



## **Annual Investigation and Compliance Report**

**3 November 2021**

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## 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.

To learn more <https://www.frc.org.hk> or follow us on LinkedIn.

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## Foreword from the Chief Executive Officer

I am pleased to share with the public our first Annual Investigation and Compliance Report, covering a reporting period of eighteen months to 31 March 2021. The purpose of this report is to alert listed entities and their auditors to the more common examples of non-compliance in listed entity financial statements and misconduct of their auditors that we find or look into in our investigations and enquiries.

By doing so, we aim to educate Boards, audit committees and managements of listed entities and their auditors, thereby avoid recurrence and enhance the quality of financial reporting and audits of listed entities.



This report also provides an overview of the operations of the investigation and enquiry functions of the FRC and a look forward at our plans for the coming year.

The FRC has been conducting enquiries into potential non-compliance in listed entity financial statements, taking action to have any such non-compliances rectified, and conducting investigations into potential misconduct by their auditors, since its inception in 2006. In relation to investigations, we were required to refer any findings of misconduct to the Hong Kong Institute of Certified Public Accountants (**HKICPA**) for consideration of disciplinary action.

Since 1 October 2019, the power to consider and take disciplinary action as a result of our investigations has been transferred to the FRC for cases relating to audits and certain other listed entity engagements completed after that date. This transfer was part of a broader reform implemented from that date to make the FRC the full-fledged regulator of auditors of listed entities in Hong Kong.

We identify matters for enquiry or investigation reactively through market surveillance, including scanning market information and encouraging members of the public and other regulators to report matters to us. We also do so through proactive monitoring of the quality of audits and financial statements of listed entities through the work of our inspection function (new since 1 October 2019) and the work of our enquiry and investigation functions in conducting our financial statements review programme.

During the early part of the reporting period, as a result of staff vacancies due to internal transfers to new functions and the disruptive impact of the COVID-19 pandemic on our own operations and those of the listed entities and their auditors whose work we enquire into and investigate, a backlog in our caseload has developed. This has

continued during the period as new cases continued to come in, some of which have been high profile and required prioritisation. In addition, we successfully implemented our memorandum of understanding (**MoU**) with the Supervision and Evaluation Bureau (**SEB**) of the Ministry of Finance of the People's Republic of China (**PRC**). As a result, in November 2020, we obtained the first batch of the audit working papers located in the Mainland relating to seven investigations with the assistance of the SEB and it was important to prioritise these investigations.

Accordingly, we have taken opportunities to enhance the efficiency of our processes in order to enable us to address the backlog of investigation cases whilst enhancing our ability to respond with agility to new significant public interest cases. For example, we are paying greater attention to the appropriateness of the time given to regulatees and other parties to comply with our requirements. Most respondents are cooperative, but we will not hesitate to take enforcement action when cooperation is not forthcoming.

We also collaborate closely with other regulators. Given the significance of PIEs with operations in the Mainland, we will continue to build on the successful implementation of our MoU with the SEB of the Ministry of Finance of the PRC. We have recently signed new MOUs with the Securities and Futures Commission, Independent Commission Against Corruption, The Stock Exchange of Hong Kong Limited and HKICPA and will work more closely with them and other local regulators on matters of common interest.

#### *Potential and actual non-compliance in listed entity financial statements*

Preparing high quality annual and interim financial statements is first and foremost the responsibility of the Boards, audit committees, managements and professionally qualified accountants of listed entities (**preparers**).

The more common areas of financial reporting where we identify potential and actual non-compliance relate to areas where preparers are required to make significant judgements or estimates. Significant judgments and estimates involve applying complex measurement techniques to assets, liabilities, income and expenses that result from or influenced by complex and often inherently uncertain transactions, other events and conditions.

Such techniques often involve: (i) fair value measurement; or (ii) the assessment of impairment of financial and non-financial assets and cash generating units. Such transactions may involve, for example: (i) business combinations or other changes in equity interests that affect the investor's ability to control or exert significant influence over the investee; (ii) financial instruments or changes in their terms; (iii) exchanges

involving non-financial assets; or (iv) contracts for the provision of goods or services to customers.

### *Potential and actual misconduct by listed entity auditors*

Auditors are responsible for obtaining assurance as to whether the financial statements of listed entities were prepared in accordance with the applicable financial reporting framework and to express their opinion on this in their report. The quality of the auditor's work is affected by the professional competence and independence of the engagement team but also by the effectiveness of the firm's quality assurance policies and procedures. For listed entity audits, these require the firm to appoint an engagement quality control reviewer (**EQCR**) to independently evaluate the important judgments made by the engagement team.

Our investigative work shows that the more common areas of actual or potential auditing irregularities involve: (i) failing to properly conduct the audit to obtain sufficient appropriate audit evidence on which to base their opinion (82%); (ii) failing to exercise appropriate professional skepticism and professional judgement (72%); and (iii) aspects of the audit where preparers are required to make significant judgements and estimates (46%). In addition, in most of our investigation cases (85%), actual or potential auditing irregularities also include failing to perform the engagement quality control review adequately.

### *Our expectations of preparers and auditors*

Both preparers and auditors need to ensure that they identify when the financial statements will need to address significant judgements and estimates. Preparers of financial statements need to make sure that appropriately competent financial reporting resources are available for the proper application of the financial reporting principles in these circumstances. Where necessary, this should include obtaining assistance from or consulting appropriate internal or external experts.

Auditors need to evaluate the risks of material misstatement in these circumstances and ensure that they respond sufficient appropriately to those risks. Such responses should include not only designing and performing sufficient appropriate audit procedures but also ensuring that the engagement team has the necessary technical competence or access to appropriate internal or external experts.

Auditors are also expected to take note of the key findings and observations set out in this report in relation to other common auditing irregularities and take appropriate

actions to make the necessary improvements to ensure that a robust audit approach is in place to deliver high quality audits.

Audit committees of listed entities have responsibility for overseeing management's preparation of the financial statements of listed entities and the auditor's performance of the external audit. The role of the audit committee is therefore crucial to hold managements and auditors to account for playing their roles in identifying and responding appropriately to significant judgments and estimates and responding appropriately to avoid other common non-compliances and auditing irregularities. They should explicitly address with both managements and auditors the adequacy of their competency to address the identified significant judgements and estimates and their need for internal or external experts.

### *Stakeholder engagement*

Transparency of our operations and the progress and outcome of our work contributes to the achievement of our mission and supports public trust in our work. Following publication of this report, we plan to conduct outreach activities with key stakeholders to further communicate our findings and our expectations of audit firm regulatees and listed entities.

