FRC Financial Reporting Council 財務匯報局

Policy and Governance

Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors

16 December 2021

FRC Financial Reporting Council 財務匯報局

About the FRC

The Financial Reporting Council is an independent body established on 1 December 2006 under the Financial Reporting Council Ordinance. It is entrusted with the statutory duty to regulate auditors of listed entities through a system of registration and recognition, and through inspection, investigation and disciplinary action.

The mission of the FRC is to uphold the quality of financial reporting of listed entities in Hong Kong, so as to enhance protection for investors and deepen investor confidence in corporate reporting.

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Foreword from the Chief Executive Officer

I am pleased to share with the public the first in our new series of *Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors* (**Guidelines**). These guidelines are an important initiative in support of the Financial Reporting Council's mission to uphold the quality of financial reporting of listed entities in Hong Kong, so as to enhance protection for investors and deepen investor confidence in corporate reporting. Accuracy, integrity, and consistency of listed entity disclosures including the financial statements are essential to maintaining investor confidence and the effective functioning of the capital markets. As a result, the FRC has a strategic focus on enhancing the quality of financial reporting and auditing through better corporate governance practices.

Recognising that the purpose of an audit is to enhance the confidence of investors in the quality of the financial statements, the purpose of our new series of guidelines is to help audit committees effectively discharge their responsibilities relating to the listed entity's auditors.

While the auditor has primary responsibility for the quality of an audit, audit committees can help ensure audit quality through performing their various duties effectively. Those duties include being primarily responsible for making recommendations to the board on the appointment, reappointment and removal of auditors, to approve the remuneration and terms of engagement of the auditors, and on any questions of resignation or removal of the auditors. Audit committees also oversee the financial reporting process, and review and monitor the effectiveness of the audit process relating to the financial statements of listed entities. Therefore, audit committees are a cornerstone in the process of maintaining audit quality and it is paramount that they exercise their duty effectively in this respect.

The Guidelines have been developed by our Department of Oversight, Policy and Governance with valuable inputs obtained through meetings and soft consultations with key stakeholders, including board members at listed entities, chairmen and members of audit committees, management of listed entities, auditors, other financial regulators, and associations for directors. Although the Guidelines are written in the context of listed entities, they can also be applied generally to private entities. They may also be helpful to risk and compliance managers, internal auditors, external auditors and senior management.

The Guidelines provide specific and practical guidelines for audit committees to establish a robust process for selecting, appointing and reappointing auditors, an essential first step in achieving audit quality. The publication highlights two key considerations for audit committees in selecting and appointing auditors: audit quality and audit fees.

Evaluating the quality of auditors

In evaluating a potential auditor from an audit quality perspective, audit committees should take into consideration a wide range of factors. Those who govern and lead audit firms have an important duty to ensure that they safeguard the public interest in the audit function of the firm. Audit firms should also demonstrate a commitment to quality, comply with all relevant ethical requirements, and demonstrate high standards of integrity, objectivity and independence. Audit firms should also have knowledge of the industry in which the listed entities they audit operate, have relevant technical competence and the expertise to handle technical matters efficiently and effectively.

Other considerations for audit committees in determining the quality of a potential auditor include the experience of the audit engagement partner and other key engagement team members. They also include whether the audit firm's methodology encourages the application of professional skepticism and the exercise of appropriate professional judgement. Also key are the effectiveness of the audit firm's quality control system, and the quality and extent of direction, supervision and review performed by the engagement partner and other experienced staff.

Further, audit committees should be satisfied that the engagement team's audit strategy demonstrates a commitment to allocate sufficient resources for the audit engagement, and to provide appropriate and timely communication and interaction with the audit committee, including the audit timetable and audit matters. They should also consider the audit firm's monitoring process for the audit, recent results from internal and external inspections, and any ongoing regulatory actions against the audit firm and audit engagement team members.

These considerations are also relevant when evaluating an incumbent auditor for reappointment although, in these cases, the audit committee can also leverage information and experience gained during the initial assessment for the auditor's appointment and interaction with the auditor during previous audits. Here again, audit quality is the prime consideration.

Audit committees may also consider the effectiveness of previous audits, for example, whether the incumbent auditor appropriately identified audit risks, whether audit issues were addressed in a timely and effective manner, and whether the incumbent auditor applied professional skepticism. The appropriate application of professional skepticism may be demonstrated, for example through challenging management on the reasonableness of key assumptions, business rationale, or commercial substance of complex or unusual transactions.

Audit committees may in addition consider whether the incumbent auditor completed past audit engagements according to the agreed timetable, whether the relationship between the auditor and management was effective, the quality of the auditor's interactions with the audit committee, and other factors such as any long association with the listed entity that may impact the incumbent auditor's independence.

Evaluating audit fee levels

It is also important for audit committees to be satisfied that audit fees are not at a level that compromises audit quality. Audit committees may consider the reasonableness of audit fees taking into account the size and structure of the listed entity, and the nature and complexity of the listed entity's businesses. Audit committees should challenge audit firms that propose charging lower audit fees than the incumbent auditor if there is no significant change in the scope of the audit engagement. In addition, audit committees should also be satisfied that the audit firm does not intend to rely on obtaining additional or higher margin non-audit services to subsidise their costs of the audit.

One effective approach to evaluating audit quality and fees is a tender process. Such a process can encourage competition and may stimulate innovation while helping to ensure a transparent and fair selection process. We recommend that audit committees consider conducting audit tenders periodically. The Guidelines outline the key stages of an audit tender process and provide guidelines on how to run an effective audit tender.

Research for our report *Overview of the Market for Listed Entity Audits in Hong Kong*, which was published in 2021, found that between 2011 and 2019 there was a rising trend in the number of listed entities that changed auditors. The Guidelines outline some key issues and procedures that audit committees should consider or perform when auditors resign or when audit committees are considering whether to remove the auditor. For example, audit committees should hold separate private meetings with the outgoing auditor and management of the listed entity to understand all the circumstances surrounding the resignation of an auditor. At the same time, audit committees should not remove the auditor to avoid a qualified opinion on the financial statements.

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To promote the transparency of audit committees' work on the selection, appointment and reappointment of auditors, the Guidelines encourage audit committees to disclose in the corporate governance report at least the reasons for the change in auditors, the selection process, the selection criteria and the basis for their selection decision; or the process and factors considered in evaluating the incumbent auditors and the basis for recommending their reappointment or not.

The Guidelines aim to provide practical guidelines for audit committees in the process of selecting, appointing and reappointing the most suitable auditor. Going forward, we will continue to work with regulated audit firms, Board Members, Audit Committees and Management of listed entities, investors and other stakeholders to develop additional guidelines for the effective discharge of their responsibilities by audit committees. Strong governance of listed entity financial reporting and audits, including through the effective performance of the audit committees' responsibilities, will enhance investor confidence in such reporting and strengthen Hong Kong's status as an international financial centre.

Marek Grabowski
Chief Executive Officer

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Section 1 INTRODUCTION

1.1 Purpose of the Guidelines

1.1.1 Quality financial reporting and independent external audits are crucial to market confidence and to the effective functioning of capital markets. The Financial Reporting Council (**FRC**) has a mission to uphold the quality of financial reporting of listed entities in Hong Kong, to enhance protection for investors and ensure the audit market in Hong Kong serves the interests of the investing public and the wider public interest. Therefore, the FRC considers that the accuracy, integrity, and consistency of listed entity disclosures are essential to maintain investor confidence and the effective functioning of capital markets. As a result, the FRC has a strategic focus on enhancing the quality of financial reporting and auditing through better corporate governance practices.

1.1.2 The board of directors of a company (**board**) is responsible for ensuring its financial statements are prepared in accordance with the applicable financial reporting framework. Auditors play a pivotal role in providing investors and other stakeholders with a high level of assurance that the financial statements of a company give a true and fair view and provide a reliable and trustworthy basis for making decisions. This contributes to the credibility of the financial statements on which they are reporting and supports financial stability.

1.1.3 While the auditor has the primary responsibility for the quality of the audit, audit committees help ensure audit quality through their various responsibilities under the Listing Rules. Among other things, these responsibilities include making recommendations to the board on the selection, appointment and reappointment of auditors; and to approve their remuneration and terms of engagement[1]. Audit committees also oversee the financial reporting process, including the audit of a listed entity's financial statements. Therefore, audit committees serve as a cornerstone of the process of maintaining audit quality and it is paramount that they effectively exercise their duty to oversee the performance of the auditor and ensure audit quality.

