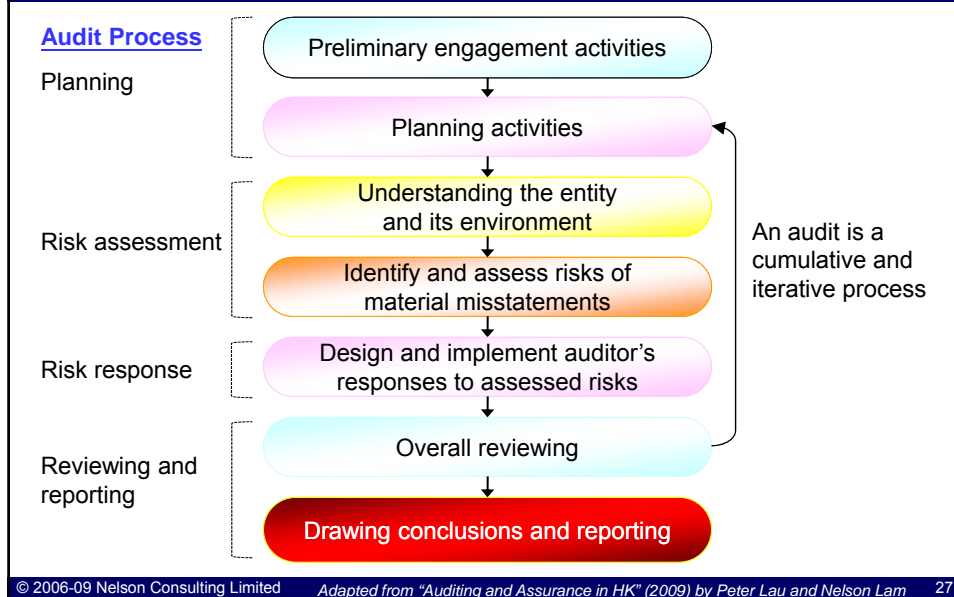
Risk Assessment and Response

One of the Critical Requirements in our Audit

**HKSA 300 – 499
Risk Assessment & Response to Assessed Risks**

- HKSA 300 Planning an Audit of Financial Statements
- HKSA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
- HKSA 320 Audit Materiality
- HKSA 330 The Auditor's Procedures in Response to Assessed Risks
- HKSA 402 Audit Considerations Relating to Entities Using Service Organizations

Audit Process Overview

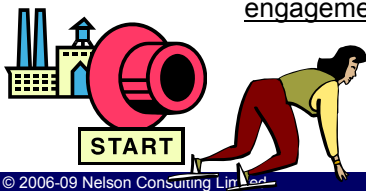


Preliminary Engagement Activities

Preliminary engagement activities

HKSA 300 Planning an Audit of Financial Statements

- The auditor should perform the following activities at the beginning of the current audit engagement: (HKSA 300.6)
 - Perform procedures regarding the continuance of the client relationship and the specific audit engagement
 - Evaluate compliance with ethical requirements, including independence
 - Establish an understanding of the terms of the engagement



Planning Activities



- The auditor **should** establish and document
 - Overall audit strategy for the audit and
 - Audit plan for the audit in order to reduce audit risk to an acceptably low level.
- Both the overall audit strategy and audit plan should be updated and changed as necessary during the course of the audit.

Planning – Overall Audit Strategy

- HKSA 300 specifically requires that:
 - The auditor should establish the overall audit strategy for the audit (HKSA 300.8)
- The overall audit strategy
 - sets the scope, timing and direction of the audit, and
 - guides the development of the more detailed audit plan.

Overall Audit Strategy



Planning – Overall Audit Strategy

- The establishment of the overall audit strategy involves:
 - a) Determining the characteristics of the engagement that define its scope
 - b) Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required
 - c) Considering the important factors that will determine the focus of the engagement team's efforts

Overall Audit Strategy

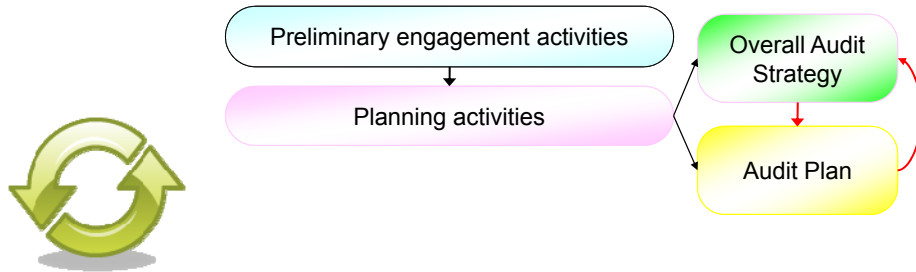


Planning – Overall Audit Strategy



- In developing the overall audit strategy, the auditor also considers
 - the results of preliminary engagement activities and,
 - where practicable, experience gained on other engagements performed for the entity.

From Strategy to Audit Plan



- Once the overall audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the overall audit strategy.
- Although the auditor ordinarily establishes the overall audit strategy before developing the detailed audit plan, the two planning activities
 - are not necessarily discrete or sequential processes
 - but are closely inter-related since changes in one may result in consequential changes to the other.

Planning – Audit Plan

- The auditor should develop **an audit plan** for the audit in order to reduce audit risk to an acceptably low level. (HKSA 300.13)
- The audit plan
 - is more detailed than the audit strategy and
 - includes:
 - A description of the nature, timing and extent of **planned risk assessment procedures** sufficient to assess the risks of material misstatements (as determined under HKSA 315)
 - A description of the nature, timing and extent of **planned further audit procedures at the assertion level** for each material class of transactions, account balance and disclosures (as determined under HKSA 330)
 - Such **other audit procedures** required to be carried out for the engagement in order to comply with HKSA