We will continue to enhance our processes and procedures to enable us to discharge our statutory duty efficiently and effectively to maintain public trust in our work.

Marek Grabowski  
Chief Executive Officer

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## Section 1

### Introduction

#### 1.1 Purpose of this report

1.1.1 The purpose of this report is to share findings and observations arising from our work to alert listed entities and their auditors to common examples of misconduct and financial reporting non-compliances found or being investigated in our work. By doing so, we aim to educate auditors and Boards, audit committees and management of listed entities about these matters and thereby to avoid recurrence and enhance the quality of financial reporting and audit. This report also provides an overview of the operations of the investigation and enquiry functions of the FRC.

1.1.2 The report includes:

- (a) An overview of the remit and powers, the work processes and the oversight mechanism of the investigation and enquiry functions (section 2 and Appendix);
- (b) A review of the progress of our work in the period in obtaining and handling evidence of potential misconduct and non-compliances and conducting investigations and enquiries (section 3);

We detect potential misconduct and non-compliances through our proactive and reactive market monitoring. We encourage and respond to complaints from members of the public, whistleblower reports and referrals by other regulators (reactive). We also monitor announcements by listed entities and other public sources of information and comments on financial reports and audits of listed entities (proactive). In addition, our proactive inspection function and our proactive financial statements review programme are designed to detect potential misconduct and non-compliances.

- (c) A summary of non-compliances with accounting requirements (section 4) and key findings and observations on auditing irregularities (section 5); and
- (d) Highlights of key aspects of our plans to further strengthen our investigation and enquiry functions in the coming year (section 6).

## **1.2 Expectations and roles of listed entities, auditors and audit committees of listed entities**

- 1.2.1 High quality financial reporting by Hong Kong's listed entities is key to maintaining Hong Kong's status as a leading International Financial Centre and as the leading international capital market for IPO fundraising. The primary responsibility for high quality financial reporting rests with the boards of directors, managements and the financial reporting officers of listed entities. Their audit committees and their auditors also play important roles in safeguarding the integrity of financial reporting.
- 1.2.2 High quality financial statements give a "true and fair view" of the financial performance and position of a listed entity. This requires the financial statements to faithfully represent the effects of transactions, other events and conditions on the listed entity's financial resources during the reporting period in accordance with the applicable financial reporting standards. True and fair financial statements provide financial information that is suitable for use by investors and other stakeholders in the financial market to make investment decisions. This includes decision they make in evaluating the directors' and management's stewardship of the financial resources entrusted to the listed entity.
- 1.2.3 Audit committees of listed entities have responsibility on behalf of the Board for overseeing the financial reporting process, internal control systems, risk management systems and internal and external audit functions. Audit Committees should monitor the quality of internal reporting by management of listed entities, evaluate the performance of the external auditors in delivering a high quality audit and report any findings to the Board of listed entities.
- 1.2.4 Auditors are responsible for obtaining assurance as to whether the financial statements of listed entities were prepared in accordance with the applicable financial reporting standards and to express their opinion on this in their report. The quality of their work and the confidence that investors may have in it is affected by their professional competence and independence. It is important that auditors communicate transparently with the audit committee and the Board of listed entities about all aspects of their audit.
- 1.2.5 Successfully upholding the quality of financial reporting by listed entities depends on the performance of these three groups of players in the financial reporting ecosystem. It is important that listed entities have competent financial management with the appropriate financial reporting experience and knowledge to prepare high quality financial statements. It is therefore important that Boards of listed entities ensure that their financial reporting management are professionally competent and properly resourced and that they appoint audit committee members with the right mix of knowledge and experience, including financial competence, to play the committee's all-important oversight role. It is important that audit committees play their role effectively in overseeing the financial reporting process and audit. It is also important that

auditors perform their audits properly in accordance with applicable professional standards.

- 1.2.6 Boards, management and audit committees of listed entities are expected to take note of the key findings and observations in respect of financial reporting non-compliances, and listed entity auditors and audit committees to take note of those relating to auditing irregularities, set out in this report and to take appropriate actions to avoid these matters arising in their financial reporting processes and audits.

### 1.3 Operations statistics

This report covers the period of 18 months from 1 October 2019 to 31 March 2021 (**the reporting period**). The preceding period covers nine months period ended 30 September 2019. All other periods presented cover a 12 month period. The change in length of these periods results from the change in our financial year end to 31 March under the new regulatory regime introduced from 1 October 2019.

**Table A: Five years summary of complaints and other reports of potential misconduct or non-compliance (Reports)**

|  | October<br>2019 to<br>March<br>2021<br>(18 months) | January to<br>September<br>2019<br>(9 months) | 2018 | 2017 | 2016 |
|--|--|---|------|------|------|
| <b>Financial statements reviews</b>      |  |   |      |      |      |
| Opening (In progress)                    | 39   | 31  | 25   | 12   | 23   |
| Financial statements selected for review | 62   | 47  | 50   | 48   | 38   |
| Cases <sup>1</sup> initiated             | (4)  | (5)   | (9)  | (2)  | (4)  |
| Advice letter issued                     | (37)   | (10)  | (21) | (7)  | (10) |
| Closed without further action            | (30)   | (24)  | (14) | (26) | (35) |
| Closing (In progress)                    | 30   | 39  | 31   | 25   | 12   |

<sup>1</sup> A case is an investigation or enquiry.

|   | October<br>2019 to<br>March<br>2021<br>(18 months) | January to<br>September<br>2019<br>(9 months) | 2018 | 2017  | 2016  |
|---|--|---|------|-------|-------|
| <b>Reports of matters</b>   |  |   |      |       |       |
| Opening (pursuable <sup>2</sup> )   | 23   | 11  | 14   | 14    | 24    |
| Reports <sup>3</sup> received   | 67   | 48  | 85   | 126   | 118   |
| Cases <sup>1</sup> initiated  | (19)   | (6)   | (9)  | (12)  | (11)  |
| Advice letter issued  | (2)  | -   | -    | -     | -     |
| Referred to specified<br>enforcement agencies   | -  | (1)   | (36) | (104) | (4)   |
| Closed without further<br>action  | (40)   | (29)  | (43) | (10)  | (113) |
| Closing (pursuable)   | 29   | 23  | 11   | 14    | 14    |
| <b>Investigations</b>   |  |   |      |       |       |
| Opening (In progress)   | 42   | 43  | 40   | 37    | 30    |
| Initiated   | 23   | 11  | 19   | 14    | 18    |
| Referred to the Hong<br>Kong Institute of Certified<br>Public Accountants<br>(HKICPA) | (7)  | (12)  | (16) | (11)  | (11)  |
| Closing (In progress)   | 58   | 42  | 43   | 40    | 37    |

<sup>1</sup> A case is an investigation or enquiry.