[1] Code provision D3.3 under the Corporate Governance Code as set out in Appendix 14 of the Main Board Listing Rules and Appendix 15 of the GEM Listing Rules issued by the Hong Kong Exchanges and Clearing Limited (**Corporate Governance Code**)

1.1.4 As shown in our Report on *Overview of the Market for Listed Entity Audits in Hong Kong* (**Market Report**) published in March 2021, there were 2,328 companies listed on the Hong Kong Stock Exchange (**HKEX**) with a total market capitalisation of HK$37,384 billion as at 31 December 2019. These listed companies were audited by 41 Registered PIE Auditors (i.e., local auditors) and 31 Recognized PIE Auditors (i.e., overseas auditors). In 2019, there were 160 entities newly listed on the HKEX and 224 entities changed their auditors. In view of the large number of listed companies in Hong Kong, the FRC has prepared the *Guidelines for Effective Audit Committees* to remind audit committees of the importance of their role in enhancing audit quality to safeguard the public interest and reinforce Hong Kong's status as an international financial centre.

1.1.5 The FRC considered it important to take into account the views and experience of key stakeholders when developing the Guidelines. Therefore, meetings and soft consultations were conducted with key stakeholders, including board members at listed entities, chairmen and members of audit committees, management of listed entities, auditors, financial regulators and associations for directors to obtain their feedback on the proposed Guidelines.

1.1.6 This publication provides specific and practical guidelines for audit committees to establish a robust process for selecting, appointing and reappointing auditors, an essential first step in achieving audit quality. Although this publication is written in the context of listed entities, it can be applied generally to private entities.

1.1.7 In addition to making recommendations to the board on the appointment, reappointment, and removal of external auditors and approving the auditor's remuneration, the audit committee is also responsible for reviewing and monitoring the auditor's independence and objectivity and the effectiveness of the audit process; reviewing the auditor's non-audit services; and reviewing the listed entity's financial information[2]. The FRC's *Guidelines for Effective Audit Committees* will continue as a series to provide further guidelines to audit committees in relation to their other responsibilities, so as to promote and support audit quality and, ultimately, the quality of financial reporting. This serves the interests of users of financial statements and deepens investor confidence in corporate reporting.

[2] See footnote 1 above

1.2 Key areas of focus for evaluation of auditors

1.2.1 This publication has identified two main interrelated areas that audit committees should consider when making recommendations to their boards on the selection, appointment and reappointment of auditors.

(a) Audit quality

An effective audit not only provides independent assurance on whether an entity's financial statements are free from material misstatements (i.e., give a true and fair view), but may also identify weaknesses in internal controls of the audited entity.

The evaluation of an audit firm from the perspective of audit quality provides audit committees with the basis to make recommendations to the board on auditor selection, appointment, and reappointment.

(b) Audit fees

Audit committees play a pivotal role in approving the remuneration of auditors. Audit committees should ensure audit fees are not at a level that compromises audit quality. Key factors in considering the reasonableness of audit fees include the nature, size, and complexity of the audit as well as market competition.

Section 2 of this publication explains key considerations for the audit committee when evaluating an audit firm's proposal from an audit quality perspective and when evaluating the proposed fees.

Section 2 SELECTION AND APPOINTMENT OF AUDITORS

2.1 Introduction

2.1.1 The evolving business environment and developing laws, regulations, financial reporting requirements and corporate governance processes create challenges for both financial reporting and audit quality. It is essential to select an auditor that will deliver a high-quality audit and therefore contribute to the quality of the entity's financial reporting.

2.1.2 The purpose of an audit is to enhance users' confidence in the credibility of financial statements, which contain reliable and relevant information for investors and other stakeholders to make informed decisions. While the primary responsibility for audit quality rests with auditors, each stakeholder plays an important role in supporting high-quality financial reporting. In particular, audit committees, in the interests of investors and other external stakeholders, play a pivotal role in monitoring how auditors enhance and maintain audit quality.

2.1.3 Code provision D3.3(a) of the Corporate Governance Code requires audit committees to make recommendations on auditor appointment. It is important for audit committees to make such recommendations based on the ability of an audit firm to deliver a high-quality audit at the engagement team and firm levels. Audit quality should be the key determinant when selecting an auditor for listed entities.

2.1.4 While auditors should perform high-quality audits regardless of the level of the audit fees, audit quality and audit fees do have a reciprocal causal relationship. In general, higher audit fees support higher audit quality as more time and resources can be allocated to carry out more thorough audit procedures to obtain sufficient appropriate audit evidence. Therefore, audit committees, in making the recommendation to the board on the selection and appointment of auditors and the determination of audit fees, need to be satisfied that audit fees are not at a level that compromises audit quality by inadequate resourcing or insufficient audit work being performed.

2.1.5 This section highlights the two key factors that the audit committees should consider in selecting and appointing auditors – audit quality and audit fees.

2.1.6 The evaluation principles can be applied to both the appointment of new auditors and reappointment of incumbent auditors. To evaluate a potential new auditor, audit committees should obtain the necessary information through the public domain and through requests to the audit firm. For an incumbent auditor, audit committees can make their evaluations through ongoing observations and information collected throughout the audit.

2.2 Key considerations for evaluating audit quality

2.2.1 According to *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality* (**Audit Quality Framework**) issued by the International Auditing and Assurance Standards Board (**IAASB**) in 2014, *a quality audit is likely to have been achieved by an engagement team that*:

- *Exhibited appropriate values, ethics and attitudes*;
- *Was sufficiently knowledgeable, skilled, and experienced and had sufficient time to perform the audit work*;
- *Applied a rigorous audit process and quality control procedures that complied with law, regulations, and applicable standards*;
- *Provided useful and timely reports; and*
- *Interacted appropriately with relevant stakeholders*[3].

2.2.2 With reference to the Audit Quality Framework, the IAASB issued International Standard on Quality Management (**ISQM**) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* in December 2020, which addresses audit firms' systems of quality control. Under ISQM 1, all audit firms that perform audits or reviews of financial statements, or other assurance or related services engagements are required to design a system of quality management to manage the quality of engagements performed by the firm. ISQM 1 requires the audit firm to apply a risk-based approach in designing, implementing, and operating the following eight components of the system of quality management:

(a) The firm's risk assessment process;

[3] Paragraph 2 of the Audit Quality Framework

(b) Governance and leadership;
(c) Relevant ethical requirements;
(d) Acceptance and continuance of client relationships and specific engagements;
(e) Engagement performance;
(f) Resources;
(g) Information and communication; and
(h) The monitoring and remediation process[4].

2.2.3 A properly designed, implemented, and operated system of quality management enables the consistent performance of quality engagements by audit firms through planning and performing engagements and reporting on them in accordance with professional standards and applicable legal and regulatory requirements.

2.2.4 In selecting auditors, audit committees should consider the following factors to evaluate a potential auditor from an audit quality perspective:

(a) Governance and leadership;
(b) Compliance with relevant ethical requirements;
(c) Industry knowledge and technical competence;
(d) Engagement performance;
(e) Communication and interaction with the audit committee; and
(f) Monitoring process.

Governance and leadership

2.2.5 The audit firm's governance and leadership wield important influence on the culture and environment that drive the mindset and behaviours of partners and staff of the audit firm and, consequently, the way audit engagement teams discharge their responsibilities.

2.2.6 Audit committees must be satisfied that an audit firm is committed to performing the audit in the interests of the entity's stakeholders and in the wider public interest. The audit firm's leadership is responsible and accountable for quality, the organizational structure, and the assignment of roles, responsibilities, and authorities to ensure they are appropriate to enable partners and staff of the audit firm to deliver quality audits.

4 Paragraph 6 of ISQM 1

Key questions to be asked by audit committees
Audit firm level
(a) What are the governance arrangements that safeguard the public interest of the audit function?
(b) Who is/are ultimately responsible and accountable for the audit firm's system of quality management? Does he/she have the appropriate experience and authority within the firm to discharge his/her responsibilities effectively?
(c) How does the audit firm demonstrate its commitment to quality?
(d) How does the audit firm identify and deal with individuals, including the leadership and the audit engagement partner, who do not act or behave in a manner that demonstrates a commitment to quality?
(e) Does the audit firm use audit quality indicators to measure the performance of audit engagement partners and, if so, how?

Compliance with relevant ethical requirements

2.2.7 Relevant ethical requirements ordinarily comprise the provisions of the Hong Kong Institute of Certified Public Accountants (**HKICPA**) *Code of Ethics for Professional Accountants* (**Code of Ethics**) related to audits or reviews of financial statements, or other assurance or related services engagements. In particular, it is important auditors demonstrate that they maintain high standards of integrity, objectivity, and independence.

