Overview of Auditing Standards – Recap and Update

6 May 2010

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Today's Agenda

Recap and Update

- Introduction and ISQC/HKSQC 1
- Objective and Planning of an Audit
- Risk Assessment
- Auditor's Responses
- Materiality
- Brief Update on Critical Revised and Redrafted ISAs/HKSAs

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Today's Agenda

Introduction and ISQC/HKSQC 1

Overview

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

Hong Kong Framework for Assurance Engagements

Audits and Reviews of Historical Fin. Information

Other Assurance Engagements

Related Services

HK Standards on Auditing (HKSAs)

HK Standards on Review Engagements (HKSRE)

HK Standards on Assurance Engagements (HKSAEs)

HK Standards on Inv. Circular Reporting Engagements (HKSIRs)

HK Standards on Related Services (HKSRSs)

Overview

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

Hong Kong Framework for Assurance Engagements

Audits and Reviews of Historical Fin. Information

HK Standards on Auditing (HKSAs)

Our focus today …….

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
  - Part 1 covering 12 documents was issued in Jun. 2009
  - Part 2 covering 15 documents was issued in Jul. 2009
  - Part 3 covering 8 documents was issued in Sep. 2009
  - Part 4 covering 3 documents was issued in Oct. 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.

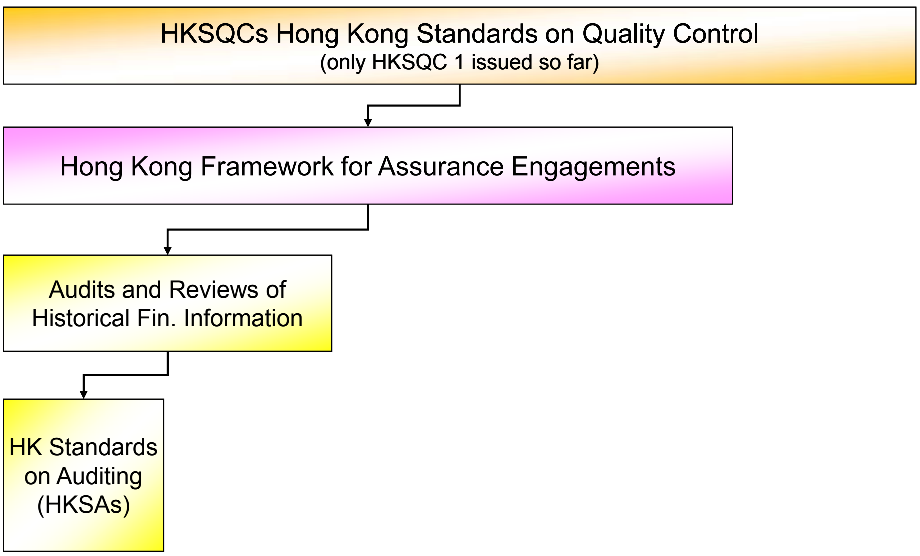
Main Changes from Clarity Project

- 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**

Overview



ISQC/HKSQC 1

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

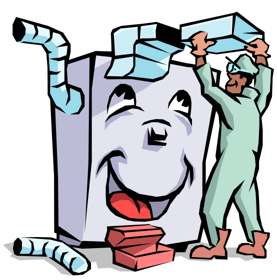
ISQC/HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagement*

- 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.

ISQC/HKSQC 1

ISQC/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.



ISQC/HKSQC 1

ISQC/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
  b) Ethical requirements
  c) Acceptance and continuance of client relationships and specific engagements
  d) Human resources
  e) Engagement performance
  f) Monitoring

- Quality Manual

- Promote internal culture
- CEO or Managing partner(s) assume ultimate responsibility

- Integrity of the client
- Competent to perform the job
- Comply with ethical requirement

- Sufficient and competent personnel committed to ethics
- Each job with appropriate staff

- **Significant new requirements**

ISQC/HKSQC 1 – Eng. 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.

ISQC/HKSQC 1 – Eng. 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.

ISQC/HKSQC 1 – Eng. 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).

ISQC/HKSQC 1 – Eng. 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.

ISQC/HKSQC 1 – Eng. 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

ISQC/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)

ISQC/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)

Today's Agenda

Objective and Planning of an Audit

ISA/HKSA 200

- ISA/HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*
  - deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with HKSAs.
    - sets out the overall objectives of the independent auditor,
    - explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives
    - explains the scope, authority and structure of the HKSAs, and
    - includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the HKSAs

ISA/HKSA 200

- ISA/HKSA 200 clearly sets out that:
  - In conducting an audit of financial statements, the **overall objectives** of the auditor are:
    a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error,
       - thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

    b. To report on the financial statements, and communicate as required by the HKSAs, in accordance with the auditor's findings.

ISA/HKSA 200

- ISA/HKSA 200 also clearly sets out that:
  - In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements,
    - the ISAs/HKSAs require that the auditor
      - disclaim an opinion or
      - withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation.

ISA/HKSA 200

- ISA/HKSA 200 points out the difference between
  - Fair presentation framework and
  - Compliance framework

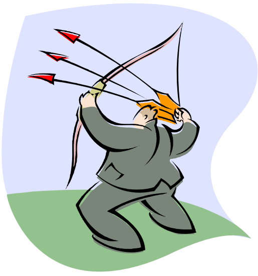
Compliance framework refers to
- a financial reporting framework that requires compliance with the requirements of the framework,
  - but does not contain the acknowledgements in (i) or (ii) set out in the "fair presentation framework".