Audit Plan

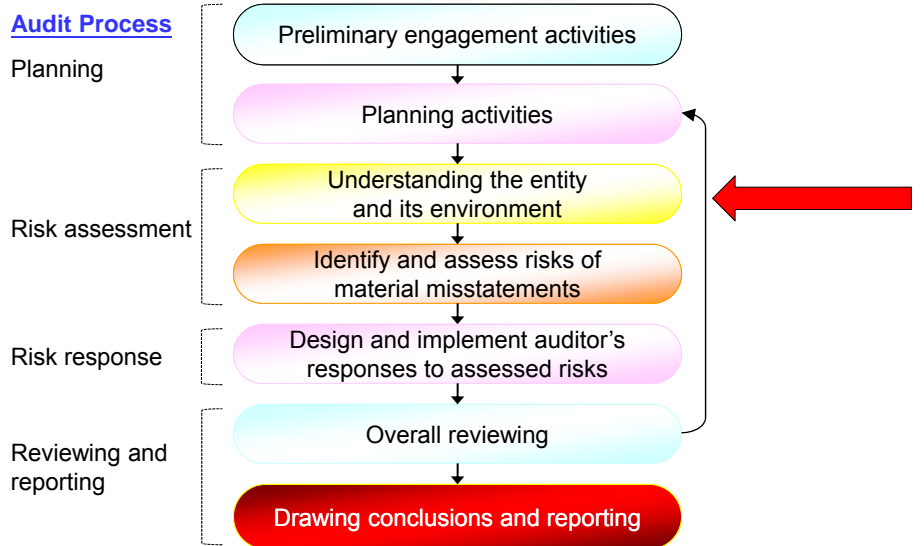
Risk Assessment Procedures

Further Audit Procedures

Other Audit Procedures

Audit Process Overview

Audit Process



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Risk Assessment Procedures

- Audit procedures to obtain an understanding are referred to as "**risk assessment procedures**"

- because some of the information obtained by performing such procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement



- Obtaining an understanding of the entity and its environment, including its internal control, is
 - a continuous, dynamic process of gathering, updating and analyzing information throughout the audit.

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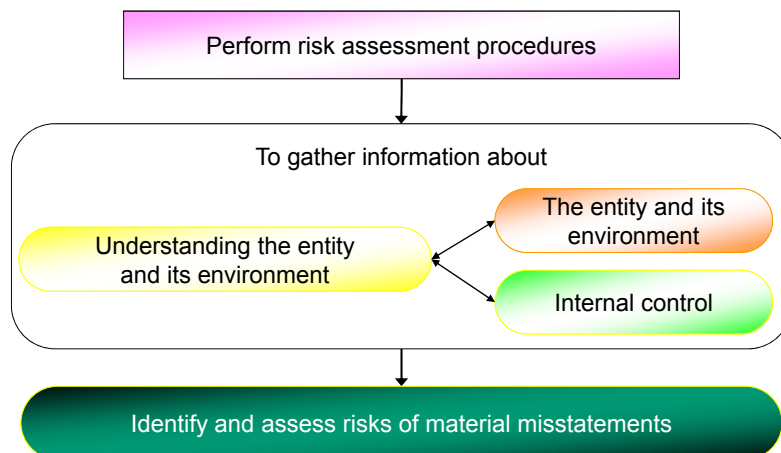
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Risk Assessment Procedures

- HKSA 315 specifically requires that:
 - The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:
 - a) Inquiries of management and others within the entity;
 - b) Analytical procedures; and
 - c) Observation and inspection. (HKSA 315.7)

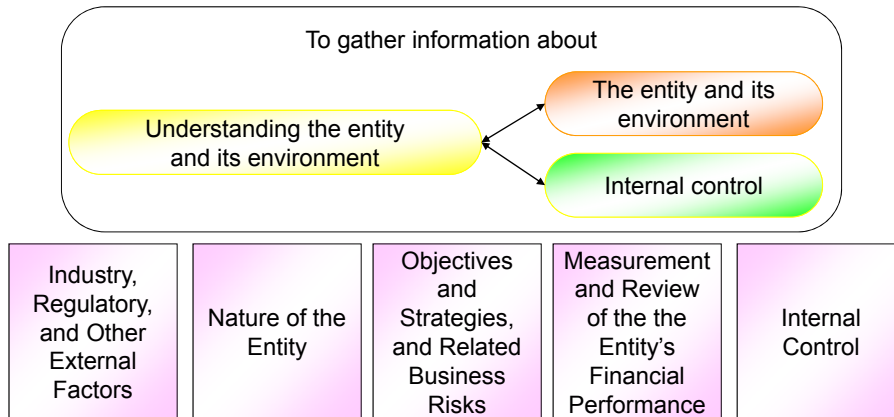


Risk Assessment Procedures



Understanding of the Entity

- Risk assessment procedures are used to obtain an understanding of the entity

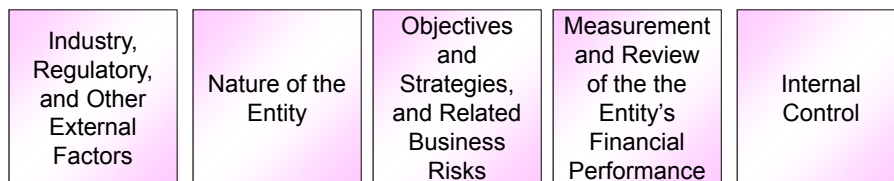


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Understanding of the Entity

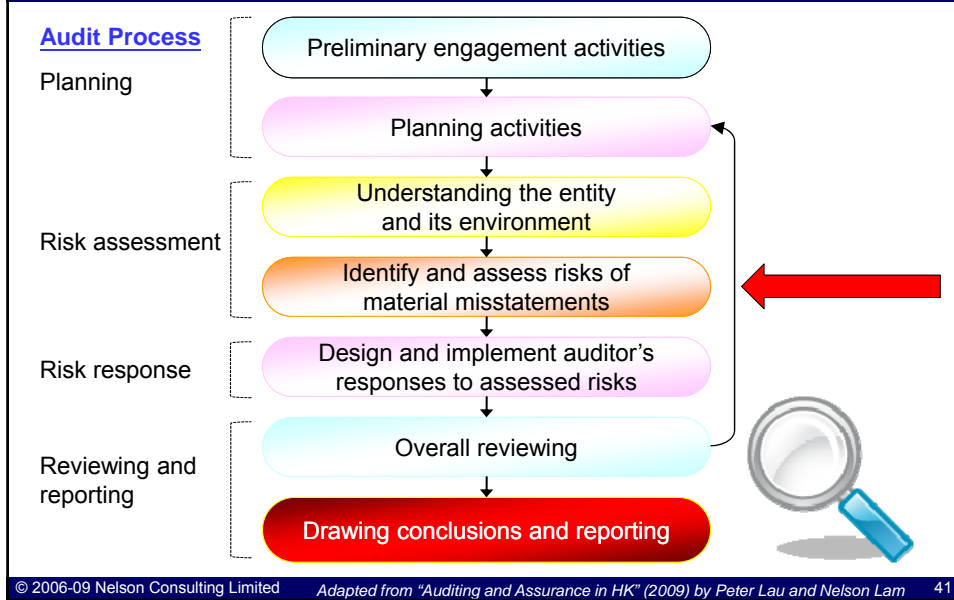
- The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:
 1. Industry, regulatory, and other external factors, including the applicable financial reporting framework.
 2. Nature of the entity, including the entity's selection and application of accounting policies.
 3. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
 4. Measurement and review of the entity's financial performance.
 5. Internal control.