<sup>2</sup> Reports are not pursuable if the subject matter of the reports is outside the remit of the FRC.

<sup>3</sup> These include complaints received from members of the public, whistleblower reports and referrals from other regulators.

| <b><i>Enquiries</i></b>                     |   |     |     |   |     |
|---|---|-----|-----|---|-----|
| Opening (In progress)                       | 1 | 3   | 2   | 2 | 2   |
| Initiated                                   | 2 | 1   | 2   | - | 1   |
| Non-compliance removed                      | - | (2) | (1) | - | (1) |
| Non-compliance not yet removed <sup>4</sup> | - | (1) | -   | - | -   |
| Closing (In progress)                       | 3 | 1   | 3   | 2 | 2   |

<sup>4</sup> Issued notice to remove the non-compliance, however the subject entity subsequently delisted and non-compliance not being removed.

## Section 2

### Overview of operations

#### 2.1 Introduction

- 2.1.1 The FRC has had the statutory power to investigate possible misconduct committed by public interest entity (**PIE**) auditors or reporting accountants and to enquire into possible non-compliance with accounting requirements in the financial reports of PIEs since its establishment in 2006.
- 2.1.2 Upon the commencement of the Financial Reporting Council (Amendment) Ordinance 2019 (**2019 Amendment Ordinance**) on 1 October 2019, the FRC has become the full-fledged independent oversight body to regulate PIE auditors through a system of registration and recognition, and through inspection, investigation and disciplinary action (**New Regime**).
- 2.1.3 Both investigation and enquiry are important FRC regulatory functions:
- (a) Investigations ensure that potential misconduct on the part of PIE auditors and registered responsible persons detected through our reactive and proactive monitoring activities (see paragraph 1.1.2(b)) are responded to timely and adequately so that appropriate follow-up action can be taken through our disciplinary function or referral can be made to the HKICPA for audit engagements completed before 1 October 2019 (**Old Regime**). Such follow-up action may include the imposition of sanctions or referral to other regulators or law enforcement agencies for conduct falling within their remit.
  - (b) Enquiries ensure that potential non-compliance with financial reporting requirements in the financial reports of PIEs identified are rectified timely and appropriately so that investors and other stakeholders are not misled by misstatements contained in financial reports of PIEs.
- 2.1.4 Details of the remit and powers of the investigation and enquiry functions are set out in the Appendix.

## 2.2 Acquiring intelligence about potential misconduct or non-compliance

2.2.1 The FRC aims to acquire intelligence about potential misconduct or non-compliance through conducting market surveillance and market monitoring activities. The FRC may do so:

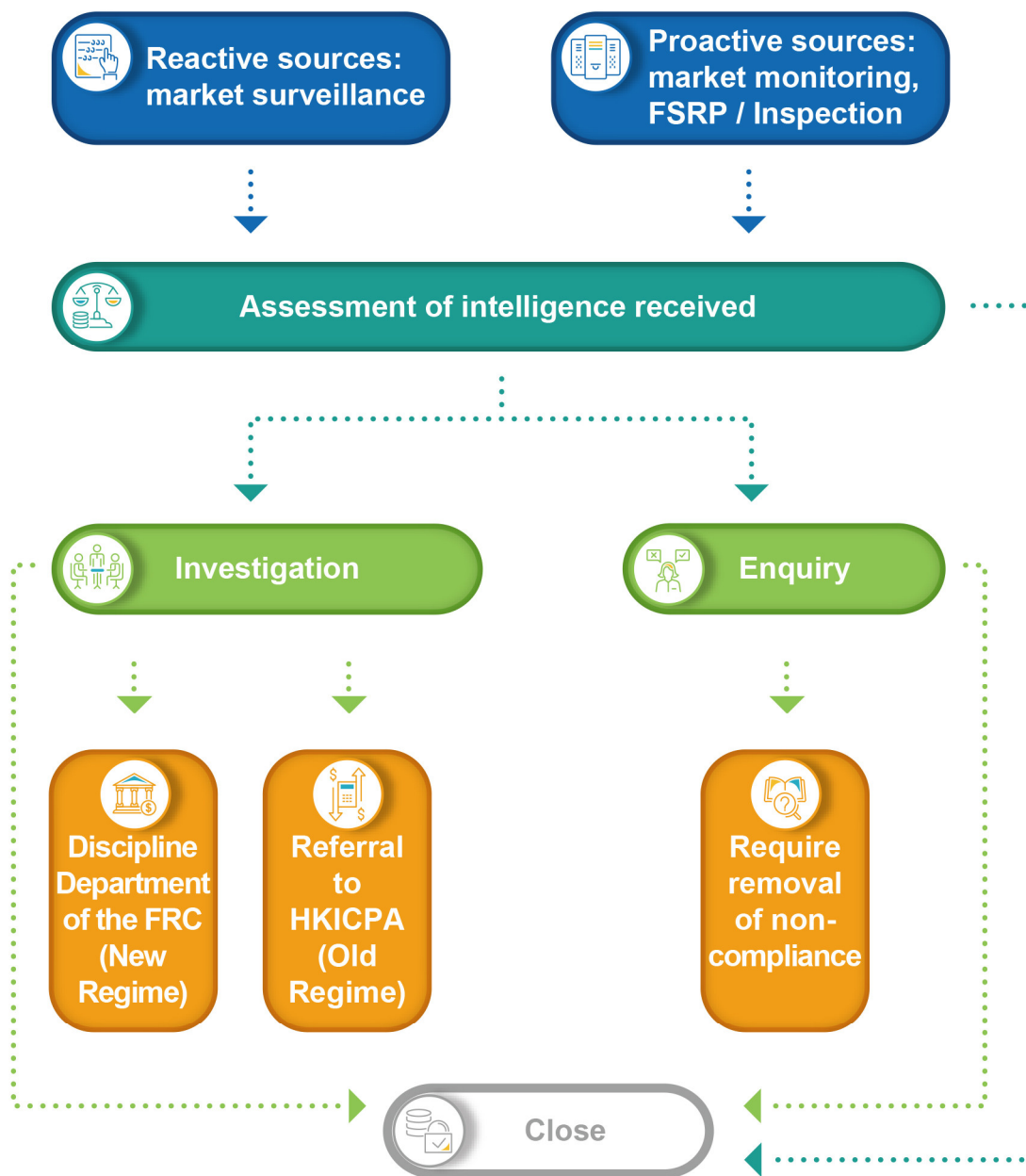
- (a) Reactively, through market surveillance activities that encourage and/or scan for complaints, reports and referrals of misconduct or non-compliance (**allegations**) from:
  - (i) members of the public;
  - (ii) whistleblowers; and
  - (iii) other regulators; or
- (b) Proactively, through our risk-based market monitoring activities:
  - (i) Inspections of PIE auditors (see our most recent annual Inspection Report); and,
  - (ii) Reviews of financial statements of PIEs under the Financial Statements Review Programme (**FSRP**) (see section 3.2).