Fair presentation framework refers to
- a financial reporting framework that requires compliance with the requirements of the framework and:
  i. Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
  ii. Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

ISA/HKSA 200

- 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).

ISA/HKSA 200



- 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 ISAs/HKSAs relevant to the audit.

ISA/HKSA 200

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

ISA/HKSA 200

- ISA/HKSA 200 also introduces the concept of **premise**, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted
  - That those charged with governance have acknowledged and understand that they have the responsibilities that are fundamental to the conduct of an audit in accordance with ISAs/HKSAs, including
    - preparation of financial statements in accordance with the applicable financial reporting framework;
    - Internal control to enable the preparation of financial statements that are free from material misstatement
    - To provide the auditor with access to all information, additional information and unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

ISA/HKSA 300

ISA/HKSA 300 Planning an Audit of Financial Statements

1. Involvement of Key Engagement Team Members — Extended requirements
2. Preliminary engagement activities
3. Planning activities — Extended requirements
4. Documentation
5. Additional considerations in initial audit engagement

ISA/HKSA 300 – Involve Members

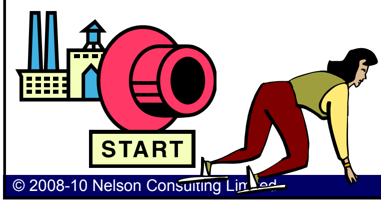
- The engagement partner and other key members of the engagement team shall be involved in planning the audit,
  - including planning and participating in the discussion among engagement team members.

Extended requirements

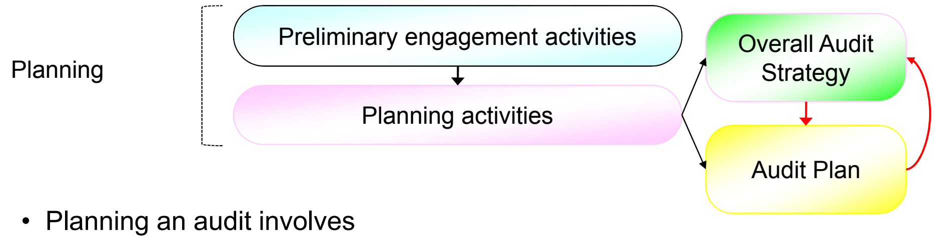
ISA/HKSA 300 – Pre. Eng. Activities

Preliminary engagement activities

- The auditor shall undertake the following activities at the beginning of the current audit engagement:
  a. Performing procedures required by ISA/HKSA 220 regarding the continuance of the client relationship and the specific audit engagement;
  b. Evaluating compliance with relevant ethical requirements, including independence, in accordance with ISA/HKSA 220; and
  c. Establishing an understanding of the terms of the engagement, as required by ISA/HKSA 210.



ISA/HKSA 300 – Planning Activities



- Planning an audit involves
  - establishing the overall audit strategy for the engagement and
  - developing an audit plan.

ISA/HKSA 300 – Overall Audit Strategy

- The auditor shall establish an overall audit strategy
  - that sets the scope, timing and direction of the audit, and
  - that guides the development of the audit plan. (ISA 300.7)

ISA/HKSA 300 – Overall Audit Strategy

Extended requirements

- In establishing the overall audit strategy, the auditor shall:
  a. Identify the characteristics of the engagement that define its scope;
  b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
  c. Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
  d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
  e. Ascertain the nature, timing and extent of resources necessary to perform the engagement. (ISA 300.8)

ISA/HKSA 300 – Overall Audit Strategy

Example

- In establishing the overall audit strategy, the auditor shall:
  a. Identify the characteristics of the engagement that define its scope;
  b. Ascertain the reporting objective to plan the timing of the audit an communications required;
  c. Consider the factors that, in the professional judgment, are signi engagement team's efforts;
  d. Consider the results of prelimina activities and, where applicable, gained on other engagements p engagement partner for the entit
  e. Ascertain the nature, timing and necessary to perform the engag

- Financial reporting framework used
- Industry-specific reporting requirements
- Locations of the components of the entity

- Reporting deadlines (interim & final)
- Key dates for expected communication with management and those charged with governance

- Determine materiality levels
- Identify potential areas with higher risks of material misstatement
- Identify material areas, balances & etc.
- Evaluate whether plan to test the effectiveness of internal control
- Identify recent significant entity-specific, industry, or other developments

ISA/HKSA 300 – Audit Plan

Planning

Preliminary engagement activities

Planning activities

Overall Audit Strategy

Audit Plan

- The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members.

ISA/HKSA 300 – Audit Plan

Planning

Preliminary engagement activities

Planning activities

Overall Audit Strategy

Audit Plan

- The auditor shall develop an audit plan that shall include a description of:

Extended requirements

a. The nature, timing and extent of planned risk assessment procedures, as determined under ISA/HKSA 315.