2.2.8 Integrity is a prerequisite for all who act in the public interest. It is essential that the audit engagement team acts, and is seen to act, with integrity, which requires not only honesty but a broad range of related qualities such as fairness, candour, and courage. The principle of objectivity imposes an obligation on auditors not to compromise their professional or business judgement because of bias, conflict of interest, or the undue influence of others. It is of particularly important that auditors are objective when they evaluate the management judgements and estimations (e.g., fair value measurements or impairment assessments) to reduce the risk that financial statements are materially misstated through management bias, whether deliberately or inadvertently.

2.2.9 Independence is required to safeguard individual members of the audit engagement team or the audit firm from influences that may compromise professional judgements[5], and helps them to act with integrity, and exercise objectivity and professional scepticism[6]. Threats to auditor independence may include:

- Financial interests that exist between the auditors and the audited entity. Holding a financial interest in an audited entity may create a self-interest threat to independence.
- Business relationships between the auditor and the audited entity. A close business relationship between the audit firm, or a member of the engagement team, or an immediate family member, and the audited entity may create self-interest or intimidation threats.
- Provision of non-audit services to audit clients. Audit firms have traditionally provided their audit clients with a range of non-audit services that are consistent with their skills and expertise. Providing non-audit services may, however, create threats to independence. The threats created are most often related to self-review, self-interest, and advocacy.
- Partners and staff may believe that their remuneration and, indeed, their ongoing careers with the audit firm are dependent on retaining an audit client, creating a familiarity or self-interest threat.
- Situations where a former member of the engagement team, or partner of the audit firm, has joined the audited entity in a position that exerts significant influence over the preparation of the accounting records and financial statements. The threats created are most often related to familiarity, self-interest and intimidation.[7]

[5] Professional judgement is defined under *the Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services* (**Glossary**) issued by the HKICPA as the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about appropriate actions in the audit engagement.

[6] Professional scepticism is defined under the Glossary as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

[7] Appendix 2 of the Audit Quality Framework

Key questions to be asked by audit committees	
Audit firm level	
(a)	What are the audit firm's policies and procedures to ensure audit engagement partners, engagement quality reviewers, and audit engagement team members understand the relevant ethical requirements that apply to them?
(b)	How does the audit firm fulfil its responsibilities in accordance with relevant ethical requirements, in particular, integrity, objectivity, and independence requirements?
(c)	How frequently does the audit firm conduct compliance tests on ethical requirements and what are the recent outcomes of compliance tests?
(d)	If the audit firm identified a breach of ethical requirements, what action has been taken to address the consequences of the breach?
(e)	How does the audit firm identify threats to independence and evaluate the significance of the threats identified?
Engagement level	
(f)	Have the audit engagement team identified any threats to independence? If yes, what safeguards are in place to eliminate or reduce threats to independence to an acceptable level?

2.2.10 Audit committees should obtain a description of the audit firm's policies and procedures for monitoring and complying with relevant ethical requirements to which the firm and the audit engagement are subject, including integrity, objectivity, and independence requirements, and be satisfied with the effectiveness of the policies and procedures. They should also obtain an understanding of how the audit firm reviews compliance with these requirements and the results of such reviews.

2.2.11 Listed entities must not appoint an auditor who is not independent. Therefore, audit committees should:

(a) Obtain a confirmation, together with a detailed independence assessment, from the audit firm that any non-audit services, financial and business relationships between the audit firm and the listed entity, and the personal relationships (including financial, employment and family relationships) between the audit engagement team members (including their immediate family members) and the listed entity, that may impair independence will be completed or terminated before the beginning of:

- The financial year that is subject to audit; and
- The auditor's appointment.

(b) Consider the reasonableness/effectiveness of any safeguards proposed by the audit firm to mitigate the independence threats of past non-audit services. Audit committees should also be satisfied that both the prior and current non-audit services provided by the audit firm do not result in the auditors reviewing their own work or decisions in the course of audit. For example, where the potential auditor was involved in the design and implementation of the listed entity's financial reporting system, whether another independent specialist will be engaged to evaluate the said system.

Industry knowledge and technical competence

2.2.12 The Market Report suggests that industry specialisation may provide competitive advantages in improving audit efficiency or enhancing audit quality. Audit firms with in-depth industry knowledge may need to spend less time and/or may be more effective in understanding the business operations, identifying audit risks, designing and performing audit procedures, and evaluating findings from them[8].

2.2.13 Audit committees should obtain from the audit firm information about audits of entities of similar size in the same industry as the listed entity in the past 5 years for evaluation of the firm's experience.

[8] Page 37 of the Market Report

2.2.14 Audit committees should be satisfied that the audit engagement team has the necessary competence by obtaining from the audit firm the composition of the audit engagement team, the profiles of the audit engagement partners, the engagement quality reviewer, and the key audit engagement team members, and by considering:

- The years of audit and relevant industry experience of the audit engagement partner, the engagement quality reviewer and the key audit engagement team members (including individuals from the audit firm's network);
- The professional qualifications held by the audit engagement partner, the engagement quality reviewer and the key audit engagement team members; and
- The ratio of qualified staff to students that will be involved other than the audit engagement partner and the engagement quality reviewer.

2.2.15 It is also important that the audit committee obtain the succession planning and steps from the audit firm to ensure that the audit firm has sufficient competent staff to provide quality audits over many years.

2.2.16 The audit engagement partner is responsible for ensuring that the engagement team collectively has the appropriate competence, and that the firm has access to the experts required to meet the needs of the engagement (e.g., taxation, valuation, actuarial, forensic, financial instruments, legal, and other experts). For example, expertise may be needed in relation to valuation of complex financial instruments, intangible assets and liabilities associated with insurance contracts, interpretation of contracts, laws and regulations, and analysis of complex or unusual tax compliance issues.

2.2.17 It could also be difficult for an audit firm to audit advanced technologies (e.g., predictive analytics, robotic process automation, blockchain, machine learning, and artificial intelligence) effectively through conventional audit procedures. If the listed entity involves advanced information technology systems, audit committees should ask audit firms to provide information demonstrating their technological capabilities and evaluate whether they have the technological expertise and the computer-aided audit tools to conduct audit procedures effectively.

2.2.18 Quality audits require professional judgement, professional scepticism, fortitude, and business, financial reporting, and auditing knowledge. The changing business and regulatory environment has led to challenges for auditors, and has affected how audits are carried out. It is important that the audit engagement team receive continuing professional development to develop and maintain the professional competence necessary to perform quality audits. The audit committee should be satisfied that sufficient and appropriate training has been provided to the audit engagement team.

Key questions to be asked by audit committees

Audit firm level

(a) Does the audit firm have relevant knowledge and experience in the listed entity's business and industry?

(b) What is the expertise of the audit firm in different technical areas (e.g., taxation, valuation, actuarial, forensic, financial instruments, legal, and other experts) to support the audit engagement team in handling complex technical matters specific to the listed entity?

(c) If the listed entity uses advanced technologies (e.g., predictive analytics, robotic process automation, blockchain, machine learning, and artificial intelligence), does the audit firm have the technological capabilities to conduct the audit effectively and efficiently?

Engagement level

(d) Do the audit engagement partner, the engagement quality reviewer, and the key audit engagement team members have the necessary professional qualifications (e.g., certified public accountants or equivalent)?

(e) What is the experience of the audit engagement partner, the engagement quality reviewer, and the key audit engagement team members in auditing entities of similar size in the same industry sector as the listed entity?

(f) Do the audit engagement partner, the engagement quality reviewer, and the audit engagement team members receive sufficient and appropriate training to keep them abreast of the changes in financial reporting/auditing standards and the industry knowledge specific to the listed entity?

(g) What succession planning is in place to ensure the continuity of a competent audit engagement team (including audit engagement partner, the engagement quality reviewer and the key audit engagement team members)?

Engagement performance

2.2.19 The audit methodology sets out the policies and procedures guiding the audit engagement team in complying with professional standards and applicable legal and regulatory requirements. It is important that audit committees obtain an understanding of whether the audit methodology has been updated for key changes in professional standards to ensure quality audits and support quality judgements made on audit engagements.

2.2.20 Professional scepticism is an attitude of the audit engagement team that includes a questioning mind and critical assessment of audit evidence. It increases the likelihood of detecting material misstatements, which is important in delivering audit quality. As indicated in our *Annual Inspection Report* published in June 2021, a lack of adequate exercise of professional scepticism was the most common finding identified across all inspections of registered PIE auditors for the period from 1 October 2019 to 31 December 2020 and had the most impact on audit quality due to the significance of the areas to which it relates[9]. It is important that the audit committee is satisfied that the audit firm's methodology encourages individual audit engagement team members to apply professional scepticism appropriately and exercise appropriate professional judgement.