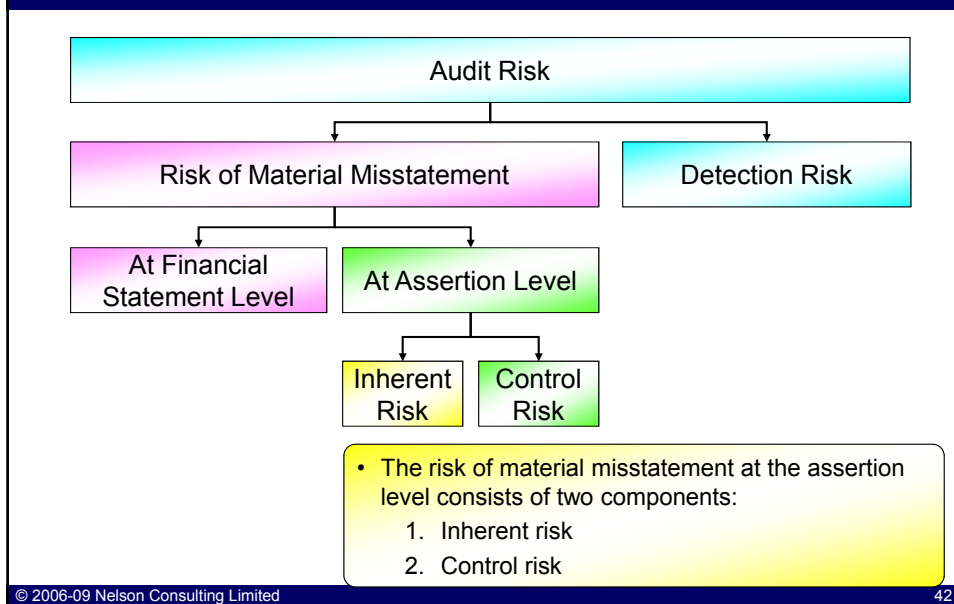
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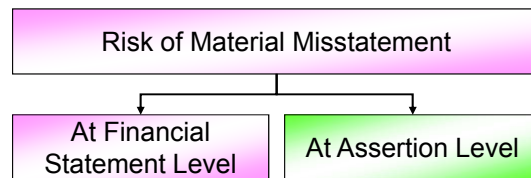
Audit Process Overview



Assessing the Risks



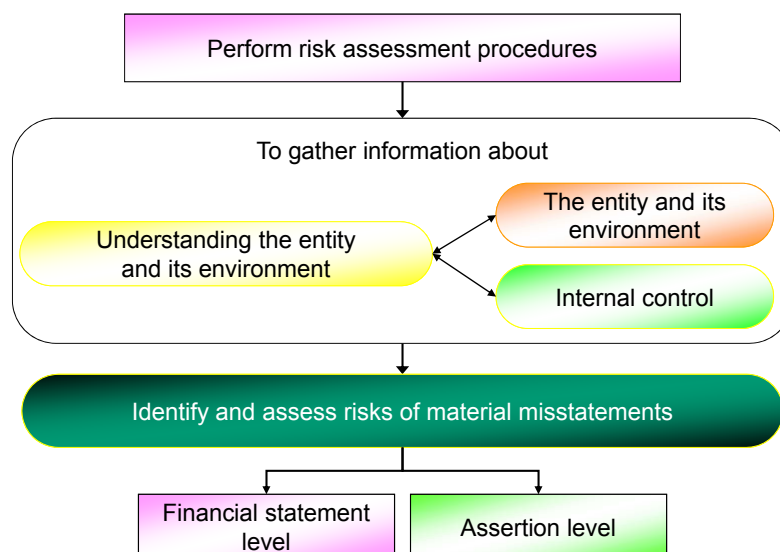
Assessing the Risks



HKSA 315 requires that

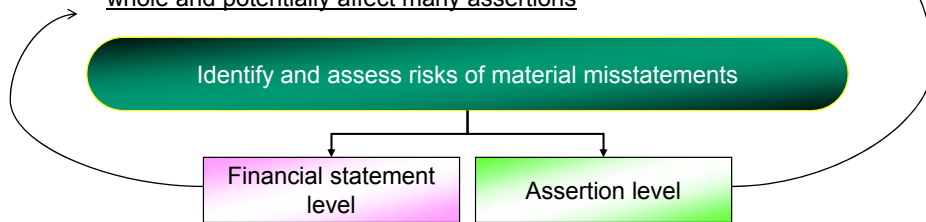
- The auditor should identify and assess the risks of material misstatement
 - at the financial statement level, and
 - at the assertion level for classes of transactions, account balances, and disclosures (HKSA 315.100)

Assessing the Risks

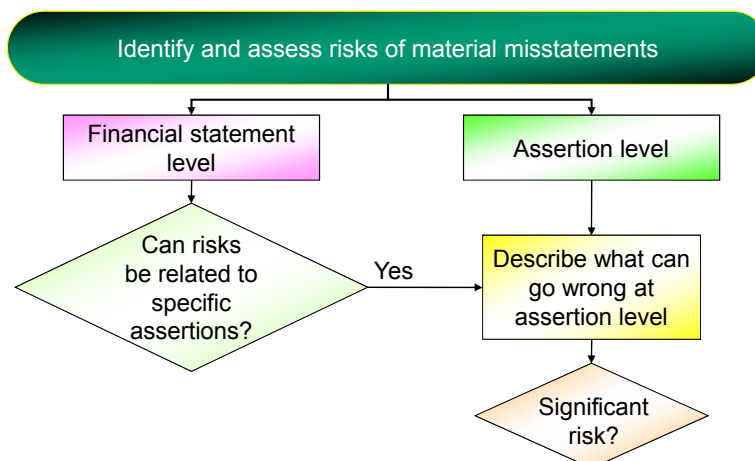


Assessing the Risks

- The auditor uses information gathered by performing risk assessment procedures as audit evidence to support the risk assessment, and
 - in turn, uses the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.
- The auditor determines
 - whether the identified risks of material misstatement relate to specific classes of transactions, account balances, and disclosures and related assertions, or
 - whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions



Assessing the Risks



Determine Significant Risks

- As part of the risk assessment, the auditor should determine
 - which of the risks identified are, in the auditor’s judgment, risks that require special audit consideration
 - such risks are defined as “**significant risks**”. (HKSA 315.108)
- The determination of significant risks, which arise on most audits, is a matter for the auditor’s professional judgment.
 - In exercising this judgment, the auditor excludes the effect of identified controls related to the risk to determine whether
 - the nature of the risk,
 - the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and
 - the likelihood of the risk occurringare such that they require special audit consideration.