Risk Assessment Procedures

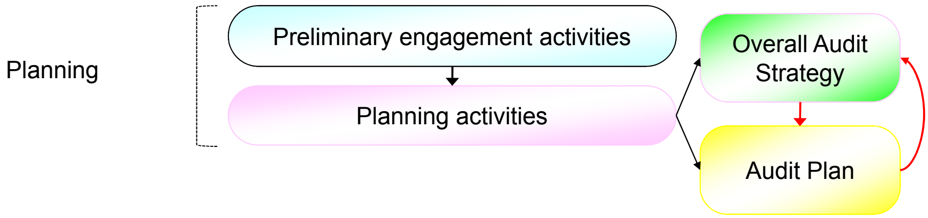
b. The nature, timing and extent of planned further audit procedures at the assertion level, as determined under ISA/HKSA 330.

Further Audit Procedures

c. Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs/HKSAs.

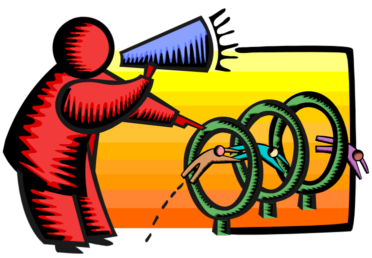
Other Audit Procedures

ISA/HKSA 300 – Audit Plan



- The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.
- The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

ISA/HKSA 300 – Documentation



- The auditor shall include in the audit documentation:
  a. The overall audit strategy;
  b. The audit plan; and
  c. Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

Today's Agenda

Risk Assessment

Audit Process Overview

Audit Process

Planning
- Preliminary engagement activities
- Planning activities

Risk assessment
- Understanding the entity and its environment
- Identify and assess risks of material misstatements

Risk response
- Design and implement auditor's responses to assessed risks

Reviewing and reporting
- Overall reviewing
- Drawing conclusions and reporting

An audit is a cumulative and iterative process

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Audit Process Overview

Audit Process

Risk assessment

Understanding the entity and its environment

↓

Identify and assess risks of material misstatements

ISA/HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*

ISA/HKSA 315 – Overview

Perform risk assessment procedures

↓

To gather information about

Understanding the entity and its environment

- The entity and its environment
- Internal control

Relevant industry, regulatory, and other external factors	The nature of the entity	The entity's selection & application of accounting policies	The entity's objectives & strategies and related business risks	Measurement and review of the entity's financial performance	The entity's internal control

ISA/HKSA 315 – Internal Control

- The auditor shall obtain an understanding of the following components of internal control:

The Control Environment

The Entity's Risk Assessment Process

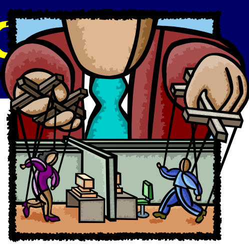
The Information System

Control Activities

Monitoring of Controls

The entity's internal control

ISA/HKSA 315 – Internal C



Explanatory before but requirement now

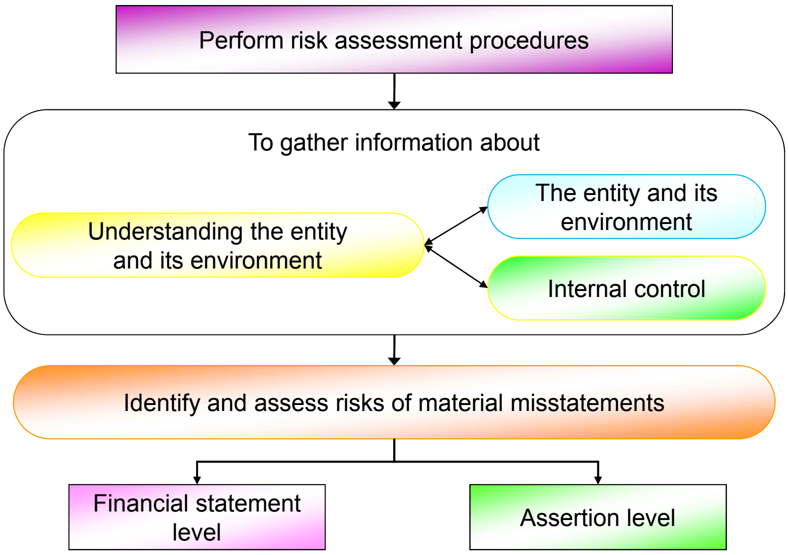
The Control Environment

Obtain an understanding of the control environment.

- As part of obtaining this understanding, the auditor shall evaluate whether:
  a. Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
  b. The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (ISA 315.14)

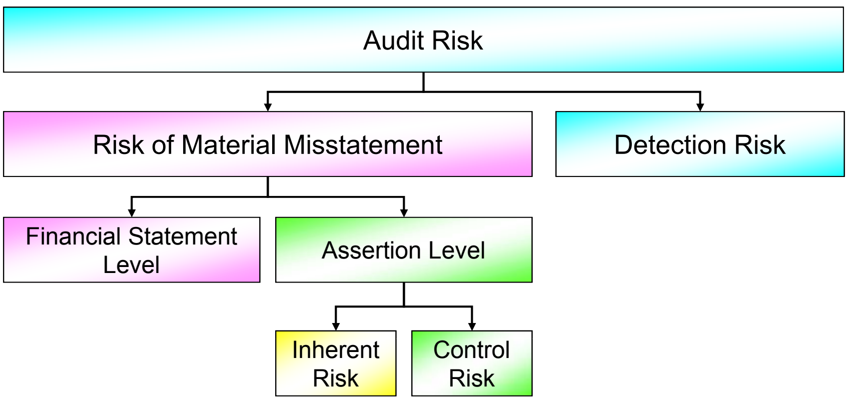
The entity's internal control

ISA/HKSA 315 – Identifying Risks



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA/HKSA 315 – Identifying Risks



