

# Let's get technical

*This column is dedicated to answering questions submitted by members regarding Institute standards*

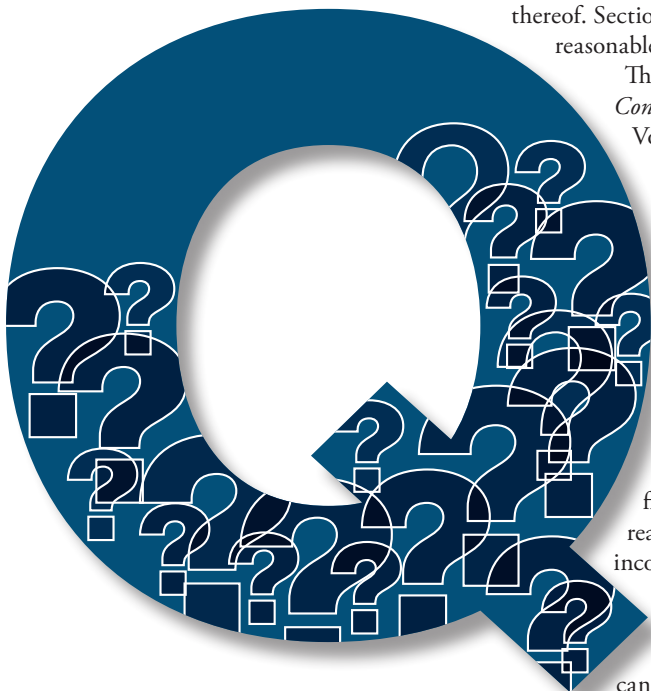
**Q.** When issuing an auditor's report on the financial statements of a company, the auditor identifies a non-compliance area with the Companies Ordinance in the directors' report. What shall the auditor do and what will be the effect on the auditor's report?

**A.** According to section 129D "Directors' report to be attached to balance sheet" of the Companies Ordinance, a company should attach a report by the directors to every balance sheet laid out in a general meeting. The report should state the company's profit or loss for the financial year and the state of its affairs as at the end thereof. Section 129F also states that the directors of the company should take all reasonable steps to secure compliance with the requirements in section 129D.

The Institute has issued HKSA 720 *Other Information in Documents Containing Audited Financial Statements*, which can be found in Volume III of the Members' Handbook. The purpose of HKSA 720 is to establish standards and provide guidance on the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

Paragraph 10 of HKSA 720 states that the objective and scope of an audit of financial statements are formulated on the premise that the auditor's responsibility is restricted to information identified in the auditor's report. Accordingly, the auditor has no specific responsibility to determine that other information is properly stated. However, the auditor should read the other information to identify material inconsistencies with the audited financial statements as stated in paragraph 2 of HKSA 720. While reading the other information for the purpose of identifying material inconsistencies, the auditor may become aware of an apparent material misstatement of fact as also stated in paragraph 14 of HKSA 720.

For guidance on the auditor's possible courses of action on material inconsistencies and material misstatement of fact, they can be found in paragraphs 11 to 18-3 of HKSA 720, covering the appropriate type of audit opinion to issue, discussion with management and seeking legal advice.



## Members helping members

*Do you want to help your fellow members? Try answering this question from a member and send an email to [hkicpa@hkicpa.org.hk](mailto:hkicpa@hkicpa.org.hk). Answers received by 20 February will be considered for inclusion in the April 2009 issue of A Plus.*

**Q.** In accordance with HKAS 12 *Income Taxes*, should an entity be required to recognize a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries? Is there any exception to the above-mentioned requirement?

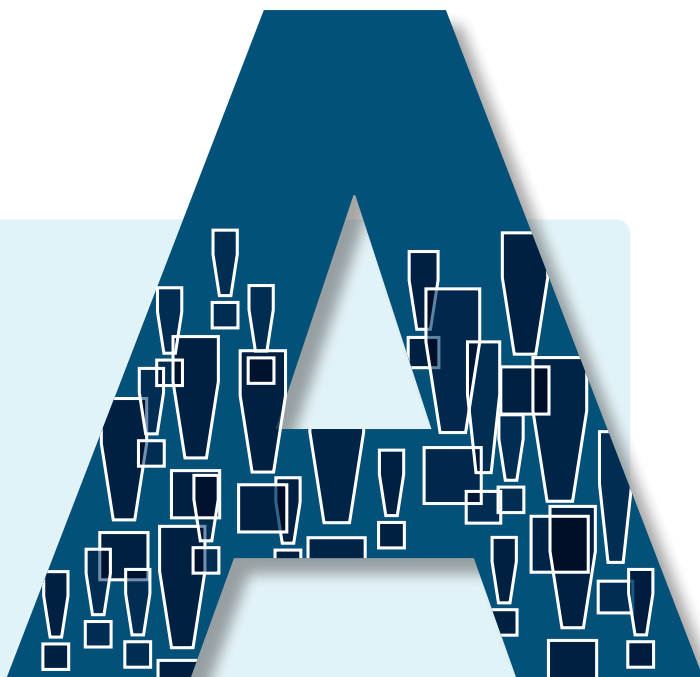
*Here is the answer to the question we asked members to help with in the November 2008 edition of A Plus:*

**Q.** Should two parties be regarded as related if they are subject to significant influence from the same source?

**A.** Paragraph 9 of HKAS 24 *Related Party Disclosures* states that a party is related to an entity if:

- a. directly, or indirectly through one or more intermediaries, the party:
  - i. controls, is controlled by, or is under common control with the entity (this includes parents, subsidiaries and fellow subsidiaries).
  - ii. has an interest in the entity that gives it significant influence over the entity.
  - iii. has joint control over the entity.
- b. the party is an associate of the entity.
- c. the party is a joint venture in which the entity is a venturer.
- d. the party is a member of the key management personnel of the entity or its parent.
- e. the party is a close member of the family of any individual referred to in (a) or (d).
- f. the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e).
- g. the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Based on the above definition of related party, two parties, say B and C, are not related to each other even



though they are both subject to the same source of significant influence from a party, A.

However, if B and C are trading with each other on non-arm's length terms, paragraph 10 of HKAS 24 requires that attention be directed to the substance of the relationship and not merely the legal form. In this respect, both B and C have to determine whether they are really acting independently in such a way that they are not subject to the significant influence of A. If transactions between B and C have been entered into under the significant influence of A, B and C should include in their financial statements a disclosure of such transactions. Arm's length transactions entered between B and C that are not subject to the significant influence of A would not be regarded as necessary for disclosure under HKAS 24.

The rationale of the above is that when B and C are transacting with each other under the significant influence of A, both B and C have indeed placed their interests under the discretion of A. Thus, by virtue of paragraph 10 of HKAS 24, both B and C are required to disclose that A is a related party and a non-arm's length transaction has been carried out under the significant influence of A. However, the identity of the counterparty to the transaction needs not be disclosed in the financial statements of both B and C, as it is not considered a related party in accordance with the definition of HKAS 24.

*You can submit questions on technical issues by sending an email to [hkicpa@hkicpa.org.hk](mailto:hkicpa@hkicpa.org.hk). The standard setting team will answer these questions in accordance with the policy on handling members' technical questions, which is posted on the Institute's website.*