Determine Significant Risks

- Significant risks are often derived from **business risks** that may result in a material misstatement. In considering the nature of the risks, the auditor considers a number of matters, including the following:
 - Whether the risk is a risk of fraud.
 - Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
 - The complexity of transactions.
 - Whether the risk involves significant transactions with related parties.
- Significant risks often relate to significant **non-routine transactions** and **judgmental matters**.
 - **Non-routine transactions** are transactions that are unusual, either due to size or nature, and that therefore occur infrequently.
 - **Judgmental matters** may include the development of accounting estimates for which there is significant measurement uncertainty.

Determine Significant Risks

Example

- Risks of material misstatement may be greater for risks relating to significant non-routine transactions arising from matters such as:
 - Greater management intervention to specify the accounting treatment.
 - Greater manual intervention for data collection and processing.
 - Complex calculations or accounting principles.
 - The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
- Risks of material misstatement may be greater for risks relating to significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:
 - Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
 - Required judgment may be subjective, complex or require assumptions about the effects of future events, for example, judgment about fair value.

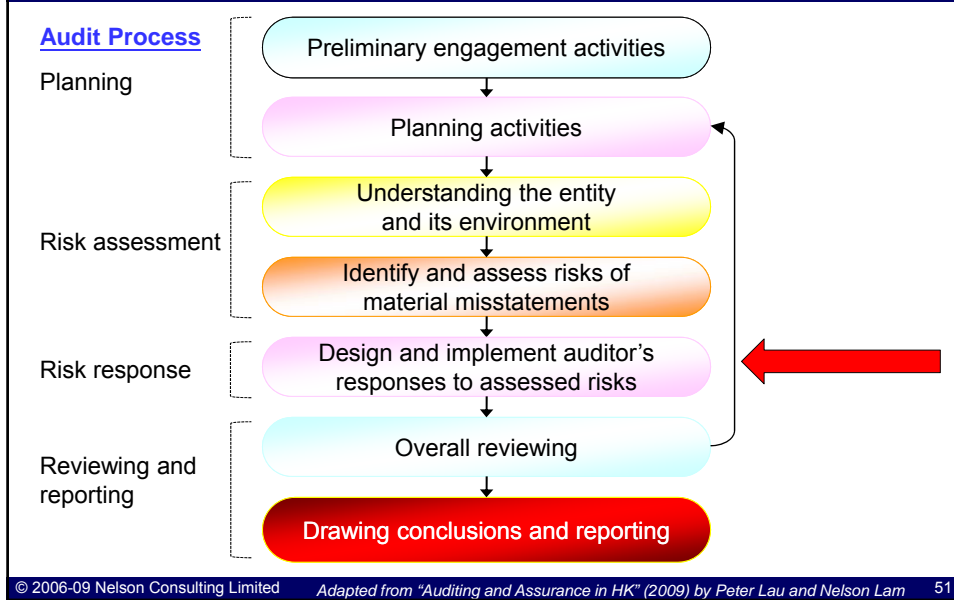
Determine Other Risks

Risks for which Substantive Procedures Alone do not Provide Sufficient Appropriate Audit Evidence

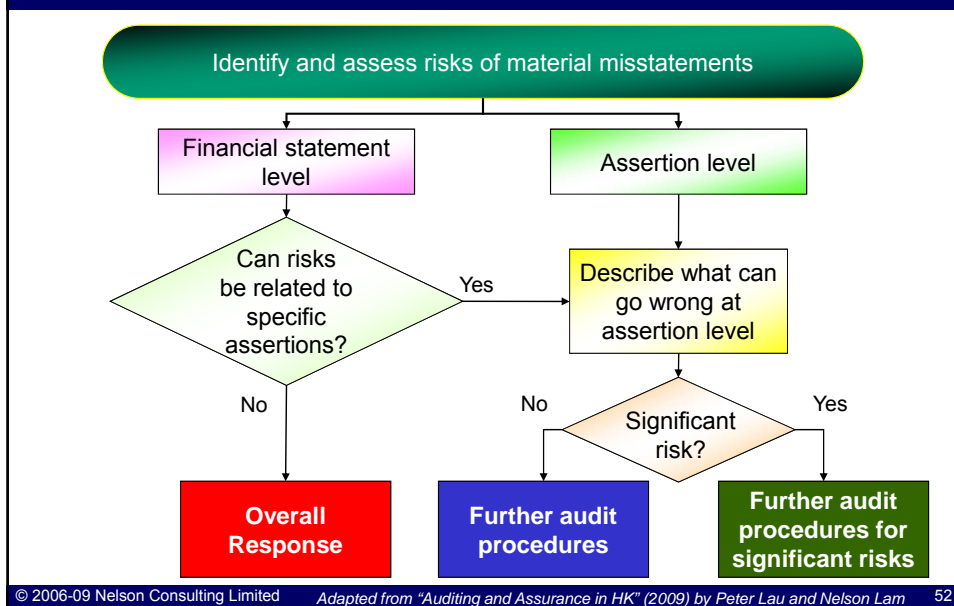
- As part of the risk assessment, the auditor should
 - evaluate the design and
 - determine the implementation of the entity's controls, including relevant control activities, over those risks
 - for which, in the auditor's judgment, it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. (HKSA 315.115)
- Ordinarily, such risks relate to significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

Any examples?

Audit Process Overview



Responses to Assessed Risks



Responses to Assessed Risks

- Based on the understanding of the entity and the assessed risks,
 - HKSA 330 imposes requirements on the auditor to determine the relevant and appropriate response to those assessed risks.
- HKSA 330 clearly requires that:
 - In order to reduce audit risk to an acceptably low level, the auditor
 - should determine **overall responses** to assessed risks at the financial statement level, and
 - should design and perform **further audit procedures** to respond to assessed risks at the assertion level. (HKSA 330.3)

Overall
Response

Further audit
procedures

Overall Responses

Example

- The auditor should determine **Overall Responses** to address the risks of material misstatement at the financial statement level. (HKSA 330.4)
 - Overall responses may include:
 - emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence,
 - assigning more experienced staff or those with special skills or using experts,
 - providing more supervision, or
 - incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
 - making general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Overall
Response