- The risk of material misstatement at the assertion level consists of two components:
  1. Inherent risk
  2. Control risk

ISA/HKSA 315 – Identif

Risk of Material Misstatement

Financial Statement Level | Assertion Level

HKSA 315 requires that

- The auditor shall identify and assess the risks of material misstatement at:
  a) the financial statement level; and
  b) the assertion level for classes of transactions, account balances, and disclosures

to provide a basis for designing and performing further audit procedures. (ISA 315.25)

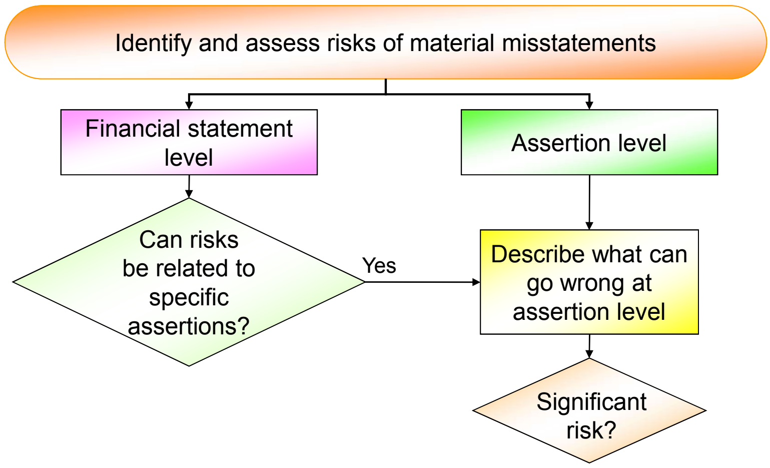
ISA/HKSA 315 – Identifying Risks

Explanatory before but requirement now

- For the purpose of identifying and assessing the risks of material misstatement, the auditor shall:
  a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
  b. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
  c. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
  d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. (ISA 315.26)

Financial statement level | Assertion level

ISA/HKSA 315 – Significant Risk



ISA/HKSA 315 – Significant Risk

Explanatory before but requirement now

- In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
  a. Whether the risk is a risk of fraud;
  b. Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
  c. The complexity of transactions;
  d. Whether the risk involves significant transactions with related parties;
  e. The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
  f. Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (ISA 315.28)

Today's Agenda

Auditor's Responses

Audit Process Overview

Audit Process

Planning
- Preliminary engagement activities
- Planning activities

Risk assessment
- Understanding the entity and its environment
- Identify and assess risks of material misstatements

Risk response
- Design and implement auditor's responses to assessed risks

Reviewing and reporting
- Overall reviewing
- Drawing conclusions and reporting

An audit is a cumulative and iterative process

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

Audit Process Overview

Audit Process

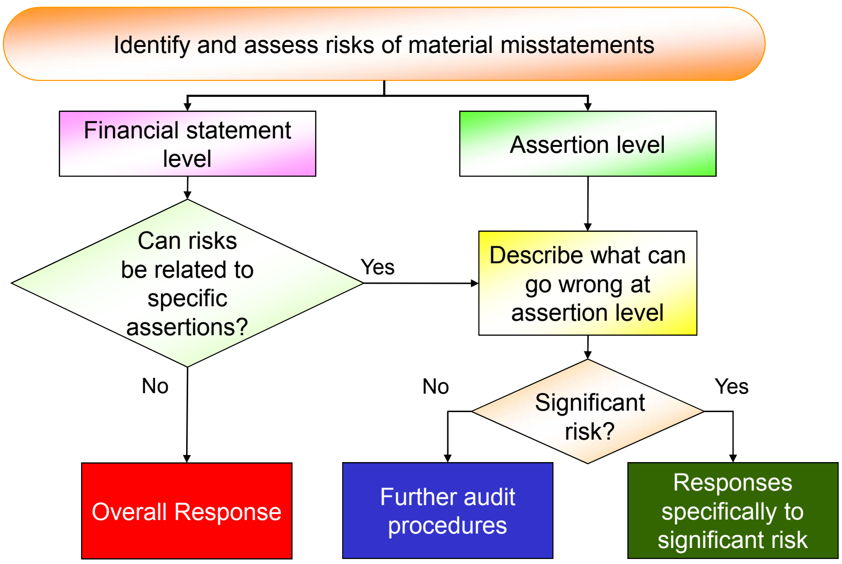
ISA/HKSA 330 *The Auditor's Responses to Assessed Risks*

ISA/HKSA 402 *Audit Considerations Relating to an Entity Using a Service Organization*

ISA/HKSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

Risk response — Design and implement auditor's responses to assessed risks

Responses to Assessed Risks



ISA/HKSA 330

- The auditor shall design and perform **further audit procedures**
  - whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (ISA 330.6)

Some explanatory materials are redrafted as requirements in the clarified ISA/HKAS 330.

