

Roundtable Discussion on Audit Quality and Climate-integrated Audits in Hong Kong

Policy, Registration and Oversight

June 2024



About the Accounting and Financial Reporting Council

The Accounting and Financial Reporting Council (**AFRC**) is an independent body established under the Accounting and Financial Reporting Council Ordinance. As an independent regulator, the AFRC spearheads and leads the accounting profession to constantly raise the level of quality of professional accountants, and thus protects the public interest.

For more information about the statutory functions of the AFRC, please visit www.afrc.org.hk.

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Executive summary

Between December 2023 and February 2024, the AFRC conducted three roundtable discussions and three individual interviews with institutional investors, members of audit committees of Hong Kong-listed companies, and representatives of PIE auditors.¹ The discussions focused on audit quality of listed companies in Hong Kong and the threat posed to it by a decade-long stagnation of their audit fees, and by opportunistic changes of auditors. They also touched on the challenges to financial reporting and audit stemming from increased market focus on climate related factors and sustainability.

In this report, we summarise the views expressed by the participants. We also include our perspectives and conclude with calls to action for the three groups of stakeholders to foster higher quality of financial reporting and audit in Hong Kong.

Audit quality: its importance, definition and determinants

High-quality audit is essential for ensuring the reliability of financial reporting and investors' ability to make informed decisions. However, as investors often lack the means to independently assess audit quality of listed companies, they heavily rely on companies' audit committees to select qualified auditors and oversee the audit process. They only pay closer attention to audits when scandals surface.

Audit committees and auditors play an active role in ensuring audit quality, but not all share the same understanding of its importance and definition. Some audit committees erroneously equate the quality of service provided by the audit firm with audit quality. The AFRC stresses the importance of differentiating audit quality from service quality, and emphasises that audit quality should take precedence over service quality when appointing auditors. The participants also call for greater transparency around auditor selection and the audit process, which will allow investors to make informed decisions.

¹ "PIE auditors" refers to practice units registered with the AFRC, which are eligible to carry out audits of Hong Kong-listed companies.

Among various determinants, the AFRC regards the right tone at the top at the audit firm as an important prerequisite for high audit quality, however during the discussion this aspect did not strongly resonate with the auditor participants.

Stagnation of audit fees paid by listed companies in Hong Kong: the impact of price wars and a compliance-driven mindset

The AFRC has observed a stagnation in the level of audit fees paid by listed companies in Hong Kong over the past decade, which translates into a decline of audit fees when adjusted for inflation.

The roundtable participants attributed the fee stagnation primarily to an intense price war among audit firms. The situation is compounded by listed companies' perception of audit as a mere compliance requirement, and auditors' difficulties in conveying the importance of high-quality audit to the companies. Together, these factors create significant pressure on audit fees.

Stagnation of audit fees as a threat to audit quality

Persistent slow growth of audit fees may force audit firms to stretch staffing resources. The firms may also struggle to generate sufficient capital to invest in staff and technology, even while maintaining a minimal profit margin. Deployment of insufficient resources to an audit engagement not only pose a direct threat to audit quality, but may also create excessive workloads on existing audit staff. Such workloads exacerbate the negative perception of the profession, making it less attractive for existing workforce and new entrants. This may further strain audit firms' resources resulting in a vicious cycle that may lead to declining audit quality.

Audit firms may turn to providing more non-audit services to subsidise an audit; however, if this revenue stream becomes substantial, it may threaten the firm's independence and the quality of the audits it provides.

The roundtable participants unanimously recognised the importance of audit quality and acknowledged that the long-term fee stagnation is likely to impair it. The AFRC is concerned that if the level of fees does not keep pace with the complexity of audit work, it may undermine audit quality. To protect the public interest and earn investors' trust, auditors must ensure that their fees allow them to dedicate adequate resources to audit engagements to deliver high-quality audits. Furthermore, audit committees have a responsibility to oversee the entire audit process and ensure its quality.

Opportunistic changes of auditors and their threats to audit quality

The low level of awareness regarding the importance of audit quality leads many companies to select auditors based solely on price, without adequately considering audit quality. As auditors are forced to compete on price, some companies seize this opportunity to cut costs by changing auditors, and selecting those that charge lower fees. Consequently, it is crucial for audit committees to monitor auditor changes and challenge auditors who offer unreasonably low audit fees.

The AFRC is concerned about instances of listed companies changing auditors near the end of the reporting period. The stated reason for such changes is often "audit fee dispute", which may conceal underlying causes, such as a disagreement about outstanding audit issues, or indicate "opinion shopping". A new auditor accepting an engagement near the end of the reporting period will face a shortened audit timeline and a potential resource crunch, making it difficult to conduct a high-quality audit. Any such change of auditors warrants closer scrutiny by investors.

The pivotal role of audit committees in resolving audit issues

Some auditor changes result from late identification of audit issues during the audit process or the company's unwillingness to compensate the auditor for the additional time and effort required to address these issues. Auditors, audit committees, boards of directors, and senior management of listed companies share the responsibility for mitigating such risk through adequate audit planning, effective communication, and enhanced transparency.

The investors participants encountered instances where audit committees demonstrated a bias toward management. The AFRC emphasises the importance of the audit committee maintaining independence when dealing with audit issues. It is also unacceptable to attempt to change auditors to avoid resolving audit issues.

The growing imperative and current limitations of climate-integrated financial reporting and audit in Hong Kong

Comprehensive, true and fair climate-integrated financial reporting and audit of listed companies is of growing importance to investors. As climate-related opportunities and risks to businesses become more relevant, it is important to incorporate these factors into the companies' financial reports and audits.

However, according to the roundtable participants, the current state of climate-integrated financial reporting and audit in Hong Kong is inadequate for assessment of such factors. Investors, in particular, were sceptical about listed companies' ability to reliably reflect climate-related factors.