2.2.21 Effective engagement performance is the essence of audit quality. The effective performance of an audit depends first on good audit planning as this helps secure adequate resources to obtain sufficient appropriate audit evidence to support the audit opinion. Audit committees should therefore obtain from the audit firm their overall audit strategy that sets out the scope, timing, and direction of the audit. The audit strategy will guide the auditor's development of the audit plan specifying the nature, timing, and extent of audit procedures to be performed in the course of the audit. It is crucial that the audit committee is satisfied that:

- The audit engagement team has sufficient and appropriate resources, including expertise and time to perform quality audits;
- The nature, timing and extent of direction and supervision of audit engagement teams and review of the work performed is in line with the size and complexity of the listed entity, the risks of material misstatement, the technical competence and experience of the audit engagement team members.

[9] Paragraph 3.2.1 of Annual Inspection Report published by FRC in June 2021

Sufficient and appropriate resources

2.2.22 Audit committees should obtain information on the selection of the engagement team, including profiles of the audit engagement partner, engagement quality reviewer, and the key audit engagement team members, to assess whether the team comprises an adequate number of staff with an appropriate mix of knowledge, skills, and other competencies required for the audit.

2.2.23 Audit committees should also obtain the audit strategy from the audit firm indicating the time to be spent:

- On different audit phases (i.e., planning, execution and reporting);
- By staff members of different seniority (i.e., audit engagement partner, engagement quality reviewer, audit managers, specialists, and other team members); and
- On key risk areas for material misstatement;

to ensure the audit firm assigns sufficient and appropriate resources to each audit phase and to address key risk areas, and that the audit engagement partner is actively involved in risk assessment, planning, supervising and reviewing the work performed by the engagement team, evaluating the evidence obtained, and in reaching final conclusions.

Scope and characteristics of the engagement

2.2.24 Audit committees should satisfy themselves that the audit strategy covers/addresses:

- Preliminary identification of significant components, areas of higher risk that may lead to material misstatement or are expected to be key audit matters, the audit approach, and the extent to which components are audited by other auditors (i.e., component auditors);
- The key audit matters of the listed entity identified by the incumbent auditor, and common key audit matters of entities in the same industry as the listed entity;
- Industry-specific requirements;
- The need for specialised expertise; and
- The timetable and form of reporting of audit findings.

Key questions to be asked by audit committees

Audit firm level

(a) How does the audit firm keep its audit methodology updated to ensure compliance with developments in professional standards and applicable legal and regulatory requirements?

(b) How does the audit methodology encourage individual audit engagement team members to apply professional scepticism and exercise appropriate professional judgement?

(c) What are the quality control procedures in place to ensure audit quality is monitored, e.g., direction, supervision and review of the audit work and the performance of engagement quality reviews?

(d) What are the processes that the audit firm applies to resolve disagreements between the audit firm and management of the listed entity?

Engagement level

(e) Does the audit strategy provided by the firm adequately reflect the scope and characteristics of the audit engagement?

(f) Does the audit strategy demonstrate the audit firm's commitment to allocate sufficient and appropriate resources to the audit engagement?

(g) Does the audit engagement team have relevant experience with audit transitions of similar companies? What is the transition plan?

(h) Does the audit strategy indicate that sufficient time is allocated for the audit partner to manage and supervise, and for key audit engagement team members to perform the audit engagement?

(i) How many audit engagements with concurrent reporting timetables has the audit engagement partner undertaken and how does the audit engagement partner ensure sufficient involvement in the audit engagement?

Communication and interaction with the audit committee

2.2.25 Audit committees should obtain the communication plan between auditors and the audit committee and should satisfy themselves that it will facilitate mutual understanding of the audit progress and ensure effective two-way discussion of significant financial reporting and auditing matters in a timely manner.

Communication plan

2.2.26 In evaluating the communication plan, audit committees should assess:

- Whether the timing of the communication with the audit committee on audit milestones (e.g., audit planning, audit fieldwork, completion of fieldwork, and reporting of audit results) meets the reporting timeline of the listed entity; and
- Whether the communication plan includes the scope of the audit engagement and focuses on the key issues that may give rise to:
  - Greater risks of material misstatement in the financial statements; and
  - Greater risks of compromising auditor independence.

Private meetings between the audit committee and the auditor

2.2.27 Audit committees should hold private meetings with auditors, in the absence of management, to review key issues within their sphere of interest and responsibility. These private meetings help audit committees maintain their independence from management by allowing them to ask questions that might not have been specifically addressed during the audit. It also allows auditors to provide candid and confidential comments to the audit committees on such matters.

Key questions to be asked by audit committees	
(a)	How does the communication plan provided by the audit firm ensure effective communication between the firm and the audit committee?
(b)	Does the audit firm arrange private meetings with the audit committee, in the absence of management, for discussion of audit issues?

Monitoring process

2.2.28 Information on regulatory actions (e.g., investigations, sanctions or enforcement matters) and inspection results provide insights on the quality of other audits led by the audit engagement partner and the engagement quality reviewer. This is relevant in assessing auditor's compliance with auditing standards and, in some cases, other aspects of audit quality.

2.2.29 Audit committees should seek information from the audit firm on whether the firm or any audit engagement team members, including the audit engagement partner, the engagement quality reviewer, and other key engagement team members, are subject to regulatory actions and evaluate whether such instances, if any, might affect audit quality.

2.2.30 In addition, audit committees should check whether there is any information from the public domain indicating possible quality issues with the audit firm. The sources of such information include:

- The annual and interim inspection reports issued by the FRC;
- Information available on the websites of the FRC and the HKICPA about investigations and/or disciplinary actions concerning the audit firm; and
- Newspapers, magazines, databases, industry publications, internet searches and other sources in the public domain.

2.2.31 Audit committees should also obtain and evaluate information from the audit firm on the results of inspections by regulatory and professional bodies (e.g., the FRC and the HKICPA). In evaluating recent inspection results, audit committees should consider:

- When was an engagement led by the audit engagement partner and the engagement quality reviewer last inspected;
- The results of engagement reviews of inspections (e.g., satisfactory, or failed); and
- The summary of findings and remedial actions taken by the audit engagement team or firm in response to the findings.

2.2.32 Moreover, audit committees should obtain and assess information from the audit firm on the results of recent internal inspection of engagements completed by the audit engagement partner and the engagement quality reviewer in light of factors highlighted in paragraph 2.2.31.

Key questions to be asked by audit committees

Audit firm level

(a) Is the audit firm subject to any past and ongoing regulatory actions? If yes, what are the details of the incidents that led to the regulatory actions?

(b) How often does the audit firm conduct internal inspections of audit engagements completed by the audit engagement partner and the engagement quality reviewer?

(c) What are the recent results from internal and external inspections? Did they identify audit quality issues within the firm? If so, what are the root-causes of any identified deficiencies and how has the audit firm addressed such deficiencies?

(d) How is the audit methodology revised in response to findings from internal and external inspections?

Engagement level

(e) Are any of the audit engagement team members, including the audit engagement partner, the engagement quality reviewer, and other key audit engagement team members, subject to any past and ongoing regulatory actions? If yes, what are the details of the incidents leading to such regulatory actions?

(f) Were the audit engagement partner or the engagement quality reviewer subject to internal or external inspection in the last three years? If yes, what were the results?

2.3 Key considerations for assessing audit fees

2.3.1 Under code provision D3.3 of the Corporate Governance Code, audit committees are primarily responsible for approving the remuneration and terms of engagement of auditors. Auditor remuneration is the fee charged by the auditor for the audit of a listed entity, i.e., the audit fee.

2.3.2 Our Market Report showed that the average annual audit fees for listed entity audits in Hong Kong remained relatively stable in the past 10 years[10], with average and median audit fees increasing at compound annual growth rates of 0.9% and 1.8% respectively. For each year from 2011 to 2019, between 6.6% and 9.6% of listed entities changed auditors and a majority of them paid lower or the same audit fees after such a change. While the Market Report noted that the decrease in audit fees may be due to various reasons, the FRC emphasized the importance of the audit committees' role in ensuring that audit quality is not compromised with reduced audit fees.

2.3.3 The Audit Quality Framework recognises that *"[t]here is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance; this will usually be reflected in the audit fee"*[11]. It is important that audit committees should award such fees, commensurate with the demands of the engagement, as would ensure that sufficient resources with appropriate expertise and experience will be allotted to enable the audit to be performed in accordance with professional standards and applicable legal and regulatory requirements.