Further audit procedures → Tests of Controls / Substantive Procedures

ISA/HKSA 330

Explanatory before but requirement now

- In designing the further audit procedures to be performed, the auditor shall:
  a. Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
     i. The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
     ii. Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
  b. Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (ISA 330.7)

Further audit procedures → Tests of Controls / Substantive Procedures

ISA/HKSA 330

Explanatory before but requirement now

- In designing and performing tests of controls, the auditor shall:
  a. Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
     i. How the controls were applied at relevant times during the period under audit;
     ii. The consistency with which they were applied; and
     iii. By whom or by what means they were applied.
  b. Determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (ISA 330.10)

Nature

Further audit procedures → Tests of Controls

ISA/HKSA 330 – Tests of Controls

Explanatory before but requirement now

- The auditor shall test controls
  – for the particular time, or
  – throughout the period,

  for which the auditor intends to rely on those controls (subject to evidence obtained in interim and significant risks), in order to provide an appropriate basis for the auditor's intended reliance. (ISA 330.11)

Timing

Further audit procedures → Tests of Controls

ISA/HKSA 330 – Tests of Controls

Example

- The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls.
  - If the auditor tests controls at a particular time,
    - the auditor only obtains audit evidence that the controls operated effectively at that time

      e.g. physical inventory count at period end
  - If the auditor tests controls throughout a period
    - the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period

      e.g. inventory delivery control over the period

Timing

Further audit procedures → Tests of Controls

ISA/HKSA 330 – Tests of Controls

Explanatory before but requirement now

- If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

  a. Obtain <u>audit evidence about significant changes to those controls subsequent to the interim period</u>; and

  b. Determine the <u>additional audit evidence to be obtained for the remaining period</u>. (ISA 330.12)

Timing

Further audit procedures → Tests of Controls

ISA/HKSA 330 – Tests of Controls

Example

- Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:
  - The significance of the assessed risks of material misstatement at the assertion level.
  - The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
  - The degree to which audit evidence about the operating effectiveness of those controls was obtained.
  - The length of the remaining period.
  - The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
  - The control environment.

Timing

Further audit procedures → Tests of Controls

ISA/HKSA 330 – Tests of Controls

Explanatory before but requirement now

- In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:
  a. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
  b. The risks arising from the characteristics of the control, including whether it is manual or automated;
  c. The effectiveness of general IT-controls;
  d. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
  e. Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
  f. The risks of material misstatement and the extent of reliance on the control.

Timing

Tests of Controls

ISA/HKSA 402

- ISA/HKSA 402 *Audit Considerations Relating to an Entity Using a Service Organization*
  - deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations.

ISA/HKSA 402

- ISA/HKSA 402 expands on how the user auditor applies ISA/HKSA 315 and 330
  - in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and
  - in designing and performing further audit procedures responsive to those risks.

- **Service organization** is defined as:
  - A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

ISA/HKSA 402

Example

- A user entity may use a service organization such as
  - one that processes transactions and maintains related accountability, or records transactions and processes related data.
- Service organizations that provide such services include, for example,
  - bank trust departments that invest and service assets for employee benefit plans or for others;
  - mortgage bankers that service mortgages for others; and
  - application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

ISA/HKSA 402

Example

- Examples of service organization services that are relevant to the audit include:
  - Maintenance of the user entity's accounting records.
  - Management of assets.
  - Initiating, recording or processing transactions as agent of the user entity.
- Smaller entities may use
  - external bookkeeping services ranging from the processing of certain transactions (for example, payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements.
    - The use of such a service organization for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.

ISA/HKSA 402

- ISA/HKSA 402 requires
  - when obtaining an understanding of the user entity in accordance with ISA/HKSA 315,
    - the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operations
  - when obtaining an understanding of internal control relevant to the audit in accordance with ISA/HKSA 315,
    - the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization.

ISA/HKSA 402

- If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:
  a. Obtaining a type 1 or type 2 report, if available;
  b. Contacting the service organization, through the user entity, to obtain specific information;
  c. Visiting the service organization and performing procedures that will provide the necessary information about the relevant controls at the service organization; or
  d. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization.

ISA/HKSA 402

- **Report on the description and design of controls at a service organization (Type 1 Report)**:
  - A report that comprises:
    i. A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and
    ii. A report by the service auditor with the objective of conveying <u>reasonable assurance</u> that includes the <u>service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives</u>.

ISA/HKSA 402

- **Report on the description, design, and operating effectiveness of controls at a service organization (Type 2 Report)**
  - A report that comprises:
    i. A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
    ii. A report by the service auditor with the objective of conveying <u>reasonable assurance</u> that includes:
        a. The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
        b. <u>A description of the service auditor's tests of the controls and the results thereof</u>.

ISA/HKSA 402

- In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report, the user auditor shall be satisfied as to:
  a. The service auditor's professional competence and independence from the service organization; and
  b. The adequacy of the standards under which the type 1 or type 2 report was issued.

ISA/HKSA 402

- In responding to assessed risks in accordance with ISA/HKSA 330, the user auditor shall:
  a. Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity;
     and, if not,
  b. Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organization on the user auditor's behalf.

ISA/HKSA 402

- When the user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively,
  - the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:
    a. Obtaining a type 2 report, if available;
    b. Performing appropriate tests of controls at the service organization; or
    c. Using another auditor to perform tests of controls at the service organization on behalf of the user auditor.