The need for independent assurance of sustainability reporting

All participants agreed that the reliability and usefulness of sustainability reporting would be significantly enhanced if independent assurance is obtained. There was a shared desire for broader adoption of assurance. They suggested that a future regulatory regime for sustainability assurance should ensure all assurance providers are regulated in a consistent manner.

In line with this, the AFRC is driving the development of sustainability assurance in Hong Kong as part of the Green and Sustainable Finance Cross-Agency Steering Group (**CASG**), of which it became a member in January 2024. The CASG aims to co-ordinate the management of climate and environmental risks to the financial sector and to accelerate the growth of green and sustainable finance in Hong Kong.

Calls to action

Based on the discussions, the AFRC issues the following calls to action for various PIE stakeholder groups:

PIE auditors should:

- Demonstrate commitment to audit quality through adherence to professional standards, robust audit planning, commitment to addressing outstanding audit issues, open communication with audit committees and being transparent with them about inspection findings, and making full and frank disclosures when resigning from an engagement; and
- Ensure charging sufficient audit fees, which allow allocating adequate resources to audit engagements, and investing in staff retention, new technologies, and training to uphold audit quality.

Audit committees should:

- Safeguard the quality of financial reporting and audit: Prioritise audit quality when selecting auditors, assert their role in negotiating adequate audit fees, preserve the auditor's independence, monitor audit execution, proactively resolve any disagreements between the auditor and management, and prepare for climate-integrated financial reporting and sustainability reporting.

Investors should:

- Encourage high quality and reliable financial reporting: Be vigilant for red flags signifying possible issues with audit quality, express their concerns about changes of auditors, audit fees, and auditor selection process when warranted, and demand that investee companies accurately reflect climate-related factors in their financial reports.

Section A

Introduction

1. The AFRC's mission

- 1.1. As the independent regulator of the accounting profession in Hong Kong, the AFRC strives to improve the quality of financial reporting and audit in the city's capital market. The AFRC maintains close and timely communication with stakeholders in the market through various channels, and actively seeks to understand their views and concerns.

2. Roundtable discussions and interviews

- 2.1. During the period from December 2023 to February 2024, the Policy, Registration and Oversight Department of the AFRC (**PRO**) held three roundtable discussions and three individual interviews with stakeholders who were selected for their expertise and experience.
- 2.2. The participants in each roundtable discussion and interview were selected from one of three groups: institutional investors, members of audit committees of Hong Kong-listed companies, and representatives of PIE auditors. We describe the selection process in Appendix II and present the list of participants in Appendix III.
- 2.3. The objective of the discussions and interviews was to gather insights that will allow the AFRC to better understand the challenges investors, listed companies, and auditors face, and to shape the AFRC's future policies and regulatory initiatives for the benefit of all stakeholders.
- 2.4. All three discussions were opened by Dr Kelvin Wong, Chairman of the AFRC. The discussions and interviews were moderated by a director of PRO. The discussions took place with the understanding that no views will be attributed to any of the participants.

- 2.5. Audit quality is a complex and nuanced topic, and its understanding varies among market participants. Therefore, initiating the discussion by addressing the importance of audit quality, defining audit quality and its determinants can ensure a shared understanding among participants, and allow the development of meaningful insights and recommendations.
- 2.6. The discussion revolved primarily around the participants' experiences with companies listed in Hong Kong. It addressed three phenomena relating to the quality of financial reporting and audit:
- (a) An observed decline of audit fees paid by listed companies after adjusting for inflation;
 - (b) Instances of opportunistic changes of auditors; and
 - (c) The varying levels of readiness among listed companies to integrate climate-related opportunities and risks in their financial reporting.
- 2.7. The questions posed during the discussions aimed to obtain the participants' views on these phenomena and their implications for audit quality. A summary of key questions posed to the participants are listed in Appendix I.
- 2.8. This report lays out the main themes of the discussions, and conveys the views and opinions shared by the participants. The AFRC's perspectives and calls to actions have also been incorporated. The content is organised in following order:
- (a) The importance of audit quality (**Section B**)
 - (b) Audit fee stagnation as a threat to audit quality (**Section C**)
 - (c) The threat to audit quality from opportunistic changes of auditors (**Section D**)

- (d) Incorporating ESG factors to enhance the quality of financial reporting and audit (**Section E**)
- (e) Calls to action for PIE auditors, audit committees of listed companies, and investors (**Section F**)

3. Opening remarks by Dr Kelvin Wong, Chairman of the AFRC

- 3.1. In opening the discussion, Dr Wong underscored the importance of bringing the expertise and experience of market participants to the issues under discussion. He highlighted the benefits of a roundtable discussion in sharing observations and views with the AFRC and the participants.
- 3.2. The quality of financial reporting and audit is of crucial importance to the three groups of stakeholders. Investors rely on accurate and complete information contained in the financial reports for their decision-making. Audit committees are responsible for monitoring, reviewing, and assessing the integrity of the financial statements of their companies. They also evaluate the qualifications, expertise, and resources of the auditor for appointment or re-appointment and monitor the effectiveness of the audit process. Auditors are responsible for auditing the companies' financial statements and providing opinions on whether they are true and fair.
- 3.3. The set-up of the roundtable discussions was informed by the application of the agency theory to the governance of listed companies. In this interpretation, audit committee members act as the agents of shareholders (investors), and auditors, in turn, are the agents of audit committees. The investor roundtable was conducted first, followed by audit committee members and subsequently auditors. This order enabled the discussion among audit committee members to benefit from the views expressed by investors, and the subsequent discussion among auditors to benefit from the insights shared by the audit committee members.

- 3.4. Investors – the main users of audited financial statements – have the power to hold companies accountable for the quality of their financial reporting. They can drive improvements in reporting and audit quality through voting their shares and engaging with investee companies. Additionally, investors can also “vote with their feet” by choosing to divest from certain companies.
- 3.5. Investors, audit committees, and auditors each have distinct roles to play in safeguarding the integrity of financial reporting and ensuring high audit quality in Hong Kong. Their contributions are instrumental in fostering the public’s trust in Hong Kong’s capital markets and in strengthening the city’s role as a prominent international financial centre.