Overall Responses Linked to Risks

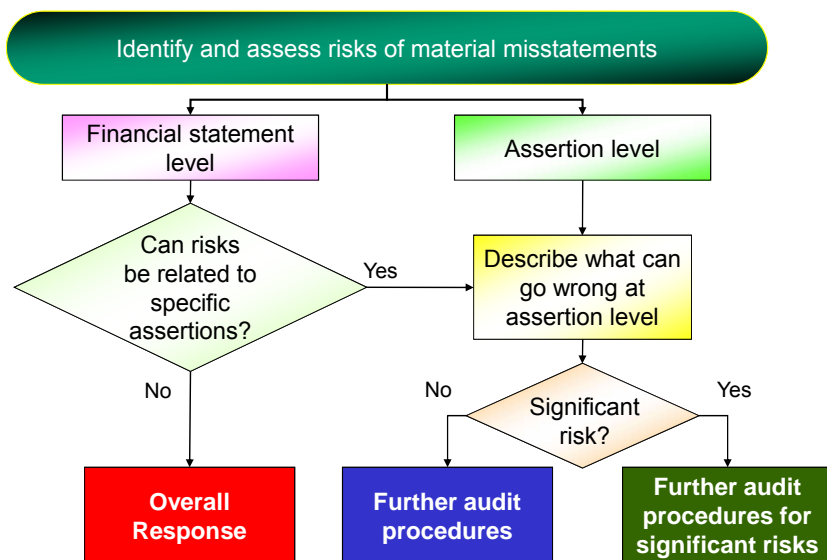
Example

Description of the issues identified	Risk resulted	Significant risk (Y/N)	Overall Responses
1. The entity is an owner-managed private entity and thus lacking formal internal control system.	The financial statements might have been prepared inaccurately.	Yes	<ul style="list-style-type: none"> The audit team is reminded to maintain professional scepticism in performing the engagement. More experienced audit staff is assigned to the engagement.
2. The computer in recording and preparing the financial information has been upgraded.	The financial information might have not been properly transferred to the new computer.	Yes (Non-routine)	<ul style="list-style-type: none"> Audit staff with experience and knowledge in computer data and source information transfer is assigned to the audit team.

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Risks at Assertion Level



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Risks at Assertion Level

- ISA 500 requires the auditor to use assertions for
 - classes of transactions,
 - account balances, and
 - presentation and disclosures

in sufficient detail to form a basis for

- the assessment of risks of material misstatement and
- the design and performance of further audit procedures. (HKSA 500.16)

Assertion level

Class of Transactions

Account Balances

Presentation and Disclosure

Further audit procedures

Further audit procedures for significant risks

Risks at Assertion Level

- Assertions used by the auditor fall into the following categories:
 - About Classes of Transactions and Events for the period under audit
 - Occurrence
 - Completeness
 - Accuracy
 - Cutoff
 - Classification
 - About Account Balances at the period end
 - Existence
 - Rights and obligations
 - Completeness
 - Valuation and allocation
 - About Presentation and Disclosure
 - Occurrence and rights and obligations
 - Completeness
 - Classification and understandability
 - Accuracy and valuation

Class of Transactions

Account Balances

Presentation and Disclosure



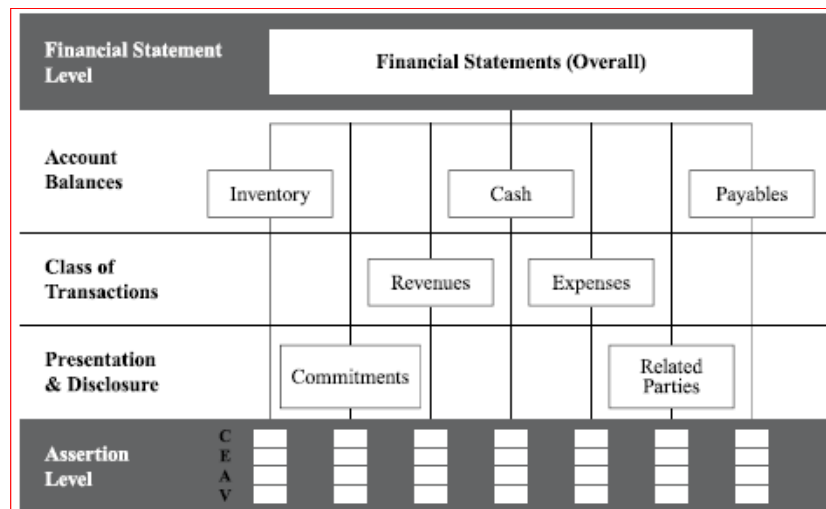
Risks at Assertion Level

- Guide to Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities (IFAC SMPC):
 - To make the use of assertions a little easier to apply to smaller entities, the Guide has combined a no. of the assertions. The 4 combined assertions and the assertions they address are illustrated in the exhibit below.

Combined Assertions	Classes of Transactions	Account Balances	Presentation and Disclosure
Completeness	Completeness	Completeness	Completeness
Existence	Occurrence	Existence	Occurrence
Accuracy and Cut-off	Accuracy Cut-off Classification	Rights and obligations	Accuracy Rights and obligations Classification and understandability
Valuation		Valuation and allocation	Valuation

- When the auditor uses combined assertions, it is important to remember that the accuracy and cut-off assertion also include classification and rights and obligations.

Risks at Assertion Level



Further Audit Procedures (FAP)

- The auditor should design and perform **further audit procedures** whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. (HKSA 330.7)
 - The purpose is to provide a clear linkage between
 - the nature, timing, and extent of the auditor's further audit procedures and
 - the risk assessment.

Nature

Timing

Extent



Further audit procedures

Further Audit Procedures (FAP)

- The auditor's assessment of the identified risks at the assertion level
 - provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.
- Often the auditor may determine that a combined approach is an effective approach, such approach would use
 - tests of the operating effectiveness of controls and
 - substantive procedures.

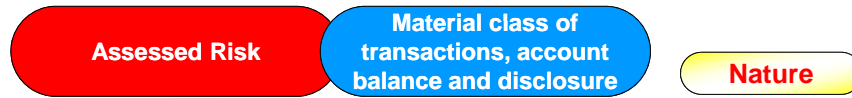
- In some cases, only performing tests of controls may achieve a good response to the assessed risk at an assertion.
- In other cases, performing only substantive procedures is appropriate for an assertions and the relevant control is not considered in risk assessment (say, no relevant effective controls have been identified or such test of control may be inefficient)

Extent

Further audit procedures

Further Audit Procedures (FAP)

- The auditor's **assessment of the identified risks** at the assertion level



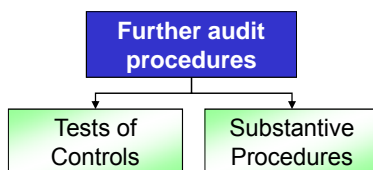
- For each material class of transactions, account balance, and disclosure (irrespective of the approach selected),
 - the auditor should design and perform substantive procedures (as required by HKSA 330.49, to be discussed in detail later)

Timing

Extent

Further audit procedures

FAP under HKSA 330



- FAPs (from the nature perspective) are divided into:
 - Test of controls
 - Substance procedures
- HKSA 330 imposes certain requirements on performing these two kinds of procedures

Nature

Timing

Extent

FAP – Tests of Controls

Tests of Controls

Expectation of Effective Controls

Substantive Procedures Alone Ineffective

- The auditor is required to perform tests of controls
 1. when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or
 2. when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.