The FRC provides a platform for members of the public and whistleblowers to make complaints or provide information about possible misconduct or non-compliance they are aware of.

## 2.3 Processes

2.3.1 A high-level overview of the process in handling complaints and other intelligence about potential misconduct or non-compliance and in conducting cases, i.e. investigations or enquiries, is set out in the diagram below.

**Diagram 1 – Overview of our process**



**Oversight**  
The Investigation and Compliance Committee oversees and the Process Review Panel reviews the handling of cases by the FRC (see section 2.4 below).



### *Reactive and proactive sources of intelligence*

- 2.3.2 The FRC may initiate an investigation or an enquiry based on reactive or proactive sources of intelligence (see paragraph 2.2.1 above).

### *Initial assessment*

- 2.3.3 In response to intelligence acquired from reactive sources, initial assessment will be conducted to determine whether there are pursuable potential allegations of misconduct or non-compliance, i.e. whether there are potential allegations that are within the remit of the FRC. When the potential allegations fall outside the remit of the FRC, the intelligence is not pursuable and will not be taken further but may be referred to another appropriate authority if within their remit.

### *Further assessment of allegations*

- 2.3.4 For intelligence acquired from proactive sources and intelligence acquired from reactive sources for which there are pursuable allegations, an assessment is conducted of the intelligence acquired and all publicly available information which may include the relevant financial statements. In addition, the FRC may seek to acquire further information proactively from other sources.

For example, if considered necessary, the FRC may request information from the listed entity, the auditor or any other relevant party. The purpose of the assessment is to identify potential allegations of potential misconduct or non-compliance and whether the evidence acquired meets the statutory thresholds for initiating an enquiry or investigation.

- 2.3.5 When the evidence acquired meets the statutory thresholds, the FRC will initiate an investigation or an enquiry. Otherwise, the FRC will not pursue the case further. However, the FRC may issue a letter of advice to the PIE and/or its auditor to highlight certain issues identified based on the evidence obtained and to suggest improvements for the preparation of future financial statements or the performance of future audits.

### *Investigation / Enquiry*

- 2.3.6 The FRC exercises the powers under the Financial Reporting Council Ordinance Cap 588 (**FRCO**) to conduct an investigation or an enquiry. This includes powers to obtain records, documents, explanations or any other information from relevant parties through issuing requirements. Applications for an extension to comply with a requirement will only be granted if made on reasonable grounds.
- 2.3.7 A report on an investigation or an enquiry is prepared to set out the potential allegations under investigation or enquiry and our analysis and findings.

Persons named in the report are provided with a reasonable opportunity of being heard before the report is adopted by the FRC.

- 2.3.8 The FRC may close the case if the potential allegations of misconduct or non-compliance with accounting requirements is not substantiated by the evidence obtained, or refer the matter to another appropriate regulatory body or law enforcement agency if applicable.

#### *Removal of non-compliance*

- 2.3.9 When an enquiry concludes that there is a non-compliance, the FRC may give a notice to the PIE concerned to remove the non-compliance in the manner and within a period as specified in the notice.
- 2.3.10 If the PIE does not remove the relevant non-compliance within the specified period, the FRC may apply to the Court of First Instance for an order requiring directors of the PIE to cause the relevant non-compliance to be removed.

#### *Disciplinary*

- 2.3.11 For investigation cases involving audits of PIE engagements completed before 1 October 2019 (**Old Regime**), the investigation findings will be referred to the Hong Kong Institute of Certified Public Accountants (**HKICPA**) for consideration of appropriate follow-up actions.
- 2.3.12 For investigation cases involving audits of PIE engagements completed on or after 1 October 2019 (**New Regime**), the investigation findings will be referred to the FRC's Department of Discipline. Where there is sufficient evidence of misconduct, the Department of Discipline will consider whether the FRC should impose disciplinary sanctions on the relevant PIE auditor and/or registered responsible person.

## **2.4 Oversight**

#### *Investigation and Compliance Committee (the ICC)*

- 2.4.1 The ICC is a committee set up by the FRC under the FRCO comprising Board members and Honorary Advisers. The ICC advises the FRC Board on matters concerning the investigation and enquiry functions and related activities to acquire and assess intelligence and obtain information about potential allegations of misconduct or non-compliance. It also provides advice on the development of strategies, guidelines and procedures and in setting selection criteria for the FSRP.
- 2.4.2 In addition, the ICC performs an annual review (both procedural and substantive) of the performance of the handling processes for the reactive and proactive sources of allegations. The ICC selects for review completed cases

which are closed without further action, using a set of selection criteria which is set annually by the ICC (**the ICC review programme**). The ICC reports their findings and recommendations to the FRC Board.

2.4.3 The scope of the ICC review programme covers assessment on the following:

- (i) compliance with internal procedures in handling the completed cases as contained in the operations manual (procedural review); and
- (ii) reasonableness of the justification for closing the case without further action with reference to financial reporting standards, auditing and assurance standards, other relevant financial reporting guidelines and statutory disclosure requirements (substantive review).

2.4.4 The ICC has completed its first review cycle under the ICC review programme covering the period from 1 October 2019 to 31 March 2021. The ICC selected 15 out of 105 completed cases of complaints, whistleblower reports, referrals and financial statements reviews that were closed without further action to review. The ICC concluded that all the selected cases had been handled in accordance with the operations manual and the decisions to close the case without further action were reasonable.

#### *Process Review Panel*

2.4.5 The Process Review Panel (**the PRP**) for the FRC is an independent non-statutory panel established by the Chief Executive of the HKSAR in 2008 to review cases handled by the FRC and to consider whether actions taken by the FRC are consistent with its internal procedures and guidelines.