Section B

The importance of audit quality

4. Trustworthiness of financial reporting

What are the benefits of high-quality audits?

The AFRC's view:

Audit quality is crucial to the credibility of financial reporting, investors' trust in the integrity of the market and the position of Hong Kong as a key international financial market. Investors rely on audit committees as their agents to monitor integrity of the company's financial statements. As a result, audit committees have a paramount role in safeguarding audit quality.

- 4.1. The investor participants described the benefits of high-quality audits as “intuitive”, indicating a natural understanding of their value. A high-quality audit ensures that the company's financial reports contain reliable financial information and is therefore crucial for making well-informed investment decisions. High audit quality instils confidence in companies' financial statements, and establishes trust in financial reporting, which is crucial for the proper functioning of the capital market.
- 4.2. Investors rely on companies' audit committees to safeguard the quality of financial reporting and audit. They place their trust in audit committees and consider them the gatekeepers of audit quality. Audit committees bear the responsibility for selecting quality auditors, determining appropriate audit fees, and overseeing the quality of the entire audit process. Companies with good corporate governance have independent, qualified, and proactive audit committees that effectively exercise these duties.

- 4.3. The relationship between competent auditors and audit committees is symbiotic, as they work together to ensure audit quality and promote robust corporate governance. Quality auditors can also add value by providing advice and educating management on the importance of the governance process. Therefore, high-quality audits are an indispensable element of a robust corporate governance framework, contributing to its overall effectiveness and reliability.
- 4.4. In making their investment assessments, investors watch for red flags regarding the quality of an audit, which can signal potential issues with the company's financial reporting or its governance. These red flags include, but are not limited to, unjustifiably low audit fees, high non-audit fee ratio, opportunistic changes of auditors, and late changes of auditors. In such cases, they exercise heightened scrutiny. If problems are identified, investors may divest. We address these red flags in following sections.

5. **Audit quality: its definition and determinants**

How would you define a high-quality audit?

The AFRC's view:

Audit quality is not readily observable by the public as certain outputs from auditors, such as audit plans and audit working papers, are not publicly available. Moreover, assessing audit quality requires professional knowledge and judgement. The AFRC conducts periodic inspections of audit firms, evaluating the quality of their audit engagements and the effectiveness of their systems of quality management.

The findings from each inspected engagement are shared with the respective audit firm, which should then share the findings with audit committees. Additionally, the overall inspection results are published in the AFRC's Annual Inspection Reports.²

²AFRC, Inspection Reports, <https://www.afrc.org.hk/en-hk/publications/periodic-reports/inspection-reports/>

- 5.1. The roundtable discussions highlighted the disparate understanding of the definition of quality audits among the users of financial statements (investors) and parties engaged in safeguarding their quality (audit committees and auditors).
- 5.2. The investor participants said they find it difficult to assess the quality of an audit based on the information available to them. In practice, investors generally assume that audits are of “reasonable” quality and only pay closer attention to them when scandals surface.
- 5.3. They also noted that publicly available information related to audit firms, including their disciplinary records and the AFRC’s Annual Inspection Report,³ can be helpful in assessing the firms’ overall audit quality.

How would you differentiate audit quality and service quality?

The AFRC’s view:

Differentiating audit quality and service quality is essential. Audit quality should always take precedence and should never be compromised by the emphasis on service quality. High audit quality serves as a foundation of the long-term sustainability of the auditor’s business.

- 5.4. In contrast to investors, audit committees and auditors benefit from involvement in the audit process. However, it became apparent during the roundtable discussion that not all participants share the same understanding of audit quality, and that some audit committees and auditors mistake the quality of service provided by the auditor for audit quality.

³ AFRC, Inspection Reports, <https://www.afrc.org.hk/en-hk/publications/periodic-reports/inspection-reports/>

- 5.5. From the perspective of audit committees, the quality of service the auditor provides is more apparent, more easily observable, and has a more immediate effect to them and the company's management than the quality of the audit. Consequently, some listed companies tend to select an auditor who offers a good audit service rather than choosing a high-quality auditor.

What are the key determinants of audit quality?

The AFRC's view:

The commitment of an audit firm to audit quality, the culture of the audit firm, and its management's commitment to honesty, professional integrity, and ethics, commonly known as the "tone at the top", are vital prerequisites for high audit quality. However, during the roundtable discussion, we observed that this aspect does not resonate deeply among auditor participants and requires further emphasis.

For comprehensive information on the key aspects of a high-quality audit, covering engagement acceptance, audit planning, execution and completion, please refer to the AFRC's 2022 Inspection Report.⁴

- 5.6. Audit committee and auditor participants have identified the following common characteristics associated with high-quality audits:
- (a) Adherence to all relevant professional standards and regulatory requirements;
 - (b) Effective and timely communication with the audit committee;
 - (c) Preparation of a timely and effective audit plan;
 - (d) Sufficient and appropriate audit documentation; and
 - (e) Appropriate auditor opinion and precise disclosures regarding key audit matters.

⁴ AFRC, "2022 Annual Inspection Report", July 2023 https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/2022_AFRC%20Inspection%20Report_eng.pdf

- 5.7. They also noted certain prerequisites that the audit firm must have in order to execute a high-quality audit:
- (a) Sufficient knowledge and competency;
 - (b) Professional scepticism and critical thinking abilities; and
 - (c) Thorough understanding of the business operations of the audited company.
- 5.8. To safeguard audit quality in Hong Kong, the AFRC has been monitoring the audit market to identify phenomena or practices that constitute threats to audit quality or obstacles to its improvement. One of them is a decade-long stagnation in audit fees, which we focus on in the following section.