2.3.4 Audit Committees should recognise that *"various factors affect audit fees, including the nature, size and complexity of the audit, the reporting requirements for a particular engagement or in the particular jurisdiction, and market competition"*[12]. A reduction of the audit fee may not generate significant savings for the listed entity but may impair audit quality, which would go against the interests of investors and other users of financial statements.

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10 According to the Market Report, the average audit fees per listed entity audit increased from HK$4.8 million in 2010 to HK$5.2 million in 2019. The median audit fees per listed entity audit in 2019 was HK$2 million, with an increase from HK$1.7 million in 2010.

11 Paragraph 110 of the Audit Quality Framework

12 Paragraph 3 of the IESBA Staff Publication *Ethical Considerations relating to Audit Fee Setting in the context of Downward Fee Pressure*

Key questions to be asked by audit committees	
(a)	How does the audit firm set the proposed audit fees?
(b)	How does the audit firm demonstrate that at the level of audit fees proposed, it is able to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements? Would the proposed audit fees enable sufficient audit resources to be allocated to the audit engagement?
(c)	Are the audit fees proposed by one audit firm significantly lower than the others? If so, how does the audit firm justify the difference?
(d)	Are the arrangements for fee variations to address unanticipated issues appropriate to ensure that the auditor is not disincentivised from allocating the necessary resources?

Size and structure of listed entities

2.3.5 The size and structure of listed entities generally has a direct relationship with audit fees. Auditors are required to perform additional audit procedures on larger entities as they have more sophisticated operational and financial processes, which entail higher audit risk.

2.3.6 Audit committees may also consider the reasonableness of the proposed audit fees in light of the size and structure of listed entities in terms of:

- Total assets, revenue and net income;
- The number and relative significance of subsidiaries and associated entities;
- The number of geographical locations where the listed entity conducts business; and
- The lines of business operated by the listed entity.

Nature and complexity of listed entities' businesses

2.3.7 Audit committees should evaluate the nature and complexity of listed entities' businesses when considering the reasonableness of the audit fee level, as those factors may affect the required audit resources and audit fees. In general terms, the complexity of listed entities' businesses and their audits are directly related to the amount of audit fees. Audit committees may consider the reasonableness of the proposed audit fees in light of the following:

- The nature of the listed entity's principal activities, and whether those activities involved are specialised industries (e.g., banking, finance, or information technology), that may increase the complexity of audits.
- The effectiveness of the listed entity's financial reporting and findings of the internal audit function, as well as its internal control over financial reporting.
- Whether the listed entity conducts complex corporate transactions, such as mergers and acquisitions, which increase the complexity of the audits and may involve expensive technical specialists.
- Whether the listed entity uses technologies such as predictive analytics, robotic process automation, blockchain, machine learning and artificial intelligence and whether computer-aided audit tools are expected to be used and technology specialists should be involved.
- Whether the listed entity's business is diversified in terms of the number of business segments.

2.3.8 Audit committees should also obtain a breakdown of proposed audit fees from the audit firm and compare it against competing firms so as to assess the reasonableness of the proposed fees:

- By seniority of staff members (i.e. the number of hours that the audit partner, audit managers, specialists, and other team members will dedicate to the audit);
- By geographical locations of the listed entity's businesses (i.e. the amount of audit fees allocated by the audit firm to component auditors at each location); and
- By business segments of the listed entity (i.e. the amount of audit fees allocated by the audit firm to the audit of each business segment).

2.3.9 Audit committees may also compare the audit fees proposed by the potential audit firms against:

- The audit fees charged by the incumbent auditor (where applicable);
- The audit fees charged by the audit firm for entities that operate in a similar industry; and
- The fees paid by other listed entities of similar size and nature for audits of similar complexity as disclosed in the Corporate Governance Reports of their Annual Reports;

to consider the reasonableness of proposed audit fees[13].

2.3.10 Audit committees should challenge audit firms charging lower audit fees compared to the incumbent auditor if there is no significant change in the scope of the audit engagement. A decrease in the audit fee may arise from efficiencies in the audit process (e.g., the use of computer-assisted audit techniques). However, an audit firm may lower audit fees in the first year and revert to normal levels within a few years (i.e., low balling). In such a situation, audit committees should be satisfied that the audit firm will deploy sufficient time and resources to perform the audit work at a lower audit fee given that the audit firm would normally need to spend more time and effort to understand the listed entity to design proper procedures in the first year of an audit engagement.

2.3.11 In addition, audit committees should also be satisfied that the audit firm does not rely on obtaining additional or higher margin non-audit services to subsidise an audit. Such a pricing strategy creates a self-interest risk for the audit firm, making it harder to assume the firm would challenge management when needed if doing so might jeopardise a lucrative non-audit service contract.

[13] Audit committees could refer to the section “Level of audit fees segregated by size of assets of listed entities across eleven industries in 2019” included in our Market Report.

Section 3 REAPPOINTMENT OF INCUMBENT AUDITOR

3.1 Introduction

3.1.1 Audit committees are responsible for evaluating the incumbent auditor for reappointment where appropriate. They should not recommend reappointment by default.

3.1.2 As indicated in our Market Report, between 2011 and 2019, a majority of listed entities in Hong Kong reappointed incumbent auditors. Therefore, the FRC considers it is critical for audit committees to develop a robust process to evaluate the appropriateness of reappointment.

3.1.3 Evaluating an incumbent auditor is as important as evaluating a potential auditor. However, less time may be required than for initial appointment as the audit committee can leverage on the information and experience gained on initial assessment and from interaction with the auditor. Audit quality is the prime consideration for such a recommendation. The key considerations to assess audit quality for the appointment of new auditors are generally the same as those for the reappointment of incumbent auditors. In addition, further considerations are set out in section 3.3.

3.1.4 Similar to the appointment of auditors, audit committees should be satisfied that the audit fees are not at a level that compromises audit quality. Audit committees should follow the guidelines in Section 2.3 in evaluating the reasonableness of audit fees.

3.2 Timing and frequency of evaluating the incumbent auditor

3.2.1 To discharge the duties of independent oversight of external audits effectively, an audit committee should evaluate the quality of the audit of the incumbent auditor on an ongoing basis by observing and interacting with the auditor during the past audit engagements.

3.2.2 It is good practice for an audit committee to meet with the auditor regularly to discuss matters relating to financial reporting, internal controls and other governance issues of the listed entity. Such meetings allow the audit committee to assess the ongoing performance of the auditor against the quality commitment it made on initial appointment and in connection with subsequent reappointments. The audit committee should also obtain the audit strategy from the auditor at an earlier stage to ensure sufficient and appropriate resources have been planned and key risks of material misstatement have been identified. If the audit committee has identified a potential issue concerning the performance of the incumbent auditor during the course of an audit, it should communicate the issue to the auditor in a timely manner.

3.2.3 The FRC recommends audit committees to at least meet with the auditor after the review of interim financial statements and the audit of the full-year financial statements to review their performance. Audit committees may also obtain an indicative audit fee for the coming year to assess its reasonableness. This will enable them to make an informed decision on reappointment before the annual general meeting.

3.3 Additional considerations for the reappointment of the incumbent auditor

3.3.1 Audit committees should consider the following procedures and factors in developing their recommendations on auditor reappointment:

(a) Audit effectiveness;
(b) Relationship between the auditor and management of the listed entity;
(c) Interaction with the audit committee; and
(d) Other considerations.

Audit effectiveness

3.3.2 Audit committees should recommend reappointment of the incumbent auditor to the board if they are satisfied with the audit quality delivered. Audit committees should evaluate the actual performance of the incumbent auditor against the guidelines set out in Section 2.2 in evaluating the quality of the incumbent auditor's work.

<u>Handling of key audit issues</u>

3.3.3 Audit committees should evaluate whether the audit plan has appropriately identified the significant risks related to the audit engagement, and whether the auditor has explained clearly how it has addressed the issues in a timely and effective manner. If there were changes in assessed audit risks during the audit engagement, audit committees should obtain an explanation from the auditor of the reasons for the changes and how the planned work was appropriately amended to address the changes in assessed risks.

3.3.4 Audit committees should satisfy themselves that the incumbent auditor has applied professional scepticism appropriately by obtaining information from the auditor and evaluating the procedures undertaken to challenge management on:

- The reasonableness of key assumptions made by management in determining estimates, e.g., cash flow forecasts and discount rates used in going concern and asset impairment assessments, and whether sufficient appropriate evidence had been collected to support the auditor's position; and
- The business rationale and commercial substance for complex and unusual transactions that might indicate fraud or the misappropriation of assets involving related parties.