FAP – Tests of Controls

Tests of Controls

Timing

- HKSA 330 also requires that
 - If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits,
 - the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit.
 - by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls. (HKSA 330.39)

Controls Changed

Controls Not Changed

FAP – Tests of Controls

Tests of Controls

- HKSA 330 requires that
 - If the auditor plans to rely on controls that have changed since they were last tested,
 - the auditor should test the operating effectiveness of such controls in the current audit. (HKSA 330.40)
 - If the auditor plans to rely on controls that have not changed since they were last tested,
 - the auditor should test the operating effectiveness of such controls at least once in every third audit. (HKSA 330.41)

Timing



Test in current audit

Controls Changed

Controls Not Changed

Test once every third audit

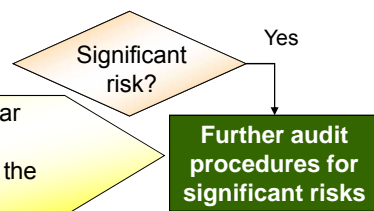
FAP – Tests of Controls

Tests of Controls

- HKSA 330 requires that
 - When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk,
 - the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. (HKSA 330.44)

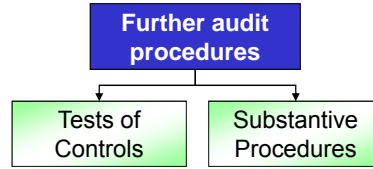
Timing

- Audit evidence from prior year deemed not sufficient
- Test should be performed in the current period



FAP – Substantive Procedures

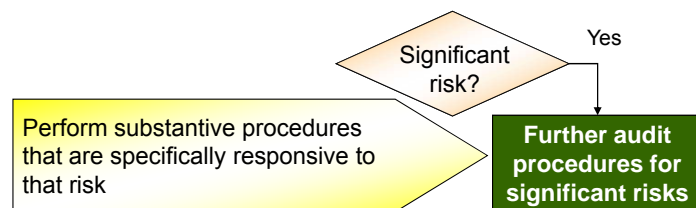
- Substantive procedures are performed in order to detect material misstatements at the assertion level, and include
 - tests of details of classes of transactions, account balances, and disclosures
 - substantive analytical procedures



FAP – Substantive Procedures

- When the auditor has determined that an assessed risk of material misstatement at the assertion level is a **significant risk**,
 - the auditor should perform substantive procedures that are specifically responsive to that risk. (HKSA 330.51)

Substantive Procedures



FAP – Substantive Procedures

Example

- The auditor identifies that the management is under pressure to meet earning expectation, discuss any implication on sales and suggest relevant substantive procedures.

- If the auditor identifies that management is under pressure to meet earnings expectations
 - there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment.
- In these circumstances,
 - the auditor may, for example, design external confirmations
 - not only to confirm outstanding amounts,
 - but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms.
 - In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

FAP Linked to Assessed Risks

Example

Issues and Risks identified	Relevant Assertions	Significant risk (Y/N)	Further Audit Procedures (Audit Responses)
1. Property acquired in Shanghai during the year	Rights and Obligations	Yes (non-routine)	<ul style="list-style-type: none"> • Land search performed in Shanghai • Physical inspection and count on property, plant and equipment to be performed
2. No property has been acquired before and the owner and staff have no knowledge on accounting new property	Accuracy, Valuation, Classification	Yes (non-routine)	<ul style="list-style-type: none"> • Consider the appropriateness of accounting policy on property adopted • Check cost of acquisition to the sale and purchase agreement and match with the payment • Verify the calculation of depreciation independently • Review the entity's impairment review

Presentation and Disclosure

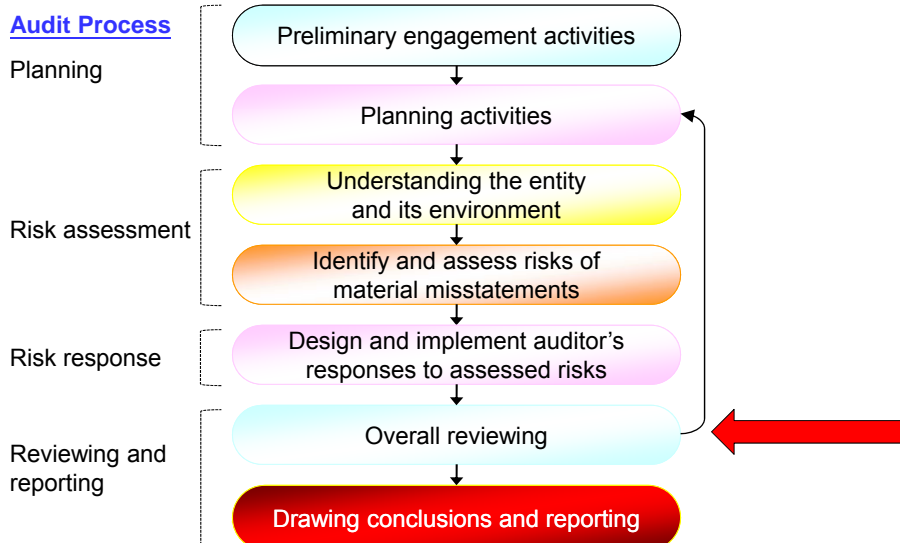
Adequacy of Presentation and Disclosure

- HKSA 330 requires that:
 - The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework. (HKSA 330.65)

Substantive
Procedures



Audit Process Overview



Evaluate Sufficiency and Appropriateness

- HKSA 330 requires that:
 - Based on the audit procedures performed and the audit evidence obtained,
 - the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (HKSA 330.66)
- An audit of financial statements is a cumulative and iterative process.
 - As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures.



