Inspection

22 December 2022

AUDIT FOCUS

2022 financial year-end audits reminders

As the year end of 2022 is fast approaching, this *Audit Focus* provides key reminders to auditors so that they can take our reminders into consideration when they perform audit work. Planning is the key to a successful and smooth audit. Auditors should have by now completed or in the progress of conducting audit planning. They should attain an in-depth understanding of their clients' businesses and perform the audit risk assessment in accordance with the HKSA 315 (Revised 2019) (2022) *Identifying and Assessing the Risks of Material Misstatement*. Engagement teams that have already completed their planning should communicate with their clients to understand whether there are any significant changes in their operations; and consider if any risk-reassessment is required.

A volatile economic environment requires auditors to remain alert to the impact of these risks to their clients. Under the current interest rate hike and the inflationary pressure, auditors need to consider the impacts of the following key areas to their audit:

a. **Fraud risk assessment** under HKSA 240 (Revised 2022) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* as there may be a greater pressure to commit financial reporting fraud to meet financial targets by the management;

b. Significant changes in the cost due to inflation may alter the **revenue recognition** and lead to more onerous contracts, that the auditors need to consider especially for long term contracts accounted under HKFRS 15 *Revenue from Contracts with Customers;*

c. **Impairment assessment** on financial assets and non-financial assets as the key assumptions such as the effective interest rate, discount rate, weighted average cost of capital and also the cash flow projection may be impacted by the changes of interest rates and inflation rates; and

d. **Going concern assessment** under HKSA 570 *Going Concern* as greater inflation and interest rate volatility may lead to increased cost of sales, loans and interest repayments, which could have impact to the estimated cash outflows in the cash flow forecasts. Hence, auditors need to pay special attention to the assessment made by their clients and the impact of changes in the macroeconomic environment on the assumptions being applied.

Ahead of the year-end audit and in order to prepare well for their audit work, firms and their auditors are expected to:

a. Review sufficiency of their internal resources to ensure engagement teams possess necessary level of skills, time and resources based on the nature and complexity of the client's business operations;

b. Coordinate with any internal or external specialists that the engagement team planned to use;

c. Ensure the scope of work is agreed and sufficient resources are available according to the plan when it comes to peak season;

d. Ensure their systems of quality management (**SoQM**) are in place to comply with the new and revised quality management standards that came into effective on 15 December 2022; and

e. Continue to monitor and evaluate the effectiveness of SoQM and make necessary improvement to identified system deficiencies.

In executing the year-end audit, auditors are reminded to pay particular attention to following 7 key areas:

1. Auditors' independence is the cornerstone of auditing

- Auditors should always maintain independence of mind and in appearance as necessary to express a conclusion, and be seen to express a conclusion, without bias, conflict of interest, or undue influence of others as required under the HKICPA's Code of Ethics for Professional Accountants.

- Auditors must neither prepare books and accounting records and financial statements for their audit clients nor request their clients to perform the audit work, for example, asking clients to select their samples for audit testing, and prepare working papers to show the audit work done.

- Before the firm accepts to provide non-assurance service to audit client, the firm must evaluate the significance of any threat to independence created by that particular non-assurance service.

2. Carry out direct supervision and on-site review

- Engagement partners take full responsibility for the direction and supervision of the engagement team members as well as to review their work, especially for the work related to significant risk areas and areas involving significant judgements.

- Engagement quality reviewers must be involved in different stages of the audit and to challenge the significant judgements made and the conclusions reached by the engagement teams.

- Group engagement partners need to closely supervise and critically evaluate the adequacy and appropriateness of the component auditors' work. Depending on the significance of the component audits, group engagement team should determine whether to conduct physical visit on client's overseas operations and carry out on-site review of component auditors' work.

3. Heighten professional skepticism and challenge status quo

- Maintain a questioning mind especially when dealing with areas such as management's significant accounting estimates and assumptions under HKSA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*, and when evaluating an entity's ability to continue as a going concern under HKSA 570 (Revised) *Going Concern*.

- Pay extra attention to areas such as significant transactions and acquisitions, and offshore bank accounts opening around year end that appeared to be lack of commercial rationale.

- Stay alert of any unusualness noted when receiving external confirmations and ensure the sent-and-receipt process of confirmations must be performed under the auditor's control.

- Evaluate all audit evidence, not just corroborative evidence but also contradictory evidence to avoid confirmation bias.

4. Common audit focus areas

- **Going concern** – Stay alert on what events or conditions, individually or collectively, that might cast significant doubt on its client's ability to continue as a going concern. Determine whether the financial statements adequately disclose these principal events or conditions, and to perform a robust assessment to verify in accordance with HKSA 570 (Revised) *Going Concern*.

- **Significant accounting estimates** – Be aware of the possible impact arising from recent changes in economic conditions such as interest rate hikes and inflationary pressure.

- **Using the work of auditor's expert** – if auditors determine that the work of auditor's expert, internal or external, is not adequate for their purposes, they must agree with that expert on the nature and extent of further work to be performed by that expert or perform additional audit procedures appropriate to the circumstances as required under HKSA 620 *Using the Work of an Auditor's Expert*.

5. Documentation is the evidence of your audit work

- Prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand what the engagement team did for the audit as required under HKSA 230 *Audit Documentation*.

- Working papers should provide sufficient details of the purpose of the audit test, nature, timing, and extent of the audit procedures performed to support the audit conclusions reached at the time of the audit.

- The extent of documentation will be very much depending on factors such as risk of material misstatement of the audit area, significance of the audit evidence, nature of the procedures and extent of significant judgement and estimates involved etc.

6. Effective communication with management and those charged with governance and regulators if necessary

- Maintain close and effective dialogue with management throughout the audit to ensure significant matters are immediately communicated and followed up by management.

- Communicate proactively with those charged with governance for the purpose of resolving significant matters and/or unexpected matters that arise during the audit.

- Any unresolved audit matters that may lead to change of auditors should be well communicated with management and those charged with governance (such as audit committees) and draw the attention of regulators to these matters, if necessary.

7. Late changes of auditors

- Auditors should always endeavour to complete the audit rather than attempt to avoid the responsibility of adversely reporting on the financial statements by resigning.

- Incoming auditors need to fully understand if there are any unresolved audit issues by communicating with the outgoing auditors and assess if they are capable to resolve these matters before accepting any new client relationship and engagement.

- Incoming auditors must properly plan the resources they need for their existing client and engagement portfolio and critically assess their competence and capabilities to perform a high-quality audit, especially when there are unresolved audit issues, and reflect their work in their audit fee, before accepting any new client relationship and engagement.