Section C

Audit fee stagnation as a threat to audit quality

6. Slow growth of audit fees paid by listed companies in Hong Kong

- 6.1. In an analysis of the audit market in Hong Kong, the AFRC noted that the mean audit fees listed companies paid over the past decade have stagnated.⁵ This stagnation translates into a decline of audit fees during the period when adjusted for inflation.
- 6.2. The AFRC is concerned about the level of fees not reflecting the increasing complexity of audit work, as numerous new accounting and auditing standards have been introduced in the past few years. The AFRC is also concerned that unreasonably low audit fees may limit audit firms' ability to allocate sufficient resources to audits and invest in staff retention, training and technology. In the long run, fee stagnation may impair audit quality.

7. Factors contributing to audit fee stagnation

What factors contribute to the stagnation of audit fees?

(i) Competition and price war among auditors

The AFRC's view:

It is the responsibility of the audit committee to monitor the execution of the audit. The audit committee must be especially watchful and analyse the risks to the quality of audit stemming from an unreasonably low audit fee. Its ability to do it hinges on the committee members' knowledge, experience, independence, and the willingness to confront the management if warranted.

⁵ AFRC, "Audit fees paid by listed companies in Hong Kong in 2020/2021", March 2023 <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/audit-fee-report/>

- 7.1. During the roundtable discussions, participants from all three stakeholder groups attributed the stagnation of audit fees to an intense price war among audit firms in Hong Kong. The auditor participants in particular noted increasing pressure to reduce audit fees in recent years, which is in line with recent survey findings published by the AFRC.^{6,7}
- 7.2. The auditor participants also shared their experiences of fee negotiations when the companies they audit switch auditors. They noted that when a listed company appoints a new auditor, there is a general expectation from the management that the audit fee will be reduced.
- 7.3. Listed companies also exert fee pressure when re-appointing auditors. Some companies use lower quotes from competing audit firms to negotiate a lower audit fee. As a result, audit firms often need to offer a discount to prevent losing the engagement.
- 7.4. The auditor participants commented that the pressure to lower fees is particularly strong during economic downturns, when companies cut costs. In such periods, audit firms need to show flexibility in their pricing strategy to retain business.
- 7.5. Even under stable economic conditions, in order to retain or win business, some audit firms may prioritise market strategies and accept fees that are lower than their actual costs. Such low-ball offers are often made with the intention of securing the engagement and the expectation that audit fees will increase in subsequent years.
- 7.6. The audit committee participants acknowledged their responsibility to monitor audit execution for quality and appropriate fees. This includes challenging auditors if the fees appear unreasonably low. However, if the auditors offer adequate explanations, such as implementation of efficiency initiatives, audit committees find it difficult to insist on higher fees.

⁶ AFRC, "Report on the Analysis of the Public Interest Entity Audit Market in Hong Kong", March 2024 <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/report-on-the-analysis-of-the-pie-audit-market-in-hong-kong/>

⁷ AFRC, "2023 Survey Report on the Implementation of Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors", March 2023 <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/survey-report/>

(ii) Low awareness of the value of high-quality audit

The AFRC's view:

Audit firms should refrain from engaging in a "race-to-the-bottom" by offering audit fees that may compromise audit quality. Instead, audit firms should differentiate themselves by providing high-quality audits.

The AFRC has undertaken various initiatives to foster a broader awareness of the importance of high audit quality among listed companies and market participants. However, audit firms should also actively communicate and demonstrate the value of a quality audit to listed companies and to investors who can use their influence as shareholders.

- 7.7. Although the participants in all three roundtable discussions agreed on the importance of high-quality audits for reliable financial reporting and the proper functioning of the capital market, they noted that such emphasis on audit quality is not common among listed companies. In their opinion, many companies see audits merely as a compliance requirement and therefore prioritise low audit fees over audit quality when selecting an auditor.
- 7.8. The audit committee and auditor participants noted that auditors in Hong Kong currently do not have the ability to compete on quality and demand commensurate fees, unlike members of other professions, such as barristers. In particular, the audit committee participants admitted that auditors are frequently the first to face pressure to reduce fees in projects involving multiple professions, such as during the negotiation of an initial public offering engagement.
- 7.9. They noted that auditors have relatively limited bargaining power compared to other professions because their impact is less easily visible and appreciated by listed companies. If the market is more aware of the importance of high-quality audits, auditors will be able to differentiate themselves and compete based on audit quality.

- 7.10. Such market realities result in a situation where it is difficult for an auditor to negotiate an increase in the audit fee. In fact, some listed companies expect a gradual decline of the audit fees over time, arguing that the auditor’s familiarity with the company makes any subsequent audits easier.
- 7.11. Contesting this view, the auditor participants emphasised that each year of audit is a distinct engagement, and the audit work in the previous year cannot be directly leveraged. As such, the costs of conducting audits will not decline in subsequent years, purely based on the auditors’ familiarity with the companies.

8. The implications of stagnant audit fees

What is the effect of slow growth of audit fees on audit quality?

(i) Insufficient deployment of resources

The AFRC’s view:

The AFRC is concerned that if the level of audit fees does not reflect the complexity of audit work, it may force audit firms to stretch staffing resources and reduce investments in staff retention, new technologies, and training, which could impair audit quality. Further, it could lead to high pressure, excessive workloads, and low job satisfaction among the staff. This in turn would contribute to the negative perception and reduce the attractiveness of the audit profession and aggravate staffing shortage in the industry. This may lead to a further declining audit quality.

The AFRC has observed an overall 6.1% vacancy rate among PIE auditors in Hong Kong.⁸ Although the AFRC has not yet observed a direct effect of labour shortage on audit quality, it recognises the resourcing challenges audit firms face in the current environment.

⁸ AFRC, “Report on the Analysis of the Public Interest Entity Audit Market in Hong Kong”, March 2024 <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/report-on-the-analysis-of-the-pie-audit-market-in-hong-kong/>

The AFRC expects PIE auditors to maintain a high standard of professionalism, and believes that resourcing challenges can be mitigated by proper planning, and candid and transparent communication with audit committees and companies' management about the importance of high-quality audits, the firms' ability to deliver them, and the adequate level of audit fees.

