

Summary	
Category	Listing Decisions Series 42-3 (LD42-3) <u>(Updated in April 2014)</u>
Name of Party	Company A and its subsidiaries (collectively the “Group”) – a GEM Board listing applicant
Subject	Whether the roll-back and roll-forward procedures adopted by the reporting accountants were acceptable to the Exchange for ascertaining the inventory levels of Company A as at the relevant year/period end dates for the purpose of the accountants’ report prepared for the initial listing of Company A’s shares on GEM?
Listing Rules	GEM Listing Rules 7.02; 7.12
Decision	Based on the material facts, the Exchange, in the first hearing of Company A’s listing application, considered the adoption of roll-back procedures to be acceptable. However, as regards the adoption of roll-forward procedures by the reporting accountants, the Exchange in the same hearing requested the sponsor to demonstrate exceptional grounds in order to justify the adoption of roll-forward procedures by the reporting accountants before accepting the practice.

SUMMARY OF FACTS

1. The accountants’ report of Company A as shown in its prospectus disclosed the audited financial statements required of a GEM listing applicant for the two financial years immediately preceding the issue of its prospectus and a stub period of eight months thereafter (that is, “Year 1”, “Year 2” and “Stub Period”).
2. The reporting accountants of the Group were appointed during the course of Year 2. As a result, the reporting accountants were not present during the stocktake of the Group in Year 1. The reporting accountants attended two stocktakes in Year 2 (at the end of the seventh month and the twelfth month of Year 2 respectively), and one at the end of the third month of the Stub Period.
3. In order to ascertain the inventory balances as at the year/period end dates of Year 1, Year 2 and the eight month Stub Period for the preparation of the accountants’ report of the Group, the reporting accountants performed inventory roll-back and roll-forward procedures.
4. In other words, the reporting accountants had to:

- roll-back for seven months to ascertain the inventory balance as at the end of Year 1 (from the end of the seventh month of Year 2 to the end of Year 1), and
 - roll-forward for five months to ascertain the inventory balance as at the end of the Stub Period (from the end of the third month of the Stub Period to the end of the Stub Period).
5. The Group maintained perpetual inventory record and internal inventory control procedures, and performed physical counts with respect to its inventories periodically.

THE ISSUE RAISED FOR CONSIDERATION

6. Whether the roll-back and roll-forward procedures adopted by the reporting accountants were acceptable to the Exchange for ascertaining the inventory levels of Company A as at the relevant year/period end dates for the purpose of the accountants' report prepared for the initial listing of Company A's shares on GEM?

APPLICABLE GEM LISTING RULES

7. GEM Listing Rule 7.02 provides that:-

“All accountants’ reports must be prepared by professional accountants who are qualified under the Professional Accountants Ordinance for appointment as auditors of a company and who are independent both of the issuer and any other company concerned to the same extent as that required of an auditor under the Companies Ordinance¹ and in accordance with the requirements on independence issued but the Hong Kong Society of Accountants [now known as Hong Kong Institute of Certified Public Accountants],...”.

8. GEM Listing Rule 7.12 provides that *“[T]he financial history of results and the balance sheet included in the accountants’ report must normally be drawn up in confirmation with Hong Kong Financial Reporting Standards or International Financial Reporting Standards”.*

9. Technical Bulletin 19 “Opening Stocks – Alternative Audit Procedures” issued by Hong Kong Institute of Certified Public Accountants (formerly Hong Kong Society of Accountants) in April 1993 sets out, among others, (i) the situations where an auditor may consider assurance on opening stocks inadequate, thus enabling the auditor to perform additional auditing procedures to ascertain the opening stocks for the giving of an unqualified opinion on the financial statements;

¹ Retitled as the Companies Ordinance (Cap. 622) with effect from March 2014 (Updated in April 2014).

and (ii) the conditions that must exist before an auditor may perform such alternative procedures.

The situations under which an auditor may perform additional procedures to obtain audit assurance on opening stocks are:-

- a. stocks have previously not been subject to an audit since the financial statements as a whole were not audited; or
- b. where, because of a limitation in scope, the previous auditor was not in a position to give a clean opinion on stocks, in particular on the existence of stocks, eg. where the auditor was appointed after the completion of the client's stocktake, was therefore unable to attend the physical stocktaking and consequently determined he was unable to form an opinion on the existence and quantity of stocks.

The conditions that must exist before an auditor may perform additional procedures mentioned above are set out in brief as follows:

- a. The entity must have performed stocktake at the period end date;
- b. Adequate and documented procedures for counting, measuring and recording quantities, cut-off, identification of third party inventories, obsolete and slow moving inventories have been established and applied by the entity;
- c. The auditors attended stocktake of the entity at a date either shortly before or after the period end and the result is satisfactory;
- d. Good internal controls over the physical movements of inventories throughout the period have been maintained by the entity and those controls are operating satisfactorily;
- e. Adequate records to identify all inventories movements throughout the period have been maintained by the entity; and
- f. All records have been retained by the entity.