3.3.5 In addition, audit committees should be satisfied that the incumbent auditor has the necessary competence by demonstrating that it has:

- Made appropriate professional judgements about materiality, risks, significant audit issues and difficult management judgements;
- Designed and carried out effective audit procedures;
- Understood and interpreted the evidence they obtained appropriately;
- Made appropriate evaluations of evidence obtained;
- Applied professional scepticism appropriately and challenged management throughout the audit engagement; and
- Reported with clarity and candour[14].

<u>Timely completion of audit work</u>

3.3.6 For every audit engagement, the audit firm should provide the audit committee with an engagement plan indicating the time to be spent on audit phases, by staff members of different seniority and on key risks of material misstatement at the planning phase of the audit. Audit committees should obtain from the incumbent auditor:

- A comparison of budgeted hours against actual hours spent on the various audit phases, by staff members of each seniority level and on key risk areas of material misstatement;
- A comparison of actual completion time against planned completion time for key milestones; and
- Reasons for significant variances

[14] Paragraph 3.41 of Audit Quality – Practice Aid for Audit Committee issued by UK Financial Reporting Council

so as to evaluate whether the incumbent auditor has completed the audit engagement according to the agreed timetable. This should also provide information on whether the audit engagement partner and other senior staff were sufficiently involved throughout the audit. Whilst inefficiency, if any, is not an audit quality issue as such, it may be a consideration in considering proposed changes in fee estimates and service satisfaction.

3.3.7 The audit committee should also evaluate whether the incumbent auditor met the agreed timelines and reporting deadlines and if not, whether there were good reasons for the delays in the interest of audit quality.

Relationship between the auditor and management of the listed entity

3.3.8 Auditors are responsible for forming an independent opinion on whether the financial statements that have been prepared by management comply with the applicable financial reporting framework. Auditors need full and timely access to high-quality information prepared and provided by management and management may benefit from the auditor's observations on possible improvements to financial reporting practices, internal control over financial reporting, insights on industry and regulatory trends, and other matters.

3.3.9 Audit committees should obtain feedback from members of management involved in the audit process in considering the effectiveness of the incumbent auditor's working relationship with management while being satisfied that the auditors have remained sceptical and objective and were prepared to challenge the reliability of the information provided by management.

Interaction with the audit committee

3.3.10 Hong Kong Standard on Auditing 260 (Revised) recognises the importance of effective two-way communication in an audit of financial statements and requires auditors to communicate with those charged with governance that include audit committees. Audit committees should be satisfied that the incumbent auditor has maintained open lines of communication with themselves, and the relationship has operated on a transparent and candid basis.

3.3.11 Moreover, the audit committee should evaluate whether the timing and content of communications were in line with what was set out in the communication plan under paragraph 2.2.25. The audit committee should also evaluate whether the auditor communicated with them as soon as practicable when circumstances warranted timely reporting, for example, a significant difficulty encountered during the audit, significant deficiencies identified in internal controls, or a possible modified opinion.

Other considerations

3.3.12 There are other factors that may affect the audit committees' recommendation on the reappointment of the auditor, such as when there are implications for the auditor's independence of the incumbent auditors.

Independence of the incumbent auditor

3.3.13 Although an understanding of the listed entity is fundamental to audit quality, a familiarity threat might be created as a result of the long association of the incumbent auditor, the audit engagement partner, and the engagement quality reviewer with the listed entity[15]. A self-interest threat might be created as a result of the firm's and the partners' concerns about losing a longstanding client or an interest in maintaining a close personal relationship with members of senior management of the listed entity. Such a threat might influence the partners' judgement and negatively impact professional scepticism.

3.3.14 Audit committees should consider the need for the listed entity to mitigate the familiarity and self-interest threats arising from the relationship, when an incumbent auditor has served a listed entity for a considerable period of time. Audit committees should also be satisfied that the incumbent auditor has adequate plans for managing mandatory changes of the audit engagement partner or engagement quality reviewer to ensure there is no undue disruption to the audit[16].

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15 A research indicated that a longer audit firm tenure leads to less timely discovery and correction of misstatements, and misstatements of greater magnitude, which indicate lower audit quality (Singer and Zhang 2018).

16 Under R540.5 of the Code of Ethics, an individual shall not act as the audit engagement partner and/or engagement quality reviewer for a period of more than seven cumulative years.

Key questions to be asked by audit committees	
(a)	Has the incumbent auditor appropriately identified and addressed significant risks of material misstatement promptly and effectively during the audit? Has the incumbent auditor addressed key audit matters appropriately?
(b)	Has the incumbent auditor reported key findings from its work on internal controls to the audit committee and addressed them appropriately in the audit?
(c)	Has the incumbent auditor applied professional scepticism, exercised appropriate professional judgement and adequately challenged management during the course of the audit?
(d)	Were the audit report and other documents presented by the incumbent auditor clear and relevant and demonstrate a commitment to audit quality?
(e)	Were the audit engagement partner and other senior staff sufficiently involved throughout the audit?
(f)	Did the incumbent auditor complete the work in a timely manner according to the agreed audit plan or were there good reasons for delays in the interest of audit quality?
(g)	Has the incumbent auditor maintained an effective working relationship with the management of the listed entity whilst maintaining its independence and objectivity?
(h)	Has the incumbent auditor responded to questions from audit committees in an insightful and timely manner?
(i)	Is the level of audit fees reasonable given the scope of the audit engagement?
(j)	Are there any material differences between actual and estimated audit fees and what are the reasons for such differences? When there have been significant unanticipated issues, have the audit fees been adjusted accordingly?

Section 4 AUDIT TENDER PROCESS

4.1 Tendering is a common process for selecting appropriate service providers. A tender process encourages competition and may stimulate innovation as audit firms seek ways to demonstrate the merits of their tenders. Even if the incumbent auditor is reappointed, experience suggests that the tender process can reinvigorate the audit approach. It also helps ensure a transparent and fair selection process by allowing listed entities to examine and compare offers by different firms under the same platform and requirements.

4.2 In light of the above, the FRC considers audit committees may conduct audit tenders to select auditors of listed entities periodically. Since there are no regulations or guidance regarding this important area, this section seeks to provide specific and practical guidelines to audit committees to conduct a robust audit tender, which is instrumental in achieving audit quality.

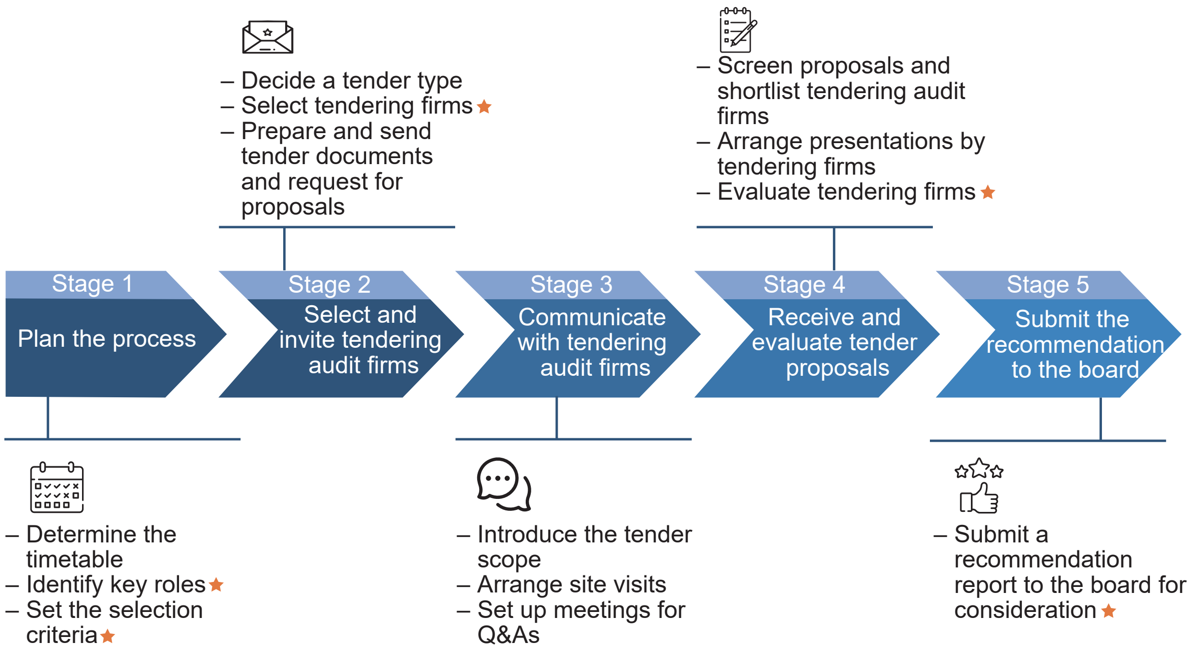
4.3 Audit tenders can be conducted by either open tenders or selective tenders.

