Towards a Stronger Regulatory Stance

Professional Standards Monitoring Committee
Operations Report 2004
Introduction

1. As part of the self-regulatory function of the Hong Kong Institute of Certified Public Accountants (“Institute”), the Professional Standards Monitoring Committee (“Committee”) of the Institute has since 1988 conducted a continuous review of published financial statements of companies listed on The Stock Exchange of Hong Kong Limited. The purpose of the review is to monitor the professional standards of the Institute’s members (“members”) who are engaged in the audit or preparation of the financial statements of companies listed on The Stock Exchange of Hong Kong Limited.

2. Where the review identifies any potential non-compliances or issues that may require further explanations, the Committee will instruct the Secretariat to write to the auditor and/or the preparer where it has a member of the Institute either on its Board or in the management team which is responsible for the preparation of the financial statements. The auditor and/or the preparer is obliged to answer the enquiry when requested to do so.

3. The Committee currently consists of 11 Certified Public Accountants drawn from member firms, commercial entities as well as The Stock Exchange of Hong Kong Limited. A team of 11 monitors who are also Certified Public Accountants assists the Committee in reviewing the selected financial statements.
4. The aim of this Report is to highlight the recent changes to the mode of operation of the Committee and the work that the Committee completed in 2004. Major findings noted by the Committee during its review of the financial statements of listed companies carried out in 2004 are enclosed in the Appendix so that members will be able to learn from the findings and improve the quality of the financial statements they prepare or upon which they report.

**Changes to the mode of operation of the Committee**

5. Given the increasing number of financial statements of listed companies that are subject to review, the Committee is of the view that it is necessary to re-consider the mode of operation and focus of the Committee in order to facilitate a more effective and efficient review of financial statements. The Council of the Institute has recently endorsed the recommendations of the Committee in respect of the changes to the mode of operation of the Committee as follows:

(a) **Role of the Committee**

The Committee will be more proactive in dealing with issues arising from the review of financial statements. Members engaged in public practice should possess the required knowledge of auditing and accounting standards. Members have the responsibility to keep themselves abreast of the latest developments in professional standards. Whilst the Committee can and will assist members by publishing the common findings noted during its review, especially in the compliance of accounting and auditing standards, the Committee is of the view that the educational role should rest with the Institute’s Continuing Professional Development function where members can be better served. Appropriate training should be given to members at an earlier stage so that members are able to properly apply professional standards. The benefit of the Committee’s work is identifying areas of non-compliance and the pitfalls to avoid in preparing or auditing financial statements. Where there has been a material non-compliance, a breach has in fact been committed and where appropriate, some forms of regulatory actions rather than “education” are warranted.

(b) **Scope of the monitors’ reviews**

Following the proposed change in the role of the Committee mentioned in 5(a) above, the monitors in future will focus on raising questions on material non-compliance issues identified in their reviews of financial statements. Matters raised for educational purposes, such as for improving disclosure and presentation of financial statements, will not be included in the letters to auditors in future, and will be put into a database for publication in the Committee’s operations report to be issued periodically. If the above approach is adopted, the attention of the Committee will be drawn to material
accounting and auditing issues that require follow-up action.

In addition, the Committee will give more guidance to the monitors to assist them in raising notes or questions in their reviews. The monitors should focus on the application of new accounting standards in their reviews of financial statements in future.

(c) Timing of reporting a case to the Council for referral to the Investigation Panels

As there is an expectation that the Institute will deal with cases in a timely manner, it is recommended that statutory investigations be triggered much sooner.

It is therefore recommended that where the Committee is of the view that there is a reasonable suspicion and belief that a member involved in the financial statements reviewed by the Committee is in breach of professional standards, rather than carrying out its own enquiries, the Committee should expedite the process for reporting the case to the Council for its consideration of conducting an investigation by an Investigation Committee.

It is expected that when the Audit Investigation Board (“AIB“) under the Financial Reporting Council (“FRC”) is established, the Committee will report any such cases to the Council for its consideration to act as the complainant to the FRC for an investigation to be carried out by the AIB.