THE ANALYSIS

10. The Exchange expects the reporting accountants appointed for the purpose under GEM Listing Rule 7.02 to conduct significant and substantive work in the preparation of the accountants' report for the purpose of listing. Such work provides a high level of assistance to the Exchange and the investing public regarding the financial information underlying the accountants' report. This work would necessarily entail the reporting accountants gathering sufficient and

appropriate evidence to support their report through a variety of procedures including inspection, observation and direct confirmation. The Exchange ordinarily considers that this should include participation in well planned stocktake procedures.

Adoption of roll-back procedures

11. Regarding the adoption of roll-back procedures by reporting accountants in preparation of their accountants' report for listing purpose, the Exchange noted that under Technical Bulletin 19 the reporting accountants must themselves be satisfied that objective situations and conditions as described therein were present before resorting to using alternative auditing procedures to ascertain the opening stocks. At the same time, the Exchange considered that each of the sponsors and directors of the listing applicant must satisfy the Exchange that it was justifiable for the reporting accountants to adopt the alternative auditing procedures to ascertain the inventory level.
12. Based on the submissions of the sponsor of Company A giving the reasons for the adoption of roll-back procedures, submissions on the internal inventory control procedures maintained by the Group, the number and intervals of physical counts that the Group had undertaken during the relevant period, and the due diligence procedures undertaken by the reporting accountants and sponsor with respect to the adoption of roll-back procedures, the Exchange considered it appropriate to adopt the roll-back procedures to ascertain the inventory level as at the year end date of Year 1.

Adoption of roll-forward procedures

13. Regarding the adoption of roll-forward procedures by reporting accountants in the preparation of the accountants' report, the Exchange noted that there was no auditing guideline which prohibited such adoption. Equally, the Exchange noted that Technical Bulletin 19 neither provided for nor specified situations where roll-forward procedures could be adopted.
14. The Exchange was of the view that the situations justifying the use of roll-forward procedures were not as compelling as the situations evoking the use of roll-back procedures. The reason being that an additional stocktake attendance by the auditor and the adoption of the normal roll-back procedures as set out in the Technical Bulletin 19 would have achieved the same result.
15. Accordingly, before allowing for the adoption of roll-forward procedures in the audit of an accountants' report for the purpose of an IPO, the Exchange would require very good reasons for such adoption for the purpose of ascertaining the inventory level at a particular date subsequent to a stocktake attendance by an auditor.

16. While noting that the value of inventory in this case was not material (amounting to approximately 7% of the net asset value of the Group as at the end of the Stub Period), the Exchange considered the adoption of the roll-forward procedures to be unusual in the circumstances and that the roll-forward period was relatively long. The Exchange therefore had concerns about the adequacy of the procedures adopted. Under the circumstances, unless there were compelling justifications for the adoption of roll-forward procedures by the reporting accountants, the Exchange would not consider such procedures to be an acceptable method to ascertain the inventory level as at the period end date of the Stub Period.

THE DECISION

First Hearing

17. Based on the Exchange's analysis of the relevant GEM Listing Rules, the applicable auditing guidelines and after considering the material facts, the Exchange determined, in the first hearing of Company A's listing application, that the adoption of roll-back procedures by the reporting accountants to ascertain the inventory levels of Company A as at the relevant year end dates was acceptable.
18. As regards the adoption of roll-forward procedures by the reporting accountants in the present case, the Exchange determined in the same hearing that the sponsor must demonstrate exceptional grounds in order to justify the adoption of roll-forward procedures by the reporting accountants before the Exchange would consider such procedures to be an acceptable method to ascertain the inventory level as at the period end date of the Stub Period.

Second Hearing

19. In the second hearing of Company A's listing application, the sponsor of Company A submitted that the reporting accountants had performed the following additional audit work:-
 - a. attended one additional inventory count conducted by the Group after the end of the Stub Period;
 - b. performed roll-back procedures to ascertain the inventory balance as at the end of the Stub Period; and
 - c. compared the inventory count records as at end of the Stub Period to the inventory roll-back analysis.
20. In addition, the reporting accountants of Company A also confirmed that no material discrepancy was found and the audit procedures in respect of the inventory balance as at the end of the Stub Period had been performed in accordance with the relevant Auditing Standards.

21. On the basis of the above submissions, the Exchange was satisfied that the various concerns on the auditing procedures for ascertaining the inventory level at different period ends during Year 1, Year 2 and at the end of the Stub Period had been fully addressed.