2.4.6 On 10 May 2021, the PRP published its 2020 annual report which covers its review of seven out of 91 cases handled by the investigation and enquiry functions in 2019. The PRP concluded that the FRC had handled its cases in accordance with its internal procedures. The PRP also recommended the FRC to continue its efforts in expediting the handling of investigation cases in a bid to clear the existing backlog. The investigation function has taken actions to expedite the process of handling cases (see paragraph 3.4.2 below)

## **2.5 Cooperation with other regulators**

### *Hong Kong*

2.5.1 Over the years, the FRC has been fostering effective collaboration with the regulatory and professional bodies in Hong Kong, including the Securities and Futures Commission (**SFC**), The Stock Exchange of Hong Kong Limited (**SEHK**) and the HKICPA through signing memoranda of understanding with an aim of enhancing investor protection. The investigation and enquiry

functions work with these bodies through regular liaison meetings, cross-referrals and sharing knowledge and information of common interest.

#### *Mainland China*

- 2.5.2 Mainland enterprises comprise H share companies, red chip companies and Mainland private enterprises. They represent a significant proportion of all listed entities in Hong Kong (around 52% by number and 80% by market capitalisation). For effective regulation of these listed entities, it is important to develop a strategic relationship with Mainland authorities, in particular the Supervision and Evaluation Bureau (**SEB**) of the Ministry of Finance of the People's Republic of China (**MoF**).
- 2.5.3 On 22 May 2019, the FRC and SEB signed a Memorandum of Understanding (**the MoU**) which marked a new page of collaboration and extended the FRC's cross-boundary auditor regulatory functions. The scope of cooperation under the MoU is the regulation of the audit profession within the respective remits of the parties.
- 2.5.4 The MoU facilitates our ability to gain access for our investigation function to audit working papers located in the Mainland with the assistance of the SEB through an effective mechanism and clear procedures, thereby enhancing the FRC's efficiency in discharging its duties in respect of investigations.
- 2.5.5 Details and progress of the requests for assistance of the SEB in relation to investigation cases are set out in paragraph 3.4.3 of this report.

## Section 3

### OUR WORK OF THE PERIOD

#### 3.1 Introduction

- 3.1.1** This section provides a review of our work of the reporting period in relation to the FSRP, the acquisition and assessment of intelligence about potential allegations of misconduct or non-compliance, and the initiation and conduct of investigations and enquiries.

#### 3.2 Financial statements review programme

##### 3.2.1 Overview

Our FSRP is a non-statutory initiative, which is part of our risk-based market monitoring activities, to monitor the quality of PIE financial reporting. The FRC launched the FSRP in 2011 with the objective of proactively reviewing financial statements of PIEs to identify possible misconduct by PIE auditors or non-compliances with accounting requirements by PIEs.

The scope of a review includes considering whether there is non-compliance with financial reporting standards, auditing and assurance standards, and other relevant financial reporting guidelines (such as accounting requirements under the Listing Rules of the SEHK).

A risk-based approach is adopted to identify and select financial statements for review based on various criteria which are reviewed and set annually and may be updated in response to subsequent changes in the current economic and regulatory environment. The selection criteria for the 2020 cycle addressing financial statements published in 2020 include:

- a. **Significant changes** - companies undergoing significant changes in business activities, financial position or results. These changes may give rise to increased risk of material misstatements in financial statements based on our experience of previous cycles;
- b. **Market events** – information disclosed by PIEs, short-sellers or media which indicate potential non-compliance and/or misconduct;
- c. **Prior year adjustments** - financial statements with significant prior period adjustments other than those reflecting a change in accounting policy or resulting from an adoption of newly introduced financial reporting standards, which may indicate possible misstatements in a prior period's financial statements and/or that the audit opinion(s) given in prior period(s) may not have been appropriate;

- d. **Modified auditor's report** - financial statements with modified auditor's report which indicate that the financial statements may be materially misstated; and
- e. **Delayed results** - delay of results announcement due to COVID-19 which indicate that the PIE's financial reporting process and/or audit might be adversely affected by COVID-19.

In addition, financial statements of PIEs prepared under Chinese Accounting Standards for Business Enterprises are also selected for review.

### 3.2.2 Key operations statistics about the FSRP

**Table B: Financial statements selected for review**

The number and percentage of financial statements selected for review under the different selection criteria are as follows:

|                                | 2020 cycle | 2019 cycle |
|--------------------------------|------------|------------|
| Significant changes            | 19 (39%)   | 9 (24%)    |
| Market events                  | 11 (22%)   | 2 (5%)     |
| Prior year adjustments         | 5 (10%)    | 1 (3%)     |
| Modified auditor's report      | 4 (9%)     | 2 (5%)     |
| Delayed results                | 10 (20%)   | -          |
| Complex valuations*            | N/A        | 9 (24%)    |
| Complex fund raising*          | N/A        | 4 (10%)    |
| Merger & Acquisition activity* | N/A        | 11 (29%)   |

\* These criteria often reflect significant changes to the operations and business activities of the PIE. Therefore, for the 2020 cycle, these criteria were not separately applied as they would be covered by the criterion on "significant changes".

**Table C: Movements in financial statements reviews**

|   | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|---|----------------------------------|--------------------------------------|
| Brought forward                             | 39                               | 31                                   |
| Financial statements selected for review    | 62                               | 47                                   |
| Completed with no follow-up action          | (67)                             | (34)                                 |
| Initiated investigations or enquiries       | (4)                              | (5)                                  |
| <b>In progress at the end of the period</b> | <b>30</b>                        | <b>39</b>                            |

A review of the financial statements is completed with no follow-up action when it does not identify a non-compliance or potential misconduct with a significant public interest impact. In situations where non-compliance or misconduct that is not significant is identified, the FRC may issue letters of advice to the PIEs and/or their auditors highlighting the issues and suggesting improvement measures.

### **3.3 Potential allegations of misconduct or non-compliance**

#### **3.3.1 Overview**

The FRC encourages complaints from members of the public, reports from whistleblowers and referrals from other regulatory bodies (informants) which provide intelligence about potential misconduct or non-compliance. When the intelligence received from such informants does not relate to potential allegations of misconduct or non-compliance that fall within the remit of the FRC, it is not considered pursuable and the FRC may direct the informant to other relevant regulatory bodies or refer the matter to such bodies directly.