Open tender – An open tender offers an equal opportunity to any audit firm to participate. Although open tenders allow for the most competition among audit firms, audit committees may need more time to evaluate the proposals of the tendering firms.

Selective tender – A selective tender is open to selected audit firms that are invited to participate. This type of tender is used when not all audit firms in the market are capable of providing audit services that require specialised knowledge and skills. Therefore, the selected audit firms are those considered by audit committees to be suitable for the audit engagement in terms of size, industry specialisation and required expertise. Audit committees should invite a sufficient number of firms to participate in the tender.

4.4 Generally, an audit tender process comprises the following five stages:

- Stage 1: Plan the process;
- Stage 2: Select and invite tendering firms;
- Stage 3: Communicate with tendering audit firms;
- Stage 4: Receive and evaluate tender proposals; and
- Stage 5: Submit the recommendation to the board.



★ Areas that audit committee needs to pay particular attention to.

Stage 1: Plan the process

4.5 Careful planning is always key to success. It is important for audit committees to determine the timing of a change in auditor and plan the tendering process accordingly.

4.6 Aligning with the responsibility of making a recommendation on auditor selection and appointment, audit committees should own the tendering process. A clear communication of the roles of audit committees and management should be prepared.

- **Audit committees** – initiate and supervise the audit tender process, make key decisions during the process, and recommend an appropriate audit firm to the board of directors after the process.
- **Management team** – provides project management and administrative support to facilitate audit committees throughout the audit tender process. Management team can be supported by external consultants where appropriate.

4.7 While audit committees can seek support and input from management of listed entities and/or external consultants, audit committee members should devote sufficient time and be involved throughout the tender process.

4.8 The ultimate goal of an audit tender is to appoint an audit firm that is likely to provide the highest quality audit. Audit committees should determine the selection criteria to evaluate the tender proposals of audit firms and their weighting. Sections 2.2 and 2.3 provide the key considerations to evaluate audit quality and audit fees. The consideration of audit quality should outweigh audit fees.

Stage 2: Select and invite tendering audit firms

4.9 Audit committees should decide whether to conduct an open tender or a selective tender based on the specific circumstances of listed entities. For example, audits for listed entities engaging in financial and information technology industries require specialised professional knowledge, skills and audit tools. Audit committees may consider using selective tenders to narrow down the range of candidates to those with relevant knowledge and skills.

4.10 Audit committees should invite a sufficient number of audit firms to participate in the audit tender. It is important not to exclude any audit firms from tendering without good reason to believe they would not be able to perform a quality audit. It is reasonable to invite the incumbent auditor to tender unless the audit committee believes otherwise due to the overall length of continuous appointment, or for reasons related to poor quality. Factors that an audit committee may consider in identifying suitable candidates include:

- The reputation of an audit firm;
- The geographical coverage of an audit firm's network relative to the geographical scope of the listed entity's business;
- Previous knowledge of a firm; and
- An audit firm's experience of auditing other entities in the industry sector and/or the regulatory environment.

4.11 Audit committees should carefully consider whether the tendering audit firms have obvious conflicts of interest or independence issues before inviting them to submit tender proposals.

4.12 Audit committees should issue a tender document to tendering audit firms being selected. For a tender process to be effective, candidates should be provided with adequate information to enable them to understand the entity's business, risks, and specific expectations of the audit engagement. They may also be provided with information containing the pre-determined selection criteria, the listed entity's strategy, organisational chart and structure, locations of operations, financial information, reporting timetable, and internal audit arrangements where applicable. This also helps mitigate the incumbent firm's inherent advantage if it is invited to participate in the tender.

4.13 Audit committees should also, in the tender document, outline the information to be included in the proposals to be submitted by the tendering audit firms. They may consider asking the firms for their most recent FRC inspection reports to gain an understanding of the firms' standards of audit quality.

Stage 3: Communicate with tendering audit firms

4.14 Audit committees, with the assistance of management, should arrange a series of communication activities to facilitate the candidates' understanding of the listed entities' businesses and operations for their preparation of tendering proposals.

4.15 Communication activities include but are not limited to:

- An initial briefing meeting to introduce the scope and requirements of the proposed audit engagement.
- Site visits, if applicable. This helps tendering audit firms gain in-depth insights into the listed entities and provides an opportunity for them to meet key management.
- Meetings with the finance team and internal audit team, if applicable, to understand the key accounting and auditing issues and the internal audit function.
- Other meetings with the listed entities' functional teams, if applicable. This arrangement is particularly useful for listed entities with complex operations and businesses to explain significant risks that are relevant to the audit engagement.

Stage 4: Receive and evaluate tender proposals

4.16 To ensure audit quality is the prime selection consideration, FRC recommends audit committees conduct a 'fee blind' evaluation. This can be achieved by requesting tendering audit firms to submit information regarding the firms' technical and quality capabilities and the level of proposed audit fees separately in two sealed envelopes. Under this two-envelope approach, audit committees should not open the envelopes containing the fee proposal until the completion of the technical assessment.

4.17 Audit committees could develop a scorecard approach to rate the audit quality offered by the tendering audit firms covering the selection criteria pre-determined in "Stage 1: Plan the process".

4.18 Audit committees can consider assigning the management team (preferably the internal audit team if applicable) to summarise the tendering audit firms' proposals to avoid potential undue influence by management. Audit committees will shortlist a number of tendering audit firms for further evaluation.

4.19 It is common practice to schedule proposal presentation sessions by the shortlisted candidates. The best practice is for the whole audit committee to attend the presentations. These presentations help audit committees understand how firms identify and address the audit risks of listed entities. Audit committees can consider giving an accounting and audit challenge to the shortlisted candidates to assess their technical competence, and posing questions related to ethics and independence to appraise each candidate's culture and the audit partner's mindset and judgements.

4.20 After evaluating the audit quality factors, audit committees should review the proposed audit fees of the tendering firms. Normally, any candidate failing to meet a threshold score for the audit quality assessment will not be further considered. The overall evaluation should combine the results of the audit quality and audit fee evaluations, based on the weighting previously set for each of these. Audit committees should question audit firms that have proposed particularly low audit fees and obtain assurances about their commitment to allocate appropriate resources and their ability to deliver a quality audit.

4.21 In case there is a need to negotiate the level of audit fees, the audit committees should participate in the negotiation together with the management team from an early stage.

Stage 5: Submit the recommendation to the board

4.22 Audit committees are responsible for making recommendations to the board on auditor appointment based on the results of the audit tender. Audit committees should submit a recommendation report which sets out the following:

(a) Description of the audit tender process;
(b) Selection criteria;
(c) Assessment of the tendering audit firms; and
(d) Basis of the recommendation.

4.23 The consideration of the audit committees' recommendation and their reports should be included as an agenda item for the board. If the board does not accept the audit committee's recommendation, the board should explain the rationale and document such a divergence of views in detail.

Section 5 AUDITOR RESIGNATION AND REMOVAL

5.1 Introduction

5.1.1 According to our Market Report, there was an upward trend in changes in auditors of listed entities between 2011 and 2019[17]. In 2020, 237 listed entities changed their auditors, with the reasons given as follows:

Reasons for change in auditors	Number of listed entities
Resignation of auditors	
• Unable to reach an agreement on audit fees	171
• Disagreement with management or unresolved issue	30
• Auditor rotation	11
• Other reasons	16
Total number of auditor resignation	228
Removal of auditors	
• Unable to reach an agreement on audit fees	6
• Other reasons	3
Total number of auditor removal	9

5.1.2 Paragraphs 300.10 and 300.11 of the Code of Ethics require the audit firm (i.e., the outgoing auditor) to prepare a letter to the audit committee and the board of directors of the listed entity ("**Letter of Resignation**" or "**Letter of Termination**"), whenever:

(a) The outgoing auditor resigns or declines to stand for re-appointment (**Resignation**); or

(b) The listed entity decides to propose to its shareholders that the outgoing auditor be removed during the auditor's term, or there is a proposal or intention not to re-appoint the outgoing auditor on the expiry of its term (**Termination**).