Work completed in 2004

6. In 2004, the Committee reviewed 152 sets of financial statements and issued 179 letters to auditors. Two cases were referred to Council of the Institute and based on the facts, Council resolved to constitute a Disciplinary Committee for one case and to instigate an Investigation Committee for the other case.

(a) Scope of review

The scope of review by the Committee covers compliance with the following professional standards, rules and regulations applicable to the financial statements selected for review:

(i) the Institute’s accounting standards, guidelines and interpretations;

(ii) the Institute’s auditing standards, guidelines and practice notes including the form and content of audit reports;

(iii) statutory requirements (including the Tenth Schedule to the Companies Ordinance, the requirements of the Companies Ordinance concerning directors’ report and financial statements);

(iv) International Financial Reporting Standards and their interpretations, where applicable.

Note: Non-compliance with the Listing Rules and the Code of Best Practice issued by The Stock Exchange of Hong Kong Limited would not be normally covered in the Committee’s review, unless the non-compliance affects the true and fair view of the financial statements or is of such a nature so as to make the financial statements potentially misleading.
(b) **Communication of review findings**

When apparent non-compliances are identified or further explanations are required, the Committee would communicate its findings to the members concerned as follows:

(i) if the subject matter in question is significant and need further clarification, letters would be sent to the members concerned asking for written explanations; and

(ii) in the past, letters would be written to the members concerned drawing their attention to the less significant matters so that improvement could be made in the financial statements to be issued in future.

It is hoped that the Committee’s communication of its findings to members, whether acting as auditors or preparers of the financial statements, achieves its role of monitoring the work of members to improve the quality of financial reporting.

(c) **Observation on the findings**

Overall, the Committee is of the view that generally members have complied with the requirements of professional standards, rules and regulations although certain non-compliances and/or inconsistencies were identified as set out in the Summary of Findings in the Appendix.

Members are strongly recommended to make their own judgment, and consider the materiality of the subject matter when applying professional standards, rules and regulations to the financial statements audited or prepared by them.

**Conclusion**

7. The Committee will continue its function of reviewing published financial statements of listed companies to monitor the standard of members who are engaged in the audit or preparation of financial statements. However, the Committee would like to stress that members have the primary obligation to keep themselves abreast of the latest developments in accounting and auditing standards, and the relevant rules and regulations applicable to the financial statements which they prepare or on which they report. The continuous efforts of the Institute and members will ensure the improvement and maintenance of the quality of financial reporting in Hong Kong.

May 2005
## Members of the Professional Standards Monitoring Committee

- Carlson Tong (Chairman)
- Estella Ng (Deputy Chairman)
- Thomas Wong (Deputy Chairman)
- Rebecca Chan
- Olivia Cheung
- Charles Chow
- Raphael Ding
- Paul Hebditch
- Jonathan Leong
- Stephen Taylor
- Debra Wong

## Secretariat

- Stephen Chan
  - Executive Director
- Alfred Wong
  - Assistant Director, Quality Assurance

---

*This Operations Report is intended for general guidance only. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Operations Report can be accepted by the Hong Kong Institute of Certified Public Accountants.*
APPENDIX: Summary of findings

1. **Hotel properties**
   The accounting policy adopted for hotel properties was inconsistent with SSAP 17 "Property, plant and equipment" in that:
   (a) No depreciation is provided on the hotel properties.
   (b) Hotel property revaluation reserves realised upon disposal of hotel properties are released to the income statement instead of directly to retained earnings.

   The inconsistency was referred by the Committee to the Financial Reporting Standards Committee of the Institute (previously the Financial Accounting Standards Committee) for consideration. The inconsistency was resolved when the Institute issued Hong Kong Interpretation 2 (previously SSAP Interpretation 23) "The Appropriate Policies for Hotel Properties" in October 2004 which applies for annual periods beginning on or after 1 January 2005.