ISA/HKSA 402

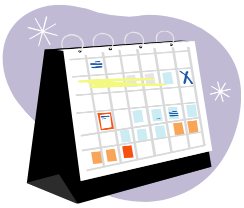
- The user auditor shall inquire of management of the user entity
  - whether the service organization has reported to the user entity, or
  - whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity.
- The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

ISA/HKSA 402

- If the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements
  - The user auditor shall modify the opinion in the user auditor's report in accordance with ISA/HKSA 705.
- The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so.
- If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion,
  - the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

ISA/HKSA 600

- ISA/HKSA 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/HKSA 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/HKSA 600

- ISA/HKSA 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/HKSA 600

Special Considerations in Group Audits

- Acceptance and continuance in group audits

- Overall group audit strategy, group audit plan and materiality

- Understanding the entity's components and group-wide controls
- Understanding the consolidation process
- Understanding component auditors
- Identify significant components

- Significant components
- Consolidation process
- Subsequent events
- Communication with component auditor
- Evaluating audit evidence

ISA/HKSA 600

- 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.

ISA/HKSA 600

- In addition to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment, 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.

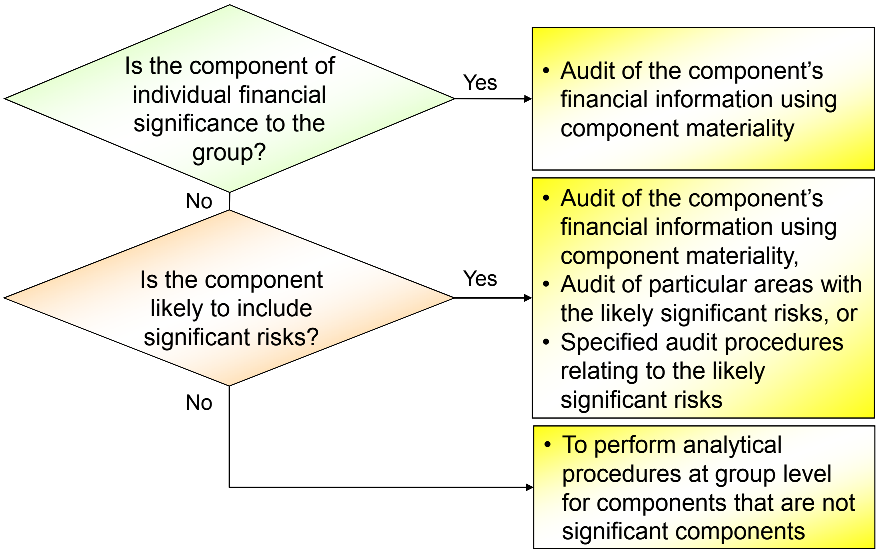
ISA/HKSA 600

- 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/HKSA 600

- 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/HKSA 600



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA/HKSA 600

- In accordance with ISA/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/HKSA 600

- 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/HKSA 600

- 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.

Today's Agenda

Materiality

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 Aud*it"; 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.

ISA/HKSA 320

- ISA/HKSA 320 sets out that:
  – The objective of the auditor is to apply the concept of materiality appropriately <u>in planning and performing the audit</u>.
- The revised ISA/HKSA 320 specifically requires an auditor to determine at least 2 types of materiality in planning an audit, namely:
  a. <u>Materiality for the financial statements as a whole</u>; and
  b. <u>Performance materiality</u>.

Materiality for the financial statements as a whole

Performance materiality

ISA/HKSA 320

Audit Process

Planning
- Preliminary engagement activities
- Planning activities

Risk assessment
- Understanding the entity and its environment
- Identify and assess risks of material misstatements

Risk response
- Design and implement auditor's responses to assessed risks

Reviewing and reporting
- Overall reviewing
- Drawing conclusions and reporting

An audit is a cu ulative and i

Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA/HKSA 320

- 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.

Materiality for the financial statements as a whole

ISA/HKSA 320

- 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.

For particular classes of transactions, a/c balances or disclosures

Materiality for the financial statements as a whole

ISA/HKSA 320

- 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.

Performance materiality

ISA/HKSA 320

- 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.

Performance materiality

ISA/HKSA 320

- The auditor shall revise **materiality** for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures)
  – in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.
- If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate,
  – the auditor shall determine
    - whether it is necessary to revise **performance materiality**, and
    - whether the nature, timing and extent of the further audit procedures remain appropriate.

Materiality for the financial statements as a whole

Performance materiality

ISA/HKSA 320

- The auditor shall 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 (a)-(c) as the audit progressed.

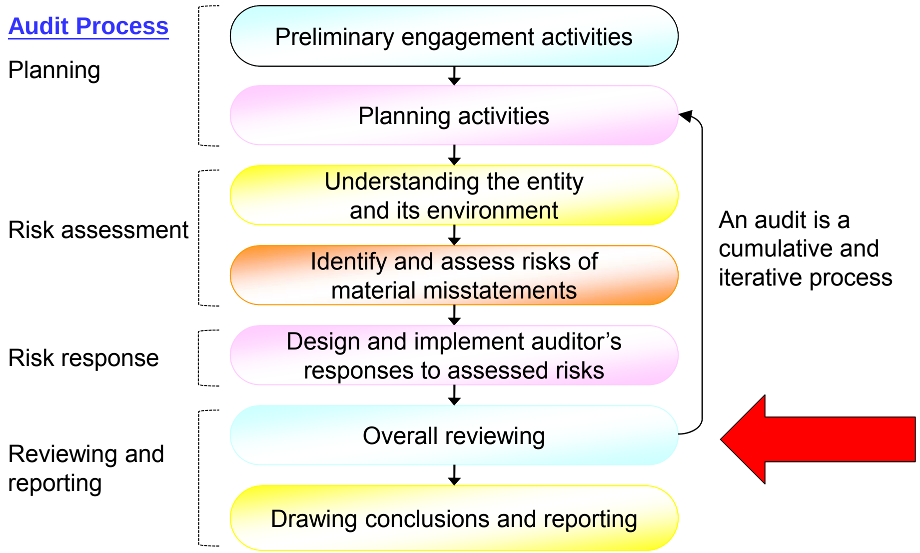
Materiality for the financial statements as a whole