- 8.1. The audit committee participants agreed that slow growth of audit fees may have a detrimental impact on audit quality. They observed that, especially if the engagement partner prioritises profit margins, insufficient resources may be deployed for conducting audits, limiting the ability of the engagement staff to perform essential audit work.
- 8.2. The auditor participants noted that although the negative impact of slow growth in fees on audit quality can be mitigated in the short term by strategic resource allocation, such an approach may not be sustainable in the longer term. Slow growth of audit fees restrict the firm's ability to make sufficient investments in staff retention, new technologies, and training, ultimately impairing audit quality over time.
- 8.3. The investor participants also raised a concern that persistently slow growth of fees may discourage some audit firms from performing thorough audit work. Auditors may hesitate to report financial reporting issues to management and/or the audit committees, as such reporting could result in increased workload without adequate compensation.

- 8.4. All roundtable participants recognised that slow growth of audit fees may force audit firms to allocate more work to their existing staff, leading to excessive workloads, and resulting in staff attrition. The resulting costs of replacing and training new employees may put further pressure on the firm's financial performance, making them less willing to invest in audit quality.
- 8.5. Such pressures also deepen the already common perception of the demanding nature of audit work, with long hours, deadline pressure, and repetitive tasks. It further solidifies the notion of audit as low value and unrewarding compared to other professions.
- 8.6. As a result, auditing is less appealing to graduates than other professions. The lack of ability to retain staff, coupled with a decrease in new entrants, may further strain audit firms' resources, resulting in a vicious cycle that may lead to declining audit quality.

(ii) Reliance on fees from non-audit services

The AFRC's view:

The reliance on revenue from non-audit services to offset low audit fees may pose a threat to audit quality. Auditor independence is the bedrock of auditing and must always be upheld without compromise. Any violation of independence rules undermines the auditor's objectivity. This, in turn, poses a serious risk to the quality of audits and their reliability.

The AFRC urges audit firms to exercise caution when accepting engagements with unreasonably low audit fees that could compromise their ability to conduct thorough and unbiased audits. Audit committees must do their parts to ensure the independence of the auditor.

- 8.7. The investor participants noted that some audit firms look to non-audit services to subsidise an audit, but this tactic has its own disadvantages. They are concerned that an audit firm's provision of non-audit services to its audited companies may compromise the firm's independence, especially if non-audit fees the firm earns constitute a significant share of its revenue. Such situation can potentially impact the objectivity of auditors during the audit process.
- 8.8. Because of their limited visibility into the audit quality, investors use proxy measures as indicators of potential issues. For example, they examine the ratio of non-audit fees to audit fees a listed company pays to their auditor in order to identify red flags related to the firm's independence. A high ratio may suggest possible compromise of the auditor's independence and potential disincentives to report audit issues in order not to antagonise the listed companies' management.
- 8.9. Some participants in the audit committee roundtable argued that engaging the auditor to provide non-audit services might not have a direct negative impact on audit quality, as long as the audit committee effectively evaluates the nature of engagement before approving it and oversee the auditor's independence of the entire audit process.
- 8.10. In addition to auditor independence, the AFRC has been monitoring changes of auditors by listed companies. While companies may change auditors in the natural course of business, some changes, in particular auditors resigning late in the reporting period raise concerns about possible financial reporting irregularities and the ability of the incoming auditors to conduct a thorough audit within the short time remaining before the reporting deadline. We address this issue in the following section.

Section D

The threat to audit quality from opportunistic changes of auditors

9. The AFRC's concerns about certain instances of auditor changes in Hong Kong

- 9.1. The AFRC has expressed concerns regarding the instances of auditors resigning from their engagements near the end of the listed companies' financial reporting periods.^{9,10,11}
- 9.2. In such instances, the resignation is often caused by a disagreement between the auditor and the company's management regarding outstanding audit issues. The AFRC is concerned that some listed companies may exploit changing auditors as a strategy to obtain a more favourable audit opinion, which raises concerns about the integrity and quality of the audit.
- 9.3. Although some auditor changes may merely be a result of the company's desire to reduce audit fees, it does not alleviate our concern. Such reduction in audit fees may still compromise the quality of audits, and have other longer-term impact, as illustrated in Section 8.
- 9.4. The AFRC recognises that Hong Kong-listed companies have made some progress in the level of transparency around auditor changes. Following the publication of the *Guidance Notes on Changes of Auditors*,¹² the AFRC observed a decrease in late changes of auditors in 2023 (29 instances) compared to 2022 (38 instances).¹³ Additionally, the AFRC found that in 2023, 79% of companies changing auditors named "audit fee disagreement" as the cause, compared to 76% in 2022. Among them, 36% provided detailed explanations in 2023 while the previous year most explanations were generic and high-level.

⁹ AFRC, "AFRC Addresses Concerns Surrounding Auditor Changes", September 2023 https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/AFRC_Addresses_Concerns_Surrounding_Auditor_Changes.pdf

¹⁰ AFRC, "Follow-up open letter on auditor changes", January 2023 https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/Follow_up_Open_Letter_to_PIE_and_AC.pdf

¹¹ AFRC, "Open letter regarding late auditor resignations", October 2022 <https://www.afrc.org.hk/media/dogjbhtr/open-letter-on-late-changes-in-auditor-appointments.pdf>

¹² AFRC, "Guidance Notes on Change of Auditors", September 2023 <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/guidance-notes-on-change-of-auditors/>

¹³ A late change of auditors refers to an auditor change from one month before the end of the financial reporting period of a PIE.

- 9.5. The AFRC has recently observed instances where audit firms with shared management personnel have restructured their portfolio of PIE audit companies across separate registered PIE audit firms. This practice may be an indication of the intent to evade regulatory oversight or disciplinary action, and as such it reflects a mentality inconsistent with professionalism, integrity, and business ethics. Such cases are currently under close scrutiny by the AFRC.

10. Change of auditors as a red flag for audit quality

How do investors react to changes of auditors?

