

# Let's get technical

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

**Q.** Regarding the change of auditors, can the outgoing auditor refuse to provide professional clearance to the incoming auditor due to the audit fee issue with the client? If the outgoing auditor does not provide professional clearance, what can the incoming auditor do?

**A.** Members may refer to sections 210, 440 and 441 of the Institute's Code of Ethics for Professional Accountants, which can be found in Volume I of the Members' Handbook for guidance.

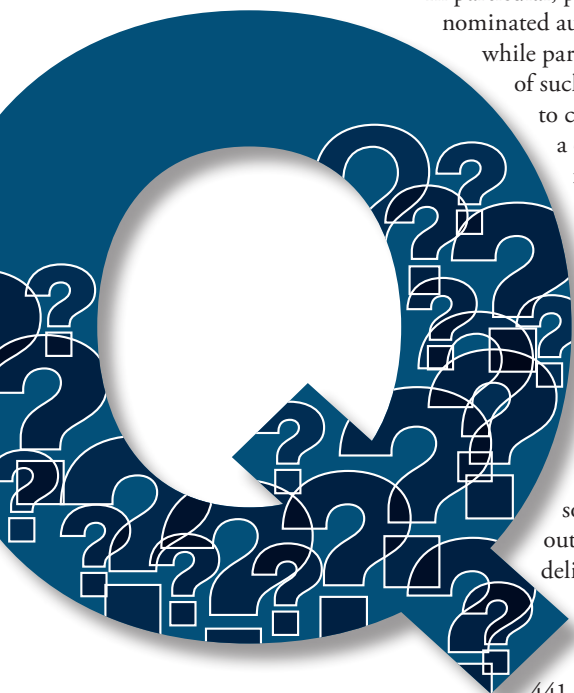
Section 210 "Professional Appointment" is based on the IFAC Code of Ethics for Professional Accountants. For Hong Kong, this is supplemented by additional guidance set out in part D of the Institute's code of ethics under sections 440 "Changes in a Professional Appointment" and 441 "Change of Auditors of a Listed Issuer of the Stock Exchange of Hong Kong."

In particular, paragraph 440.1 states that when a change of auditor is contemplated, the nominated auditor should write to the existing auditor to obtain "professional clearance," while paragraph 440.2 states that the existing auditor should act promptly upon receipt of such written request from the nominated auditor. When it is the wish of a client to change auditors, the existing auditor should not cause undue hindrance to such a change and should cooperate with the client and the nominated auditor to facilitate the flow of information and an effective changeover.

If there is no professional or other reasons why the proposed nominee should not accept nomination, the existing auditor is to reply accordingly without delay. However, if the existing auditor considers it appropriate to discuss the client's affairs with the proposed nominee, he needs the client's permission to do so. If the request is not granted, the auditor should report that fact to the proposed nominee who should not accept nomination.

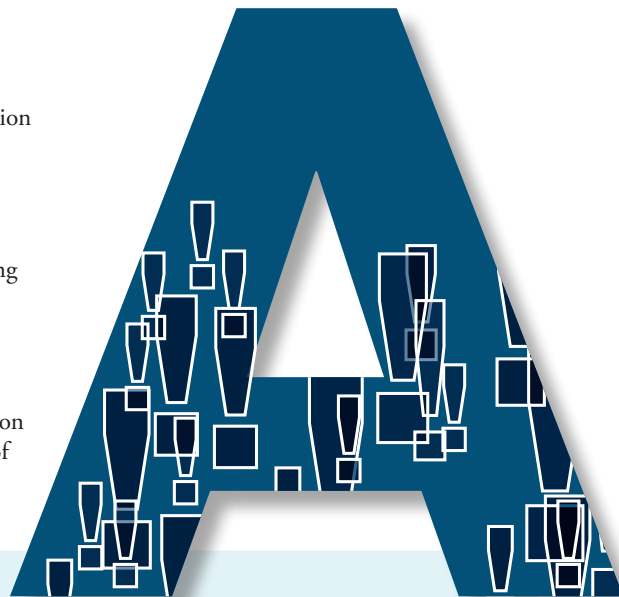
If the proposed nominee does not receive a reply from the existing auditor within a reasonable time and he has no reason to believe that there are any unusual circumstances surrounding the proposed change, according to paragraph 440.26, he should try to get in touch with the existing auditor by some other means. If he is unable to do so, or is unable to obtain a satisfactory outcome in this way, he should send a further letter, preferably by a recorded delivery service, stating that unless he receives a reply within a specified time, he will assume that there are no issues he should be aware of before deciding whether or not to accept the nomination.

For auditors of listed companies, further guidance is provided in section 441 of the ethics code. It is important that the situation concerning the change of



auditors be disclosed in full to avoid the possibility of the market being misled. The purpose of this section, which has been prepared in consultation with the Stock Exchange of Hong Kong and the Securities and Futures Commission, is to establish a framework to enhance communication by auditors with a listed issuer where there is a change of auditors. The framework requires the outgoing auditors to prepare a letter to the audit committee and the board of directors setting out the circumstances leading to their resignation or termination.

Auditors of Hong Kong incorporated listed issuers should note that section 140A(2) of the Companies Ordinance requires that an auditor who resigns from office before the expiry of his term must include in his resignation a statement of any circumstances connected with his resignation that he believes should be brought to the notice of members or creditors of the company. Otherwise, the auditor is required to provide a statement noting that there are no such circumstances.



## Members helping members

*Here is the answer to the question we asked members to help with in the January/February 2009 edition 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?**

**A.** Temporary differences arise in respect of investments in subsidiaries when the carrying amount of investments in subsidiaries – namely the parent’s share of the net assets of the subsidiary, including the carrying amount of goodwill – becomes different from the tax base (which is often cost) of the investments. Such differences may arise in a number of different circumstances, such as:

- (a) the existence of undistributed profits in subsidiaries, which increase the parent’s investment in the subsidiary to above its tax cost;
- (b) a reduction in the parent’s investment in the subsidiary to below tax cost due to impairment of investment; and
- (c) movements in the carrying amount of a foreign entity due to changes in foreign exchange rates when a parent and its subsidiary are based in different countries.

Accordingly, paragraph 39 of HKAS 12 *Income Taxes* requires an entity to recognize a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, except to the extent that both of the following conditions are satisfied:

- (a) the parent is able to control the timing of the reversal of the temporary difference; and
- (b) it is probable that the temporary difference will not reverse in the foreseeable future.

Paragraph 40 further states that in a parent/subsidiary relationship, the parent controls the dividend policy of its subsidiary and is thus able to control the timing of the reversal of temporary differences associated with that investment. In this case, when the parent has determined that those profits will not be distributed in the foreseeable future, the parent does not recognize a deferred tax liability.

Where no deferred tax liability is recognized if an entity applies paragraph 39, it is required to disclose the aggregate amount of temporary differences associated with investments in subsidiaries for which deferred tax liabilities have not been recognized in accordance with paragraph 81(f) of HKAS 12. Moreover, subject to consolidation adjustments, the group continues to recognize the deferred tax assets and liabilities that are recognized in the subsidiary’s own financial statements, and the deferred tax assets and liabilities that arise from fair value adjustments on acquisition of that subsidiary.

Example 3 of Appendix B accompanying HKAS 12 provides more guidance on how the above-mentioned principles are applied in a parent/subsidiary relationship.

*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.*