Every pursuable potential allegation of misconduct or non-compliance identified from these channels or from our FSRP or Inspection function is evaluated to determine whether to initiate an investigation or an enquiry. Pursuable matters are closed with no follow-up action when the evidence obtained does not meet the statutory thresholds for initiating an investigation or enquiry or if the allegations would not have a significant public interest impact, based on our evaluation.

#### **3.3.2 Evidence provided by informants**

It is important that an informant provides information that is accurate and sufficient for the FRC to identify and assess the potential allegations. The information should include:

- (i) The name of the PIE auditor, registered responsible person and/or the listed entity that are relevant in the circumstances;
- (ii) Specific details of the conditions, events or circumstances indicating the potential misconduct or non-compliance including, where relevant, details of the dates and parties involved should also be provided; and
- (iii) Copies of any relevant documents providing evidence in support of the allegations.

Where the intelligence provided by an informant is not sufficient to initiate an investigation or enquiry into potential allegations of misconduct or non-compliance, the FRC may not be able to pursue the potential allegations.



We welcome such intelligence sources that are anonymous and the FRCO (section 52) provides statutory protection for the informants, including confidentiality of their identity if disclosed. However, informants are encouraged to provide contact details to enable the FRC to follow up or clarify information received or to obtain further information if considered necessary.

### 3.3.3 Key operations statistics relating to matters reported by informants

During the reporting period, we received 77 reports of matters by informants, of which 67 related to pursuable allegations, and the remaining 10 related to matters outside the remit of the FRC. We completed the assessment of 61 reports relating to pursuable allegations, of which 42 were completed with no follow-up action. Investigations or enquiries were initiated in respect of the remaining 19 reports. As at 31 March 2021, 29 reports relating to pursuable allegations received were still being assessed.

*Table D: Movements in reports by informers*

|   | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|---|----------------------------------|--------------------------------------|
| Brought forward                                 | 23                               | 11                                   |
| Reports received                                | 77                               | 55                                   |
| Non-pursuable matters <sup>5</sup>              | (10)                             | (7)                                  |
| Reports of pursuable allegations<br>received    | 67                               | 48                                   |
| Completed with no follow-up action              | (42)                             | (29)                                 |
| Referred to specified enforcement<br>agencies   | -                                | (1)                                  |
| Initiated investigations or enquiries           | (19)                             | (6)                                  |
| <b>In progress at the end of the<br/>period</b> | <b>29</b>                        | <b>23</b>                            |

<sup>5</sup> The subject matters of these reports are outside the remit of the FRC.



**Table E: Sources of matters reported**

|  | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|--|----------------------------------|--------------------------------------|
| Members of the public*                     | 34                               | 37                                   |
| Whistleblowers                             | 18                               | 4                                    |
| Other regulators                           |                                  |                                      |
| ▪ Hong Kong Exchanges and Clearing Limited | 12                               | 10                                   |
| ▪ SFC                                      | 5                                | 1                                    |
| ▪ HKICPA                                   | 4                                | 3                                    |
| ▪ Commercial Crime Bureau                  | 4                                | -                                    |
| <b>Total</b>                               | <b>77</b>                        | <b>55</b>                            |

\* Including 10 non-pursuable reports (2019: seven)

There has been an increase in pursuable reports from whistleblowers during the reporting period. Whistleblowers raised allegations of potential auditing misconduct or non-compliance and often provided insider information to enable us to further pursue the matters raised.

**Table F: Category<sup>6</sup> of PIE auditors in pursuable reports**

|                          | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|--------------------------|----------------------------------|--------------------------------------|
| Category A firms         | 38                               | 33                                   |
| Category B firms         | 20                               | 14                                   |
| Category C firms         | 9                                | 3                                    |
| Overseas firms           | 1                                | -                                    |
| <b>Total<sup>#</sup></b> | <b>68</b>                        | <b>50</b>                            |

<sup>#</sup> A report may involve more than one auditor and therefore the total number shown above is higher than the total number of pursuable reports as disclosed in Table D above.

<sup>6</sup> PIE auditors are categorised into four types: Category A firms (with >100 PIE audits), Category B firms (with 10 to 100 PIE audits), Category C firms (with less than 10 PIE audits) and Overseas firms (i.e. non-Hong Kong firms).

## 3.4 Investigations

### 3.4.1 Overview

When potential misconduct by PIE auditors is identified through evaluation of matters reported or review of financial statements under the FSRP, the FRC may initiate an investigation into the possible misconduct under the FRCO.

### 3.4.2 Key operations statistics about investigations

During the reporting period, the FRC handled 42 investigations brought forward from 2019 and 23 new investigations that were initiated in the period. Seven of these investigations were completed and referred to the HKICPA for consideration of any disciplinary or other actions, as they related to audits of PIE engagements under the Old Regime.

**Table G: Movements in investigations**

|   | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|---|----------------------------------|--------------------------------------|
| In progress at the beginning of the period  | 42                               | 43                                   |
| Initiated in the period                     | 23                               | 11                                   |
| Handled during the period                   | 65                               | 54                                   |
| Completed during the period                 | (7)                              | (12)                                 |
| <b>In progress at the end of the period</b> | <b>58</b>                        | <b>42</b>                            |
| Old Regime                                  | 56                               | 42                                   |
| New Regime                                  | 2                                | -                                    |
|   | <b>58</b>                        | <b>42</b>                            |

The investigations initiated during the reporting period included the above two investigations under the New Regime.

The allegations of potential misconduct in the 23 investigation cases initiated in the reporting period relate to auditing irregularities in the following areas:

- (a) Professional skepticism and professional judgement;
- (b) Sufficient appropriate audit evidence;
- (c) Auditing accounting estimates;
- (d) Using the work of an auditor's expert;
- (e) Assessing the risks of material misstatement;
- (f) Related party transactions;

(g) Engagement quality control review.

During the reporting period, there were staff vacancies in the Department of Investigation and Compliance due to internal transfer to new functions and disruptive impact of the COVID-19 pandemic on our operations and those of our regulatees and PIEs. These resulted in fewer investigation cases being completed in the reporting period as compared to the previous period. With a similar level of complaints received and investigations initiated, a backlog of cases has developed. We have taken opportunities to enhance the efficiency of our processes in order to enable us to address the backlog of investigation cases whilst enhancing our ability to respond with agility to new significant public interest cases.

For example, we are paying greater attention to the appropriateness of the time given to regulatees and other parties to comply with our requirements to provide information, attend interviews or review the findings of our investigations and enquiries. Requests for extension of the deadline to comply with our requirements will only be granted if made on reasonable grounds. The majority of respondents are cooperative, but we will not hesitate to take enforcement action when such cooperation is not forthcoming. Failure to comply with a requirement without reasonable excuse amounts to an offence under section 31 of the FRCO.