The AFRC's view:

Late changes of auditors carry a particular risk for audit quality and are of special concern to the AFRC. An auditor appointed with little time remaining before the reporting deadline could be struggle to plan and execute a thorough, high-quality audit. The risk is increased if there are disagreements between the auditor and the company's management over audit issues.

To address the concerns surrounding auditor changes, particularly late changes of auditors, the auditors and listed companies should prioritise improving audit planning, effective communication, and enhancing disclosures to raise transparency.

- 10.1. From investors' perspective, any change of auditors, in particular frequent or late change, constitutes a red flag, and requires a higher level of scrutiny of the listed company. If warranted, investors' engagement teams should reach out to investee companies for explanations and evaluate the qualifications of the incoming auditors.

- 10.2. The investor participants noted that in Hong Kong, investors' power to prevent or instigate a change of auditors is limited, as some companies have controlling shareholders and voting actions by an investor may have limited practical effect. In those situations, investors can only rely on company directors and audit committees to appoint auditors that can deliver high-quality audits.
- 10.3. Additional concerns arise when a board of directors requests the auditor to resign, rather than directly removing the auditor. This approach can bypass certain statutory requirements, and therefore raise suspicions about the management's intentions, the company's overall corporate governance, and the quality of financial statements.
- 10.4. The audit committee participants said that such a request does not automatically imply opinion shopping. It could arise from the auditor's unsatisfactory performance or a disagreement between the auditor and management regarding audit scope and fees.
- 10.5. Sometimes, more complex audit issues tend to be identified by senior audit managers or partners, who may get involved in the audit at a later stage. Any newly identified issues may result in the need for additional audit work at that time. The auditor may request for additional fee. If management or audit committee disagree, it may result in a late request for a change of auditors.
- 10.6. The audit committee participants noted that a late change of auditors is a significant decision for a listed company, and is not taken lightly, since the public may perceive it as an indication of potential unresolved audit issues. Therefore, in the event of a disagreement, changing the auditor should be considered only as a last resort. Instead, audit committee members should act independently and use their utmost effort to resolve outstanding audit issues.

11. The pivotal role of audit committees in resolving audit issues

What should audit committees do to ensure high audit quality?

The AFRC's view:

When it comes to resolving audit issues, the shared responsibility for it falls upon auditors, audit committees, boards of directors, and senior management of listed companies. However, particular attention is often given to the crucial role played by audit committees in handling and addressing these issues. As the central, independent party, audit committees serve as a key link in the process.

When confronted with a disagreement between the auditor and the management over an audit issue, it is important that audit committees gain a thorough understanding of the issues, engage in early and candid communication with auditors, preferably through private meetings without the presence of management, and form an unbiased view. It is also crucial for audit committees to maintain independence from both management and auditors.

Any attempt to change auditors with the intention to avoid resolving audit issues with auditors is deemed unacceptable. The AFRC will take immediate action to investigate any misconduct and may refer the relevant directors and/or listed companies to other regulatory authorities if necessary.

- 11.1. The investor participants said that they have high expectations of audit committees to act as their agents in overseeing audit quality. This includes selecting a quality auditor, setting appropriate audit fees, and monitoring audit execution. To fulfil these expectations, audit committees should discharge their duties independently and objectively. Unfortunately, based on the investor participants' experience with Hong Kong-listed companies, many audit committees lack independence and tend to show a bias towards management.

- 11.2. The auditor participants had a more nuanced view of this situation, based on direct experience. They said that the level of engagement and independence of audit committees varies with their composition, and is significantly influenced by the members' experience, ability, and relationship with management. The auditors also noted that certain audit committees tend not to be directly involved in resolving audit issues, delegating this responsibility to the company's management and auditor.

12. Choosing high-quality auditors

What factors should be considered when selecting an auditor?

The AFRC's view:

Audit quality should be the prime consideration for auditor selection. To enable audit committees to make well-informed decisions to appoint auditors, the AFRC emphasises the importance of auditors proactively sharing their inspection findings with audit committees. This facilitates the effective discharge of audit committees' responsibility in upholding audit quality. In addition, to promote transparency, the AFRC publishes the overall inspection results and disciplinary records of registered PIE auditors on its website.¹⁴

- 12.1. All roundtable participants unanimously agreed that audit quality should be given a higher priority than audit fees in the process of selecting an auditor.
- 12.2. The investor participants said that to evaluate an auditor change by an investee company, they need to thoroughly understand its auditor selection process, including the selection criteria, the auditor evaluation process, and the key considerations taken into account during the selection. They also seek information regarding the auditor's track record on audit quality, including inspection findings and disciplinary records.

¹⁴ Relevant information is accessible on the AFRC's website.

The latest annual inspection report can be found in the AFRC "2022 Annual Inspection Report", July 2023 https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/2022_AFRC%20Inspection%20Report_eng.pdf

The disciplinary records of registered PIE auditors can be found in the "Find a Registered PIE Auditor" page, <https://www.afrc.org.hk/en-hk/auditor-search/find-a-registered-pie-auditor>, where they are published alongside the respective auditors' profiles.

- 12.3. The audit committee participants agreed that selecting an auditor with necessary industry experience and expertise, and a good track record is of value. However, not all of them were aware that such information is available to them, and that they have the option to request the audit firm to provide the findings from its inspections by the AFRC.

Should audit committees conduct a tendering process when selecting auditors?

The AFRC's view:

The AFRC recommends that audit committees consider conducting audit tenders periodically. They foster competition and stimulate innovation, while promoting transparency and fairness in the selection. It is important to recognise that the scale of the tender can be tailored to meet the specific needs of each company, and the benefits it brings can outweigh the costs if proper planning is in place.

- 12.4. The investor participants said they would have more confidence in audit quality if audit committees conducted tendering when selecting auditors. They also agreed that conducting the tendering process in a fee-blind manner would help prevent the selection of auditors solely based on the lowest audit fee.
- 12.5. Although the audit committee participants acknowledged the benefits of tendering, some noted that it may be costly and impractical for small and medium-sized companies.
- 12.6. Selecting a suitable auditor is important, and as risks related to climate change increase, it becomes more beneficial if the auditor has expertise in this area. To keep investors well informed, climate-related opportunities and risks must be adequately reflected in the companies' financial reporting. In the following section, we assess if Hong Kong-listed companies are prepared and equipped to do it and what is needed for progress in this area.