Performance materiality

ISA/HKSA 450

- ISA/HKSA 450 *Evaluation of Misstatements Identified during the Audit*
  - deals with the auditor's responsibility to evaluate the effect
    - of identified misstatements on the audit and
    - of uncorrected misstatements, if any, on the financial statements.
- ISA/HKSA 450 is a new standard that has been derived from the revision of ISA/HKSA 320 on audit materiality.

ISA/HKSA 450



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA/HKSA 450

- ISA/HKSA 450 sets out that the objective of the auditor is to evaluate:
  a. The effect of identified misstatements on the audit; and
  b. The effect of uncorrected misstatements, if any, on the financial statements.
- ISA/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 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.

ISA/HKSA 450 – Consideration

- The auditor is required to determine whether the overall audit strategy and audit plan need to be revised if:
  a. The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or
  b. The aggregate of misstatements accumulated during the audit approaches materiality determined, including
     - materiality for the financial statements as a while and
     - performance materiality,

     in accordance with ISA/HKSA 320 as discussed above.

ISA/HKSA 450 – Communication

- When misstatements are accumulated during the audit, the auditor is required to:
  a. Communicate all such accumulated misstatements with the appropriate level of management, unless prohibited by law or regulation; and
  b. Request management to correct those misstatements.
- If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor is required to:
  a. Obtain an understanding of management's reasons for not making the corrections and
  b. Take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

ISA/HKSA 450 – Evaluation

- Before evaluating the effect of uncorrected misstatements,
  – the auditor must reassess materiality determined to confirm whether it remains appropriate in the context of the entity's actual financial results.
- Then, the auditor must determine whether uncorrected misstatements are material, individually or in aggregate.
- Uncorrected misstatements are defined
  – to be misstatements that the auditor has accumulated during the audit and that have not been corrected.

ISA/HKSA 450 – Evaluation

- In making this determination, the auditor shall consider:
  a. The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
  b. The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole

ISA/HKSA 450 – Evaluation

Example

- Circumstances that may affect the evaluation include the extent to which the misstatement:
  – Affects compliance with regulatory requirements;
  – Affects compliance with debt covenants or other contractual requirements;
  – Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
  – Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
  – Affects segment information presented in the financial statements;
  – Has the effect of increasing management compensation;
  – Affects other information that will be communicated in documents containing the audited financial statements that may reasonably be expected to influence the economic decisions of the users of the financial statements
    - For example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review"

ISA/HKSA 450 – Evaluation

- Unless prohibited by law or regulation, the auditor must communicate with those charged with governance
  - uncorrected misstatements and
  - the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.
- The auditor's communication must include:
  a. To identify material uncorrected misstatements individually and to request that uncorrected misstatements be corrected; and
  b. To communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

ISA/HKSA 450

- The auditor must request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.
- A summary of such items must be included in or attached to the written representation.

ISA/HKSA 450

- 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.

Today's Agenda

Brief Update on Critical Revised and Redrafted ISAs/HKSAs

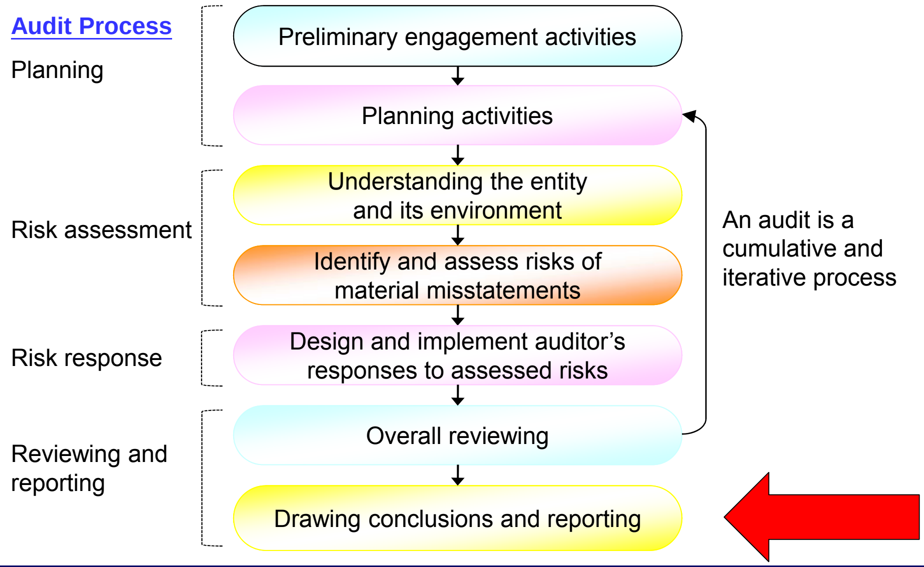
16 Revised & Redrafted ISA/HKSA

200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
260	Communication with Those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
320	Materiality in Planning and Performing an Audit
402	Audit Considerations Relating to an Entity Using a Service Organization
450	Evaluation of Misstatements Identified during the Audit
505	External Confirmations
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
580	Written Representations