In addition, instead of making requests for the provision of information from relevant parties voluntarily, we are also taking earlier advantage of our statutory powers under the FRCO to initiate an investigation or enquiry and require relevant parties to provide the information to us (see paragraph A1.6 of the Appendix). This enables us to control the process of obtaining the information we need for our investigations more effectively.

**Table H: Category of PIE auditors involved in investigations outstanding at the end of the period**

|                  | As at<br>31 March 2021 | As at<br>30 September<br>2019 |
|------------------|------------------------|-------------------------------|
| Category A firms | 27 (46.5%)             | 26 (61.9%)                    |
| Category B firms | 20 (34.5%)             | 12 (28.6%)                    |
| Category C firms | 11 (19.0%)             | 4 (9.5%)                      |
|                  | <b>58 (100%)</b>       | <b>42 (100%)</b>              |

**Table I: Year of initiation of investigations outstanding at the end of the period**

|                       | As at<br>31 March 2021 |                       | As at<br>30 September 2019 |                       |
|-----------------------|------------------------|-----------------------|----------------------------|-----------------------|
|                       | AWP* located in<br>HK  | Mainland <sup>#</sup> | AWP* located in<br>HK      | Mainland <sup>#</sup> |
| 2019/2021 (18 months) | 22                     | 1                     | -                          | -                     |
| 2019 (9 months)       | 10                     | 1                     | 10                         | 1                     |
| 2018                  | 9                      | 3                     | 13                         | 3                     |
| 2017                  | 2                      | 6                     | 3                          | 6                     |
| 2016                  | 2                      | 1                     | 3                          | 1                     |
| 2014                  | -                      | -                     | 1                          | -                     |
| 2013                  | 1                      | -                     | 1                          | -                     |
|                       | <b>46</b>              | <b>12</b>             | <b>31</b>                  | <b>11</b>             |

\* AWP means audit working papers

<sup>#</sup> Further details on the progress of these cases are set out in paragraph 3.4.3

**Table J: Regulatory outcome of referrals to the HKICPA**

During the reporting period, the HKICPA completed regulatory actions in response to 16 investigations that the FRC had completed and referred to them in earlier years (2016 to 2020), as follows:

|  | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|--|----------------------------------|--------------------------------------|
| Resolution by agreement ( <b>RBA</b> ) | 9                                | 1                                    |
| Disciplinary sanctions                 | 6                                | 7                                    |
| Settlement                             | 1                                | -                                    |
|  | <b>16</b>                        | <b>8</b>                             |

For the nine cases completed through RBA and the one case completed by settlement, the relevant parties were publicly reprimanded, ordered to pay an administrative penalty and required to reimburse the costs of the FRC and the HKICPA.

For the six cases with disciplinary sanctions, there were significant allegations and the relevant parties were reprimanded, ordered to pay an administrative penalty ranging from HK\$50,000 to HK\$400,000 and required to reimburse the costs of the FRC and the HKICPA. In four of these cases, the practising certificates of the four engagement partners and two engagement quality

control reviewers were also ordered to be cancelled or not to be issued for a period from six months to three years.

### **3.4.3 Cooperation with SEB regarding audit working papers located in the Mainland**

Under the MoU, we made requests for assistance of the SEB in gaining access to audit working papers located in the Mainland for 12 investigation cases during the reporting period.

With the assistance of the SEB, the FRC obtained the first batch of the audit working papers located in the Mainland which involves seven investigations in late November 2020, despite all the practical challenges brought about by the pandemic situation during the reporting period. We have given priority to these seven cases and two of these cases have been completed as of the date of this report. The remaining five cases are expected to be completed in the coming months and through early 2022.

## **3.5 Enquiries**

### **3.5.1 Overview**

In cases where it appears to the FRC that there might be non-compliance with accounting requirements by a PIE, an enquiry may be initiated to be conducted by either the staff of the FRC or a Financial Reporting Review Committee (**FRRC**) with delegated power from the FRC Board.

Under the FRCO, an FRRC consists of a Panel Convenor who is to be the chairperson of the FRRC and at least four other members of the Financial Reporting Review Panel (**FRRP**) of the FRC. Members of the FRRP are appointed because of their experience in accounting, auditing, finance, banking, law, administration or management, or because of their professional or occupational experience. As at 31 March 2021, the FRRP had 47 members, including nine Convenors.

### **3.5.2 Key operations statistics about enquiries**

During the reporting period, the FRC handled one enquiry case brought forward from the previous period and two cases were initiated during the period.

**Table K: Movements in enquiries**

|   | October 2019<br>to<br>March 2021 | January 2019<br>to<br>September 2019 |
|---|----------------------------------|--------------------------------------|
| In progress at the beginning of<br>the period   | 1                                | 3                                    |
| Initiated in the period                         | 2                                | 1                                    |
| Handled during the period                       | 3                                | 4                                    |
| Completed                                       | -                                | (3)                                  |
| <b>In progress at the end of the<br/>period</b> | <b>3</b>                         | <b>1</b>                             |

The three enquiries in progress were initiated in March 2019, December 2019 and March 2021 respectively. The potential non-compliance with accounting requirements of these enquiries relate to:

- (a) the accounting for financial instruments;
- (b) the measurement of operating rights and standing timbers; and
- (c) the potential understatement of certain borrowings.

## Section 4

### Findings and observations on financial reporting non-compliances

#### 4.1 Introduction

- 4.1.1 This section highlights our findings and observations regarding non-compliance with financial reporting requirements identified in investigations and enquiries completed or handled and during our review of financial statements under the FSRP during the reporting period.
- 4.1.2 For principles-based financial reporting standards to work effectively, preparers of financial statements and their auditors need to understand the purpose and content of the standards sufficiently for appropriate applications to their circumstances. Having the appropriate expertise to be able to apply the applicable financial reporting standards properly, in particular relating to complex transactions and those that require the exercise of significant judgement, is a prerequisite for ensuring the financial statements are properly prepared.