Section E

Incorporating Environmental, Social and Governance (ESG) factors to enhance the quality of financial reporting and audit

13. Hong Kong-listed companies' unpreparedness for climate-integrated financial reporting

Are listed companies in Hong Kong ready to integrate climate-related factors in their financial statements?

The AFRC's view:

It is of growing importance for listed companies to effectively integrate climate factors into their financial statements. This includes accurately assessing these factors, determining the associated costs, establishing timelines, and adhering to the relevant disclosure requirements.

- 13.1. Climate change and sustainability considerations are increasingly important in business strategy and financial reporting. However, during the roundtable discussions, the investor participants indicated a low level of confidence, between 1 and 10 out of 100, that ESG and climate-related factors are reliably reflected in the financials of Hong Kong-listed companies. Their confidence is lower for smaller companies.
- 13.2. The auditor and audit committee participants showed a higher level of confidence in the integration of climate factors, with ratings ranging from 20 to 85 out of 100 for auditors and 20 to 60 for audit committee members. All participants in the roundtable discussions shared the view that, even with a strong desire to succeed, Hong Kong-listed companies are still in early stages when it comes to ESG. The journey towards full ESG implementation is a long one, and its timeline remains uncertain.

- 13.3. The investor participants noted that the energy and property sectors in Hong Kong stand out for their extra efforts in ESG implementation and reporting. However, many listed companies provide only qualitative disclosures, and it is difficult to assess the effect of the disclosed information on their financials. Still others provide only boilerplate disclosures, which investors find of little use.
- 13.4. The audit committee participants commented that the reluctance of listed companies to provide meaningful disclosures often stems from a lack of guidance. Although the International Accounting Standards Board (**IASB**) encourages the consideration of material climate factors and their inclusion in companies' financial statements, there are no unified standards or guidance on how to do it.
- 13.5. Therefore, even if the management has the necessary data, the company may choose not to disclose it due to the lack of clear reporting standards and requirements. Companies also tend to avoid making non-mandatory disclosures to avoid assuming responsibility for possible misstatements and to minimise their reputational risk.
- 13.6. The audit committee and auditor participants noted that the situation is made worse by the shortage of ESG expertise among Hong Kong companies. It especially concerns professionals who have the necessary skills to effectively evaluate climate-related factors and conduct relevant assessments.

14. Rising demand for sustainability assurance

What are your expectations on sustainability assurance?

The AFRC's view:

It is important for Hong Kong to adopt a comprehensive framework for sustainability reporting, along with relevant standards and guidelines to which companies can adhere.

The AFRC is one of the financial regulators that lead the development of a sustainability disclosure ecosystem in Hong Kong. In January 2024, the AFRC became a member of the Green and Sustainable Finance Cross-Agency Steering Group (CASG). As a member, the AFRC is committed to driving the work on sustainability assurance. Collaborating with other CASG members and stakeholders, the AFRC will strive to establish a regulatory regime and clear standards for sustainability assurance.

- 14.1. Independent assurance of sustainability disclosures is currently not required in Hong Kong. The investor participants noted that among the few companies that have obtained assurance, the scope of material information that is assured is mostly very narrow. For example, only Scope 1 and 2 carbon emissions are assured,¹⁵ and only limited assurance is obtained.
- 14.2. The investor participants additionally noted that some companies obtain assurance on certain generic assertions solely for the purpose of being able to demonstrate the fact in their annual sustainability reports. However, such assurance holds little value to the users of the report. In their view, obtaining an appropriate assurance on sustainability reporting helps improve the credibility of the reports. It is crucial, therefore, that a comprehensive assurance framework for sustainability reporting is established.

¹⁵ Scope 1 greenhouse gas (GHG) emissions are those that a company generates directly in the course of its operations. Scope 2 emissions are indirect, generated for example by providers of electricity the company uses. Scope 3 emissions are those generated by the company's suppliers and the use of its products.

- 14.3. The roundtable participants commented that most listed companies are still in the “wait-and-see” mode while relevant standards and regulations are being formulated. Although they acknowledged that independent assurance of reported data would greatly enhance the reliability and usefulness of sustainability reporting, they also highlighted that currently most companies listed in Hong Kong are not prepared for sustainability assurance and making it mandatory will need a significant transition time. To achieve preparedness, company boards and audit committees need to boost the level of awareness and expertise on sustainability and independent assurance.
- 14.4. In today’s non-regulated environment, sustainability assurance is offered in Hong Kong by auditors and other non-audit providers. The roundtable participants agreed that if, and when, a new regulatory regime is implemented, it should cover all providers, including non-audit providers.
- 14.5. The roundtable discussions and interviews have yielded a plethora of valuable insights that will help the AFRC formulate policy initiatives, improve audit quality in the city and boost the profile of the audit profession. In the following section, we offer calls to action for each group of stakeholders.

Section F

Calls to action

15. For public interest entity (PIE) auditors: To demonstrate commitment to audit quality

15.1. Based on the discussion outcome, the AFRC urges PIE auditors to take the following actions, which address critical areas of concern, in order to foster market development. The key actions are divided into two categories: Systems and Strategies.

Systems

15.2. Auditors should:

- (a) Showcase their commitment to audit quality by demonstrating knowledge, competence, thorough understanding of the companies' business operations, professional scepticism, critical thinking, and adherence to all relevant professional standards in the entire audit process;
- (b) Prepare an effective audit plan, implement robust audit programme, maintain sufficient and appropriate audit documentation, and issue an appropriate audit opinion and precise disclosures on key audit matter;
- (c) Allocate adequate and appropriate resources to each audit engagement, and when facing audit issues, invest efforts in resolving them instead of immediately resigning;
- (d) Maintain active, timely, open and candid communication with audit committees, especially when audit issues are identified, to prevent last-minute surprises and facilitate resolution of issues;

- (e) Proactively share both internal and external inspection findings with audit committees to enable audit committees to effectively discharge their responsibility in upholding audit quality; and
- (f) When resigning, make adequate disclosure about the underlying circumstances in the letter of resignation.