[17] In 2011, 107 listed entities (7.3% of the total number of listed entities) changed their auditors. In 2019, the figure rose to 224 (9.6% of the total number of listed entities).

The Letter of Resignation or Termination should set out the circumstances leading to the resignation or removal of the outgoing auditor, i.e., all occurrences that, in the opinion of the outgoing auditor, affect the relationship between the listed entity and the outgoing auditor.

5.1.3 As an independent auditor regulator, the FRC is concerned that audit quality is not affected by any changes in the appointment of auditors. This section outlines some key issues that audit committees should consider when auditors resign or when audit committees intend to remove auditors.

5.2 Resignation of auditors

5.2.1 As a body responsible for overseeing the relationship with auditors, audit committees should investigate any issues that have caused or contributed to the resignation of auditors, other than those arising from auditor rotation. Audit committees should carefully review the Letter of Resignation to understand the reasons for the auditor resignation and consider whether any action is required. Audit committees may also want to hold separate meetings with the auditor and the management to understand all the circumstances.

Unable to reach an agreement on audit fees

5.2.2 The FRC emphasizes the importance for audit committees to satisfy themselves that the audit fees are not at a level that compromises audit quality. Audit committees should refer to Section 2.3 for key considerations when evaluating audit fees. They should obtain an understanding of the differences between actual and estimated fees and the differences between actual and estimated audit hours to satisfy themselves that the level of audit fees is reasonable given the scope of the audit engagement.

5.2.3 It is also important for the audit committee to be satisfied that the level of audit fees is the actual reason for the auditor's resignation and that the auditor did not resign due to the discovery of a suspected fraud, malpractice or mismanagement.

Disagreement with management or unresolved issues

5.2.4 The outgoing auditors may disagree with management on the scope of audit (e.g. preventing the auditor from requesting external confirmation of specific account balances), management's estimates and assumptions, choices of accounting policies, or financial statement disclosures. There are also instances of outgoing auditors resigning due to unsolved issues. In these situations, audit committees should obtain an understanding from the outgoing auditors of their concerns arising from the disagreement or any unresolved issues and why those issues have given rise to the auditors' decisions to resign.

5.2.5 The audit committee should hold a private meeting with the outgoing auditor without the presence of management to provide a frank and open forum for the outgoing auditor to explain any matters of disagreement or unresolved issues. The audit committee should make similar arrangements to hear from management of the listed entity.

5.2.6 The audit committee should then consider whether external consultants with specialised expertise are needed to investigate the underlying issues or to provide an opinion on difficult or contentious issues that caused the disagreement or unresolved issues.

5.2.7 If possible, the audit committee should agree on follow up actions with management of the listed entity and the auditor to resolve disagreements on audit issues. The audit committee should also monitor the execution of the follow up actions.

5.3 Removal of auditors

5.3.1 Auditors have a duty to shareholders to report on the financial statements. Other users of financial statements also rely on the audited financial statements to make informed decisions. It is in the public interest that auditors complete the audit engagement to report on the financial statements of listed entities when they have been appointed unless there are good reasons why they cannot continue. Audit committees should only remove auditors in extreme situations, for example, when auditors are in breach of ethical requirements or unable to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements.

5.3.2 Audit committees should not remove auditors to avoid a qualified opinion on the financial statements since this may go against the interests of the shareholders and investing public in hearing the auditors' views.

5.3.3 If the audit committee is not satisfied with the quality of the audit provided by the audit firm, the committee should consider not reappointing the incumbent auditor at the next general meeting when its term expires except in extreme circumstances. Removing an auditor at a late stage may harm shareholders, by delaying result announcements and risking a suspension of trading. If there are genuine audit quality issues, the audit committee should raise them with the auditor in an attempt to have them addressed.

5.3.4 Under Rule 13.88 of the Main Board Listing Rules and Rule 17.100 of the GEM Listing Rules, a listed entity must, at each annual general meeting, appoint an auditor to hold office from the conclusion of that meeting until the next annual general meeting. The listed entity must not remove its auditor before the end of the auditor's term of office without first obtaining approval from shareholders at a general meeting. It must send a circular proposing the removal of the auditor to shareholders with any written representations from the auditor, not less than 10 business days before the general meeting. An issuer must allow the auditor to attend the general meeting and make written and/or verbal representations to shareholders at the general meeting.

Section 6 DISCLOSURES IN THE CORPORATE GOVERNANCE REPORT

6.1 Under Paragraph E(d)(i) of Mandatory Disclosure Requirements of the Corporate Governance Code, a listed entity is required to disclose in the Corporate Governance Report how the audit committee fulfilled its responsibilities in the following areas:

- Review of the quarterly, half-yearly and annual results of the listed entity;
- Review of the risk management and internal control system, and the effectiveness of the internal audit function of the listed entity; and
- Other duties under the Corporate Governance Code issued by the Hong Kong Stock Exchange.

6.2 Currently, listed entities provide limited disclosures on how audit committees discharges their responsibilities regarding the selection, appointment and reappointment of auditors. While there are no disclosure requirements under the Listing Rules in this respect, listed entities are strongly encouraged to provide informative summaries of the relevant work carried out and factors considered in their Corporate Governance Reports. These disclosures not only enhance the transparency of audit committees' work, but also demonstrate the openness and accountability of the boards of listed entities.

6.3 The disclosures should have the following characteristics:

- Be entity-specific rather than boiler-plate;
- Describe in detail the actions taken by the board and/or the audit committee instead of listing the normal functions as stated in the terms of reference; and
- Provide explanations for the decisions or judgements made by the board and/or the audit committee.

<u>For selection and appointment of a new auditor</u>

6.4 When a listed entity appoints a new auditor, stakeholders are interested in the reasons and selection criteria underlying the appointment. In such circumstances, the disclosures in the Corporate Governance Report should include the following:

- Reasons for the change in auditors;
- The selection process of the new auditor (e.g., audit tendering or any other processes);
- Selection criteria and the basis for the decision;

- A statement that the audit committee has considered all relationships (including provision of non-audit services) between the listed entity and the new auditor when assessing the independence and objectivity of the new auditor; and
- If the board does not accept the audit committee's recommendation, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different view[18].

For reappointment of the incumbent auditor

6.5 When a listed entity reappoints an incumbent auditor, stakeholders are interested in how the audit committee has evaluated the auditor's performance. In such circumstances, the disclosures in the Corporate Governance Report should include:

- An explanation of how the audit committee has challenged and assessed the effectiveness of the incumbent auditor, in particular in handling key audit issues;
- The evaluation process and the factors considered by the audit committee in the process;
- The basis for the audit committee's decisions on the reappointment;
- The length of tenure of the incumbent auditor; and for how long the audit engagement partner has held the role and the succession planning if the partner is due for rotation;
- A statement that the audit committee has considered all relationships (including provision of non-audit services and long-term audit relationship if applicable) between the listed entity and the incumbent auditor when assessing the independence and objectivity of the incumbent auditor; and
- If the board does not accept the audit committee's recommendation, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different view[19].

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[18] Code provision D3.5 of the Corporate Governance Code

[19] See footnote 18 above

Section 7 LOOKING AHEAD

7.1 There is no doubt that audit committees play an extremely important role in supporting audit quality through their monitoring of financial reporting processes and related internal control systems, reviewing financial information and overseeing the relationship with the external auditors.

7.2 As the first instalment in a series of guidelines for audit committees, this publication aims to provide practical guidelines for audit committees in the process of selecting, appointing and reappointing the most suitable auditor based on its ability to perform a high-quality audit and enhance users' confidence in the quality of the listed entity's financial reporting. The FRC plans to issue more guidelines for audit committees in discharging their responsibilities more effectively, as well as promoting and supporting audit and financial reporting quality. Among the upcoming publications are guidelines on *Assessing Auditor Independence and Objectivity and Review of Significant Financial Reporting Issues and Judgements*.

7.3 Audit committees are expected to put these guidelines into practice. The FRC will collaborate with other regulators to promote the active adoption of these guidelines by audit committees, in addition to monitoring the implementation by listed entities.

7.4 Moreover, the FRC will be engaging audit committees and other stakeholders in relation to these guidelines by organising and participating in seminars and education sessions, since it is vital to do so in enhancing the quality of financial reporting and auditing to support Hong Kong's status as an international financial centre.

7.5 As more experience is gathered from the FRC's inspection and investigation functions, the FRC will continue to provide feedback to stakeholders on common audit deficiencies to prevent such issues from recurring. These guidelines should enable audit committees to question their auditors on how they are addressing such issues in seeking to perform high-quality audits.

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