16 Revised & Redrafted ISA/HKSA

600	Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
601	Using the Work of an Auditor's Expert
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
800	Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

Audit Process Overview



Adapted from "Auditing and Assurance in HK" (2009) by Peter Lau and Nelson Lam

ISA/HKSA 705 and 706

- Modified opinion was originally under ISA/HKSA 701
- The clarity project separates the requirements of ISA/HKSA 701 into
  - ISA/HKSA 705 *Modifications to the Opinion in the Independent Auditor's Report*
  - ISA/HKSA 706 *Emphasis of Matter and Other Matter Paragraphs in the Independent Auditor's Report*

ISA/HKSA 705

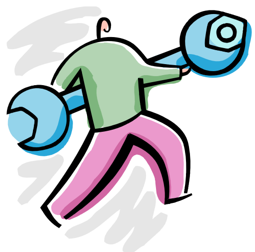
- ISA/HKSA 705 *Modifications to the Opinion in the Independent Auditor's Report*
  - deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with ISA/HKSA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

ISA/HKSA 705

- ISA/HKSA 705 sets out the objective of the auditor is to express clearly an <u>appropriately modified opinion</u> on the financial statements that is necessary when:
  a. The auditor concludes, based on the audit evidence obtained, that <u>the financial statements as a whole are not free from material misstatement</u>; or
  b. The auditor is <u>unable to obtain sufficient appropriate audit evidence</u> to conclude that the financial statements as a whole are free from material misstatement.

Disagreement

Limitation



ISA/HKSA 705

- ISA/HKSA 705 also specifically includes:

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statement	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified Opinion	Adverse Opinion
Inability to obtain sufficient appropriate audit evidence	Qualified Opinion	Disclaimer Opinion

ISA/HKSA 705

- ISA/HKSA 705 clearly defined the meaning of **pervasive**:
  - A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.
  - Pervasive effects on the financial statements are those that, in the auditor's judgment:
    i. Are not confined to specific elements, accounts or items of the financial statements;
    ii. If so confined, represent or could represent a substantial proportion of the financial statements; or
    iii. In relation to disclosures, are fundamental to users' understanding of the financial statements.

ISA/HKSA 705

- ISA/HKSA 705 newly requires:
  - If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements,
    - the auditor shall request that management remove the limitation.
  - If management refuses to remove the limitation,
    - the auditor shall
      - communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and
      - determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence

ISA/HKSA 705

- ISA/HKSA 705 newly requires:
  - If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
    a. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive,
       - the auditor shall qualify the opinion; or
    b. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
       i. Withdraw from the audit, where practicable and possible under applicable law or regulation; or
       ii. If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

ISA/HKSA 705

- ISA/HKSA 705 newly requires:
  - When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole,
    - the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. (so-called "piecemeal opinion")
      - To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

ISA/HKSA 706

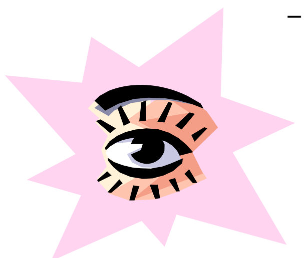
- ISA/HKSA 706, *Emphasis of Matter and Other Matter Paragraphs in the Independent Auditor's Report*
  - Deal with additional communication in the auditor's report when the auditor considers it necessary to:
    a. Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
    b. Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

ISA/HKSA 706

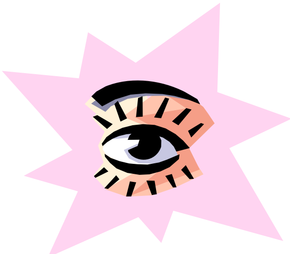
- ISA/HKSA 706 specifies:
  - <u>**Emphasis of Matter paragraph**</u>
    - A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, <u>is of such importance that it is fundamental to users' understanding of the financial statements</u>.
  - <u>**Other Matter paragraph**</u>
    - A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, <u>is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report</u>.

ISA/HKSA 706

- ISA/HKSA 706 provides for the auditor to use an Emphasis of Matter <u>only if</u> the auditor has obtained <u>sufficient appropriate audit evidence</u> that the matter is <u>not materially misstated in the financial statements</u>.
- It also requires that an Emphasis of Matter paragraph <u>only refer to information presented or disclosed in the financial statements</u>.
  - This reinforces the fact that an Emphasis of Matter may <u>not be used as an alternative to a modified opinion</u>, but leaves the question of whether to include one at all to the judgment of the auditor.

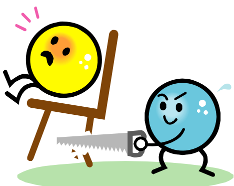


ISA/HKSA 706



- When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
  a. Include it immediately after the Opinion paragraph in the auditor's report;
  b. Use the heading "Emphasis of Matter," or other appropriate heading;
  c. Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
  d. Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

ISA/HKSA 706



- If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report and this is not prohibited by law or regulation,
  – the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter," or other appropriate heading.
  – The auditor shall include this paragraph immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section..

Overview of Auditing Standards – Recap and Update

6 May 2010

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