2. **Intangible assets**
   (a) The reasons disclosed for the recognition of intangible assets arising from development did not meet all the recognition criteria as specified in paragraph 45 of SSAP 29 "Intangible assets".
   (b) The disclosures on intangible assets were not fully addressed in the financial statements, especially those required in (a), (c) and (e) of paragraph 107 of SSAP 29.
   (c) Some companies did not start amortisation although intangible assets were recognised and the accounting policy note indicated that intangible assets were stated at cost less accumulated amortisation and impairment losses. For the sake of clarity, the Committee recommends that explanations should be made in the financial statements where this circumstance arises.
   (d) No impairment losses were recognised for intangible assets despite indications shown in the financial statements that the intangible assets might have been impaired. For example, there is substantial goodwill but the subsidiary to which the goodwill relates has resulted in continued and considerable operating losses to the group. For the sake of clarity, the Committee recommends that where these circumstances arise, further disclosures should be made to explain why the intangible assets were not impaired.

3. **Consolidated financial statements and accounting for investments in subsidiaries**
   (a) Disclosures relating to the acquisition and disposal of subsidiaries under paragraph 45 (b)(v) of SSAP 32 “Consolidated financial statements and accounting for investments in subsidiaries” and paragraph 38 of SSAP 15 “Cash flow statements” were overlooked in the preparation of the financial statements.

   In the notes to some financial statements showing the reconciliation of the
accumulated depreciation of fixed assets at the beginning and end of the reporting year, the movements during the reporting year included accumulated depreciation balances arising from the acquisition of subsidiaries. However, since the cost of fixed assets acquired via the acquisition of subsidiaries should be determined at their fair values at the date of acquisition, any accumulated depreciation balance of fixed assets prior to the date of acquisition should be adjusted against their fair values rather than shown separately.

(b) Where the results of associated companies were not equity accounted for, the reasons for not doing so were not disclosed as required by paragraph 38(c) of SSAP 10.

(c) Where the investing group held more than 20% equity interest in an investee but the investing group did not apply the equity method of accounting for the interest in the investee, there were insufficient explanations in the financial statements to rebut the presumption of the existence of significant influence. “Significant influence” is defined under paragraph 2 of SSAP 10. According to paragraph 3 of SSAP 10, significant influence is presumed to exist “if an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee”.

(d) Failure to disclose detailed information about material associated companies as required under paragraph 37 of SSAP 10.

(e) Failure to properly account for companies over which the investing group no longer exercises significant influence. The relevant requirements are set out in paragraph 10 of SSAP 10.

5. Impairment losses

(a) Under paragraph 1 of SSAP 31 “Impairment of assets”, the requirement for assessing impairment does not apply to all assets. The accounting policy note should specifically state the class of assets that is subject to an annual impairment test.
(b) Despite material impairment losses being recognised in the financial statements, the amortisation charges in the year subsequent to the recognition of impairment losses remained the same as before. The requirement of paragraph 62 of SSAP 31 is that the amount charged should be adjusted in future periods to allocate the asset’s revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

(c) Where material amounts of impairment losses were charged against the income statement during the year, the disclosures required by paragraphs 113(a) and 117 of SSAP 31 were not made.

6. Inventories

Omission to disclose:

(a) the cost of inventories recognised as an expense during the year according to the requirements of paragraph 32(a) of SSAP 22 "Inventories"; and

(b) the carrying amount of inventories which were carried at net realisable value at the balance sheet date according to the requirements of paragraph 30(c) of SSAP 22.


(a) Provisions for expenses were recognised when the required recognition criteria of the “existence of a present obligation” stated in paragraph 14 of SSAP 28 “Provisions, contingent liabilities and contingent assets” was not met.

(b) The disclosures as required by paragraphs 84 and 85 of SSAP 28 were not fully made in the financial statements.

8. Deferred tax

(a) Omission of the disclosure requirements under paragraph 81(e) and (g) of SSAP 12 “Income taxes”.

(b) Recognition of all deferred tax assets and liabilities is required, except those explicitly exempted, under paragraphs 15, 24 and 34 of SSAP 12.

9. Revenue recognition

(a) Inconsistency with the stage of completion basis as required by paragraph 19 of SSAP 18 “Revenue” was noted in that income from the rendering of services was often recognised when the services were rendered.