Evaluate Sufficiency and Appropriateness

- HKSA 330 requires that:
 - The auditor should conclude whether sufficient appropriate audit evidence has been obtained
 - to reduce to an acceptably low level the risk of material misstatement in the financial statements. (HKSA 330.70)
 - If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion,
 - the auditor should attempt to obtain further audit evidence.
 - If the auditor is unable to obtain sufficient appropriate audit evidence,
 - the auditor should express
 - a qualified opinion or
 - a disclaimer of opinion. (HKSA 330.72)



Today's Agenda



Update (ISA Clarity Project in HK)

The IAASB Clarity Project



- In 2004, the IAASB of International Federation of Accountants also began a comprehensive programme to enhance the clarity of its ISAs (termed as the [IAASB Clarity Project](#))
 - The programme involved the application of new drafting conventions to all ISAs, either as part of
 - a substantive revision, or
 - through a limited redrafting,to reflect the new conventions and matters of clarity generally.
- The IAASB clarity project was completed in March 2009.

The IAASB Clarity Project



- The final set of clarified standards comprises
 - 36 International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1, including:
 - One new standard (ISA 265), addressing communication of deficiencies in internal control;
 - 16 standards containing new and revised requirements (these have been referred to as "revised and redrafted ISAs"); and
 - 20 standards that have been redrafted to apply the new conventions and reflect matters of general clarity only (these have been referred to as "redrafted ISAs and redrafted ISQC 1").
- Unless otherwise specified, the clarified pronouncements are effective for audits of financial statements for periods beginning on or after 15 December 2009.

The IAASB Clarity Project in HK

- HKICPA announced that:
 - the clarified HKSAs will use the equivalent ISA as the underlying standard and will conform with the equivalent ISAs.
 - Where necessary, local guidance will be included as in the extant HKSAs.
- HKICPA committed to issue the clarified HKSAs in batches over the period from June to September 2009.
 - Part 1 covering 12 documents was issued in June 2009.
 - Part 2 covering 15 documents was issued in July 2009.
 - Part 3, the last part, is planned to be issued by September 2009.



The IAASB Clarity Project in HK

- The clarified HKSAs have the same effective date as the ISAs, i.e. for audits of financial statements for periods beginning on or after 15 December 2009.
- As most companies in Hong Kong have a 31 December year end, the first audit using the clarified standards would normally be for the period ending 31 December 2010.



Main Changes from Clarity Project

- All ISAs/HKSAs contain certain improvements arising from IAASB's Clarity Project including improvements in language and clarity of purpose.
- Broadly, these include:
 - Identifying the overall objectives of the auditor when conducting an audit in accordance with ISAs, setting an objective in each ISA, and establishing an obligation on the auditor in relation to those objectives;
 - Clarifying the obligations imposed on auditors by the requirements of the ISAs and the language used to communicate such requirements; and
 - Eliminating ambiguity about the requirements an auditor needs to fulfill.

Main Changes from Clarity Project

- The ISAs and HKSAs now have a new structure, in which information is presented in separate sections:
 - **Introduction**
 - Introductory material may include information regarding the purpose, scope, and subject matter of the ISA/HKSA, in addition to the responsibilities of the auditors and others in the context in which the ISA/HKSA is set.
 - **Objective**
 - Each ISA/HKSA now contains a clear statement of the objective of the auditor in the audit area addressed by that ISA/HKSA.
 - **Definitions**
 - **Requirements**
 - Each objective is supported by clearly stated requirements. Requirements are always expressed by the phrase "the auditor shall."
 - **Application and Other Explanatory Material**

IAS/HKSA 200 (Clarified)

- ISA/HKSA 200 (clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* set out the conventions followed in the standards and the obligations of the auditors who follow them.
 - Among other matters, it clarifies that the auditor is required **to have an understanding of the entire text of an ISA/HKSA** to understand its objectives and to apply its requirements properly.
 - It also explains that, in addition to objectives and requirements, ISAs/HKSAs contain guidance for carrying out their requirements.
 - Such guidance may explain more precisely what a requirement means or is intended to cover, or include examples of procedures that may be appropriate in the circumstances.
 - While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an ISA/HKSA.

IAS/HKSA 200 (Clarified)

- ISA/HKSA 200 (clarified) also introduces new guidance in relation to
 - professional skepticism,
 - professional judgment,
 - the implications of the inherent limitations of an audit, and
 - other matters relevant to the application of the ISA/HKSA.
- All clarified ISAs/HKSAs follow the new clarity structure and have been drafted in light of the obligations and conventions set out in ISA/HKSA 200 (clarified).




IAS/HKSA 200 (Clarified)

- In accordance with ISA/HKSA 200, the auditor in auditing financial statements is required to:
 - a. Comply with the relevant ethical requirements.
 - b. Plan and perform an audit with professional skepticism.
 - c. Exercise professional judgment in planning and performing an audit of financial statements.
 - d. Obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.
 - e. Comply with all HKSA's relevant to the audit.

IAS/HKSA 200 (Clarified)

- To conduct an audit of financial statements in accordance with HKSAs, HKSA 200 requires an auditor to comply with all HKSAs relevant to the audit.
- An HKSA is relevant to the audit when the HKSA is in effect and the circumstances addressed by the HKSA exist.
- The auditor is required to comply with each requirement of an HKSA unless in the circumstances of the audit:
 - a. The entire HKSA is not relevant; or
 - b. The requirement is not relevant because it is conditional and the condition does not exist.

Other Critical Clarified ISA/HKSA

- ISA/HKSA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
- ISA/HKSA 320 Materiality in Planning and Performing an Audit 
- ISA/HKSA 450 Evaluation of Misstatements Identified during the Audit 
- ISA 600 Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors) 
- ISA 705 Modifications to the Opinion in the Independent Auditor's Report
- ISA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

ISA/HKSA 320 and 450

- In the clarity project of ISA, the consideration of materiality is divided into:
 - a. Materiality in planning and performing an audit of financial statements in ISA 320 "*Materiality in Planning and Performing an Audit*"; and
 - b. Materiality in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements in ISA 450 "*Evaluation of Misstatements Identified during the Audit*".
- HKSA 320 and HKSA 450 issued in Hong Kong follow the same clarity result.

ISA/HKSA 320 and 450

- The auditor applies the concept of materiality and audit risk throughout the audit and in:
 - a. Planning and performing the audit; and
 - b. Evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.
- The revised HKSA 320 specifically requires an auditor to determine at least 2 types of materiality in planning an audit, namely:
 - a. Materiality for the financial statements as a whole; and
 - b. Performance materiality.

ISA/HKSA 320 and 450

- Materiality for the financial statements as a whole must be determined when the auditor establishes the overall audit strategy.
- The auditor's assessment of materiality helps the auditor determine
 - what items to examine and
 - whether to use sampling and analytical procedures.