Strategies

15.3. Auditors should:

- (a) Ensure they have sufficient staff resources before undertaking any audit engagement;
- (b) Only accept engagements with audit fees that allow them to devote sufficient time and appropriate resources to carry out all necessary steps to deliver high-quality audits;
- (c) Never compromise audit quality by deliberately reducing or skipping essential audit procedures; and
- (d) Provide adequate staff training to ensure that audit professionals possess up-to-date knowledge on the latest professional developments, including integration of climate-related factors into audit.

16. For audit committees: To safeguard the quality of financial reporting and audit

16.1. Audit committee members should:

- (a) Assert their role in audit fee negotiation and ensure that audit fees are set at a level that enables auditors to dedicate sufficient time and appropriate resources to conduct a quality audit. Challenge audit firms that propose charging a lower-than-expected audit fee;
- (b) Thoroughly evaluate the auditor's independence and ensure that the audit firm does not intend to rely on non-audit services to subsidise the costs of the audit, which may compromise independence;
- (c) Monitor the audit execution throughout the entirety of the process to ensure audit quality;

- (d) Maintain independence and take proactive action when resolving disagreements between management and auditors;
- (e) Establish a robust set of processes and procedures in selecting an auditor and always prioritise audit quality over audit fees in auditor selection; and
- (f) Equip themselves with the necessary knowledge, skills and information to monitor the quality and reliability of the company's financial and sustainability reporting.

17. For investors: To encourage high quality and reliable financial reporting and audit

17.1. Investors should:

- (a) Exercise their voting power during shareholder meetings to vote against the appointment or removal of auditors, when it may compromise audit quality, thereby expressing their concerns regarding the quality of financial reporting and audit practices;
- (b) Actively pose questions to listed companies on their auditor selection process, audit fees, audit quality and sustainability reporting during shareholder meetings;
- (c) Drive listed companies to establish an open platform for constructive communications between the management and the auditors on unresolved audit issues; and
- (d) Express concerns and expectations on sustainability reporting during shareholder meetings and through direct conversations with management.

Appendix

I. Key questions posed during the roundtable discussions

- What are the benefits of high-quality audits?
- How would you define a high-quality audit?
- How would you differentiate audit quality and service quality?
- What are the key determinants of audit quality?
- What factors contribute to the stagnation of audit fees?
- As an investor (audit committee member), what are your expectations regarding the role of the audit committee (auditors) in upholding audit quality?
- What is the effect of slow growth of audit fees on audit quality?
- How do investors react to changes of auditors?
- What should audit committees do to ensure high audit quality?
- What factors should be considered when selecting an auditor?
- In reality, where does the audit committee typically stand when there is a disagreement between the auditor and management?
- As an audit committee member, what factors would make you consider changing an auditor?
- Should audit committees conduct a tendering process when selecting auditors?
- Are listed companies in Hong Kong ready to integrate climate-related factors in their financial statements?
- Which type of company and/or industry stands out for good performance in sustainability reporting?
- In your estimation, how long do you anticipate it will take for the industry to reach a stage where users of sustainability reporting feel sufficiently confident in its quality?

- What challenges does your company face when integrating climate-related factors into financial reporting?
- What are your expectations on sustainability assurance?

II. Methodology

Selection of participants

In order to gather insightful information and gain a comprehensive understanding of the challenges faced by investors, audit committees of listed companies, and auditors, the participants of the roundtable discussions were selected based on their expertise. This approach ensures that the discussions yield valuable insights, providing us with pertinent information that inform our decision-making process.

When selecting institutional investors, we took into account several key factors, such as the seniority and decision-making authority of the representatives and the operational size of the institutional investment firms in Hong Kong and globally.

When choosing audit committee members, we considered companies' market size and formal recognition for good corporate governance within the past three years. We also took into account the relevant professional experience of the committee members.

When inviting representatives of PIE auditors, we chose representatives from audit firms that hold significant market share of audits, major associations comprising members who are PIE auditors and qualified accountants in Hong Kong, as well as advisory board members of reputable universities in Hong Kong.

Conduct of the discussions and interviews

The roundtable discussion with investors took place on 8 December 2023, followed by one with audit committee members on 11 December 2023, and one with PIE auditor representatives on 14 December 2023. Furthermore, we conducted three interviews with audit committee members who were not able to attend the roundtable discussion in January and February 2024.

III. List of participants (in alphabetical order of surnames)

The AFRC would like to acknowledge the participation and insights contributed by the following participants in the roundtable discussions and individual interviews, who dedicated their time and shared their expertise.

Institutional Investors:

- Alexander Chan, Invesco Hong Kong Limited
- Tina Chang, Fidelity International
- Johnson Kong, BlackRock
- Nana Li, Impax Asset Management
- William Ng, HSBC Global Asset Management (Hong Kong) Limited
- Kristy Wong, Amundi Hong Kong Limited

Audit Committee Members:

- Kelly Chan
- Elizabeth Lam
- Stephen Law
- Eric Li
- Albert Ng
- Joseph Poon
- Ernest Wong
- Peter Wong
- Edwin Yeung
- Stephen Yiu

PIE Auditor Representatives:

- Clement Chan, Hong Kong Association of Registered Public Interest Entity Auditors Limited
- Caroline Chiu, Ernst & Young
- Charles Chow, PricewaterhouseCoopers
- Felix Lee, KPMG
- Roy Leung, Accounting Advisory Board, the University of Hong Kong
- Robert Lui, CPA Australia
- Parco Wu, Society of Chinese Accountants and Auditors
- Yu Man Yeung, Deloitte Touche Tohmatsu

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