The inconsistency was referred to the Financial Reporting Standards Committee. It was resolved when the Institute issued Hong Kong Interpretation 3 (previously SSAP Interpretation 24) “Revenue - Pre-completion Contracts for the Sale of Development Properties” in March 2005 which applies to pre-completion contracts for the sale of development properties entered into on or after 1 January 2005.

(b) Revenue from government grants was recognised on a cash basis which is not
consistent with the accrual basis of accounting prescribed in paragraph 26 of SSAP 1 “Presentation of financial statements”. The adoption of cash basis, however, is acceptable if the requirement under paragraph 17 of SSAP 35 “Accounting for government grants and disclosure of government assistance” is met.

(c) The amount of each significant category of revenue recognised during the period was not disclosed separately according to the requirements of paragraph 35(b) of SSAP 18.

10. Incomplete accounting policies disclosed

The accounting policies disclosed should be clear and comply fully with the requirements of the relevant accounting standards. Apart from the disclosures mentioned in other specific findings, the Committee advises members to consider the examples below of which the disclosures of the following underlined wordings in the accounting policies are recommended:

(a) According to the requirements of paragraph 12 of SSAP 14 “Leases”, “lessees should recognise finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property, or if lower, at the present value of the minimum lease payments”.

(b) According to the requirements of paragraph 102 of SSAP 31 “Impairment of assets”, “the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years”.

(c) According to the requirements of paragraph 9 of SSAP 13 “Accounting for investment properties”, investment properties are not depreciated “except where the unexpired term of the lease is 20 years or less, in which case depreciation must be provided on the then carrying amount over the remaining term of the lease”.

(d) According to the requirements of paragraph 3 of SSAP 22 “Inventories”, net realisable value is determined on the basis of “the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale”.

11. Comparative information / figures

(a) Where the comparative figures were restated to conform with the current year’s presentation, the reason for and a description of the nature of material reclassification were not disclosed in accordance with the requirements of paragraph 42 of SSAP 1 “Presentation of financial statements”.

(b) The financial statements failed to disclose comparative information for certain items, such
as directors’ remuneration, five highest paid employees, capital commitments and related party transactions, which is in breach of the requirements of paragraph 39 of SSAP 1.

12. Form and content of audit report

(a) The basis for qualifying an audit opinion was sometimes not explained sufficiently to enable readers to fully understand the reason for the qualification. Where a qualified opinion in respect of limitation of audit scope was issued, the type of evidence that was necessary but not available was not stated. According to paragraph 39(a) of SAS 600 “Auditors’ reports on financial statements”, the auditors should include a description of the factors leading to the limitation in the section of their report setting out the basis of their opinion.

(b) In cases where a qualified opinion in respect of a disagreement was issued, the disclosures required by paragraph 45(a) of SAS 600 were not fully made.

(c) In a few cases that new auditors issued a qualified opinion in respect of limitation of scope, the subject matter of the qualification was the same as that mentioned in the audit report issued by the predecessor auditors. It was unclear whether the scope limitation was imposed by the reporting entity or due to circumstances surrounding the audit.

(d) Attention should be paid to paragraph 43 of SAS 600 which requires that, where a limitation imposed by the reporting entity is known at the time of considering the audit engagement, the auditors would normally not accept such a limited engagement as an audit engagement.

(e) According to paragraph 44 of SAS 600, “where a scope limitation is imposed by circumstances, auditors would normally attempt to carry out reasonable alternative procedures to obtain sufficient audit evidence to support an unqualified opinion”. Where a scope limitation is imposed by circumstances, the auditors should explain clearly in their auditors’ report why they could not reasonably carry out alternative procedures and the type of audit evidence that they failed to obtain.

(f) For companies which are incorporated outside Hong Kong, the auditors’ report should state whether the financial statements were properly drawn up in accordance with “the disclosure requirements of the Hong Kong Companies Ordinance” in compliance with section 141(3) of the Companies Ordinance (Cap. 32), paragraph 19.23 of Chapter 19, paragraph 19A.34 of Chapter 19A and paragraph 28 of Appendix 16 of the Main Board Listing Rules or paragraphs 24.16 and 24.20 of Chapter 24 and paragraphs 25.28 and 25.32 of Chapter 25 of the GEM Listing Rules.