ISA/HKSA 320 and 450

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



ISA/HKSA 320 and 450

- **Performance materiality:**
 - means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
 - if applicable, also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.
- The auditor is required to determine performance materiality for purposes of:
 - a. Assessing the risks of material misstatement and
 - b. Determining the nature, timing and extent of further audit procedures.

ISA/HKSA 320 and 450

- In evaluating the misstatements, the objective of the auditor is to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on the financial statements.
- HKSA 450 specifically requires the auditor to accumulate misstatements identified during the audit, other than those that are **clearly trivial**.
 - The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.



ISA/HKSA 320 and 450

- “Clearly trivial” is not another expression for “not material.”
 - Matters that are clearly trivial will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with HKSA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.
 - When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.



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ISA/HKSA 320 and 450

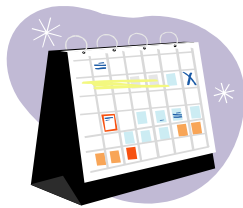
- The auditor must include in the audit documentation the following amounts and the factors considered in their determination:
 - a. Materiality for the financial statements as a whole;
 - b. If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;
 - c. Performance materiality; and
 - d. Any revision of the above materiality from (a) to (c) as the audit progressed.
- In evaluating the identified misstatement, the auditor must include in the audit documentation:
 - a. The amount below which misstatements would be regarded as clearly trivial;
 - b. All misstatements accumulated during the audit and whether they have been corrected; and
 - c. The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

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ISA 600 (Not yet issued by HKICPA)

- ISA 600 *Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)*
 - No matter it is an audit of group financial statements or not, the auditor's duties are the same.
 - ISA 600 only deals with the special considerations that apply to group audits, in particular to those involve other auditors to audit the components, i.e. component auditors.



ISA 600

- ISA 600 specifies that the objectives of the auditor are:
 - a. To determine whether to act as the auditor of the group financial statements (i.e. the acceptance and continuance for group audits); and
 - b. If acting as the auditor of the group financial statements:
 - i. To communicate clearly with **component auditors** about the scope and timing of their work on financial information related to components and their findings; and
 - ii. To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

ISA 600 – Summary



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ISA 600 – Summary

- The group engagement team is also required to determine the following:
 - a. Overall materiality for the group financial statements as a whole.
 - b. Materiality for particular area.
 - c. Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit
 - Component materiality is the materiality for a component determined by the group engagement team.
 - d. Clearly trivial level – the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

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ISA 600 – Summary

- In addition to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment (see Chapter 15), the group engagement team is required to:
 - a. Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage; and
 - b. Obtain an understanding of the consolidation process, including the instructions issued by group management to components.

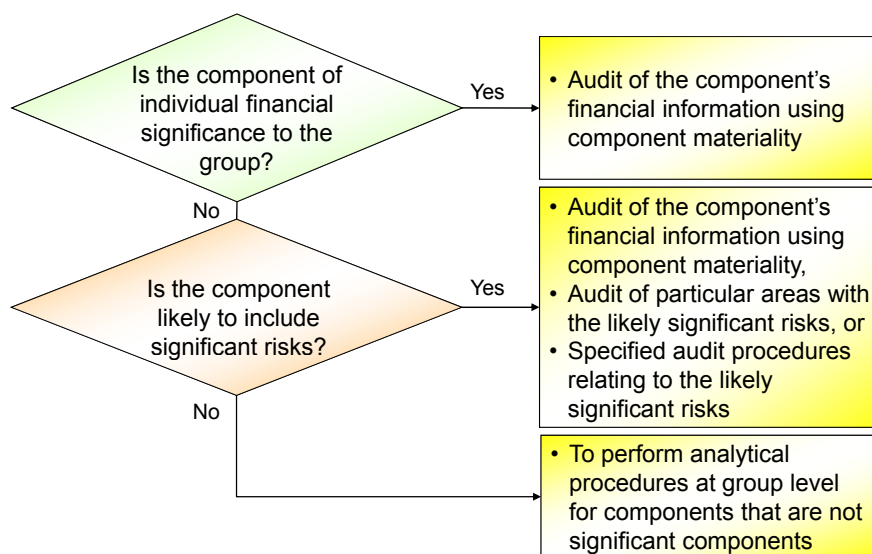
ISA 600 – Summary

- Group-wide controls are not exactly the same as internal controls and are applicable over group financial reporting.
 - Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.
- The group engagement team's understanding of the consolidation process also includes the matters relating to:
 - a. Applicable financial reporting framework, and
 - b. Consolidation adjustments and reclassifications.
- To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components.

ISA 600 – Summary

- When a component is a significant component,
 - the group engagement team is required to request a component auditor to perform work on the financial information of a component.
- Significant component is defined to be a component identified by the group engagement team:
 - a. That is of individual financial significance to the group, or
 - b. That, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

ISA 600 – Summary



ISA 600 – Summary

- In accordance with HKSA 600,
 - the group engagement team is also required to determine the nature, timing and extent of its involvement in the work of the **component auditors**.
- If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work,
 - the group engagement team is required to evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements.
- Based on its understanding of the component auditor,
 - the group engagement team is required to determine whether it is necessary to be involved in the further audit procedures.

ISA 600 – Summary

- Based on the understanding of the consolidation process, the group engagement team is required to design and perform further audit procedures on the **consolidation process** to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process.
 - This must include evaluating whether all components have been included in the group financial statements.
- The group engagement team is required to evaluate:
 - a. the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and
 - b. whether any fraud risk factors or indicators of possible management bias exist.

ISA 600 – Summary

- The group engagement team is required to include in the audit documentation the following matters:
 - a. An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.
 - b. The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.
 - c. Written communications between the group engagement team and the component auditors about the group engagement team's requirements.

The IAASB Clarity Project in HK

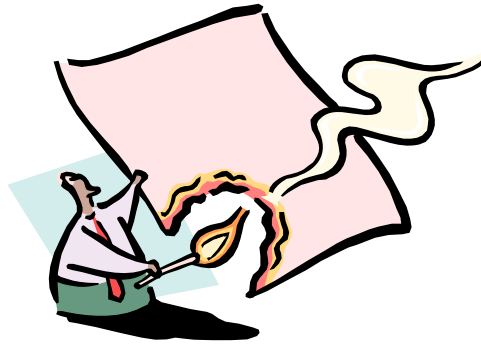
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Changes are inevitable!

Overview of Auditing Standards – Recap and Update

7 August 2009



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Overview of Auditing Standards – Recap and Update

7 August 2009



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