#### 4.2 Earnings per share

- 4.2.1 In an investigation, we found that a listed entity materially overstated the earnings per share due to the understatement of the average number of shares used as the denominator. This understatement occurred because the listed entity failed to appropriately apply special considerations in determining the effect on the average number of shares of a bonus issue and an open offer of shares during the period.
- 4.2.2 The denominator in an earnings per share ratio is a proxy for a standard unit of an entity's capital available to generate profits throughout the period. When new shares are issued part way through the period in exchange for new capital, the new capital only contributes to profit generation for part of the period. Averaging the number of existing and new shares in issue according to their respective periods in issue takes account of the limited contribution the new capital makes to profit in measuring earnings per share.
- 4.2.3 However, if the amount of new capital raised for each new share is not proportionate to the capital relating to each existing share (e.g. a bonus issue), adjustments are required to be applied in measuring the average number of shares (i.e. the denominator) to reflect the difference in the amount of capital raised by the new shares in accordance with Hong Kong Accounting Standard (HKAS) 33 *Earnings Per Share*.

## 4.3 Business combination

### *Fair value measurement*

- 4.3.1 A listed entity issued its own shares as part of the purchase consideration for a business combination. Hong Kong Financial Reporting Standard (**HKFRS**) 3 *Business Combinations* requires the consideration transferred, i.e. the shares issued in this case, to be measured at fair value at the date of the acquisition.
- 4.3.2 HKFRS 13 *Fair Value Measurement* defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available.
- 4.3.3 In view of the requirements under HKFRS 3 and HKFRS 13 as mentioned above, the consideration shares should be measured at the market price of the shares at the date of the acquisition. However, the consideration shares were recognised at the issue price as set out in the sale and purchase agreement in the financial statements.

### *Recognition of identifiable assets acquired*

- 4.3.4 A listed entity acquired all equity interest in an unlisted company that engaged in the operation of solar power stations in the PRC. The unlisted company obtained a 20-year business licence from the relevant authority to operate solar power stations in the PRC.
- 4.3.5 According to HKFRS 3, the listed entity should recognise, separately from goodwill, the identifiable assets acquired in the business combination including intangible assets. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion.
- 4.3.6 The business license was an intangible asset arising from a contractual arrangement. Therefore, it meets the contractual-legal criterion for recognition separately from goodwill. However, the business license was not recognised as an intangible asset acquired arising from the business combination in the financial statements.

## 4.4 Consolidated financial statements

- 4.4.1 HKFRS 10 *Consolidated Financial Statements* establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.



Pursuant to paragraphs 5 to 7 of HKFRS 10, an investor controls an investee if and only if the investor has all the following:

- (a) Power over the investee, i.e. the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns (defined as "relevant activities" in HKFRS 10).
- (b) Exposure, or rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.
- (c) The ability to use its power over the investee to affect the amount of the investor's returns.

- 4.4.2 Under HKFRS 10, the control analysis requires an understanding of all arrangements which govern the way decisions about the relevant activities are made, for example, appointing the key management personnel and approving the business development plan of the investee, and the rights of all investors.
- 4.4.3 The investigation found that a listed entity did not properly carry out a control analysis in relation to an investee in accordance with HKFRS 10.
- 4.4.4 The listed entity established a new investee company with a third party (**the Other Shareholder**) and held a majority shareholding in the investee. The listed entity then injected an existing business carried out by its wholly-owned subsidiary into the investee resulting in a dilution of its interest in the injected business.
- 4.4.5 The listed entity continued to consolidate the results and assets and liabilities of the injected business on the basis of its majority shareholding in the investee and a mutual understanding between the listed entity and the Other Shareholder that the management of the investee was left to the management nominated by the listed entity due to their expertise and connections necessary to operate the injected business.
- 4.4.6 However, the Articles of Association of the investee contained a mechanism which required the agreement of both the listed entity and the Other Shareholder on significant matters in relation to the relevant activities of the investee. The mutual understanding did not constitute a contractual arrangement which would prevent the Other Shareholder from exercising its rights as explicitly set out under the Articles of the investee. As a result, the listed entity did not have unilateral power to make substantive financial and operating decisions in cases where the Other Shareholder opposed the decisions (paragraph 4.4.1(a)).

- 4.4.7 In addition, it was also observed that the expertise and connections of the management was not irreplaceable and thus, did not create an operational barrier or incentive to prevent the Other Shareholder from exercising their veto rights.
- 4.4.8 Based on the observations described on paragraphs 4.4.6 and 4.4.7 above, the listed entity did not have substantive rights that gave it “the current ability to direct” the relevant activities of the investee (paragraph 4.4.1 (a)), and therefore did not have control over the investee. Consequently, the listed entity lost control over the injected business upon the injection of the business into the investee. Therefore, the consolidation of the investee and the injected business in the listed entity’s accounts did not comply with HKFRS 10.
- 4.4.9 When a listed entity loses control of an investee, the listed entity should discontinue the consolidation of the investee and a gain or loss on disposal is recognised in profit or loss. Therefore, the listed entity should have discontinued the consolidation of the injected business and recognised a gain or loss upon injection of the business into the investee.

## **4.5 Intangible assets**

- 4.5.1 A listed entity recognised a sales contract acquired in a business combination as an intangible asset. The sales contract provided a right to sell a specific product in the PRC for a period of one year and would be renewed automatically and unconditionally unless prevented by force majeure or termination of the contract. The sales contract was subsequently renewed for another 18 months at no cost and with all significant terms of the sales contract unchanged.
- 4.5.2 From the acquisition date, the sales contract was amortised over the remaining contractual period of seven months.
- 4.5.3 Our investigation found that the listed entity failed to consider the terms of the sales contract, in particular there was no specific condition or significant cost for renewal, when determining the useful life for the purpose of amortization. Had the management properly considered the contractual terms in assessing the useful life of the intangible asset, it should have been treated as an intangible asset with indefinite useful life after initial recognition.

## 4.6 Financial Instruments

### *Measurement of convertible bonds*

- 4.6.1 A listed entity settled certain financial liabilities by the issuance of convertible bonds. During our investigation, we found that the entity engaged a valuation expert to perform valuations of the convertible bonds as at the dates of issuance. Despite the entity being well aware that there was a difference between the aggregate carrying amounts of the financial liabilities extinguished and the aggregate fair values of the convertible bonds determined by the valuation expert, the entity determined that the aggregate fair value of the convertible bonds issued should be recognised at the same amount as that of the liabilities extinguished, i.e. no gain or loss was recognised.
- 4.6.2 According to HKAS 32 *Financial Instruments: Presentation*, these convertible bonds should have been initially measured at their fair value. Had the convertible bonds been accounted for using the fair value, the difference between the fair value and the carrying amount of the liabilities extinguished would be recognised in profit or loss.

### *Impairment of investment in an equity instrument*

- 4.6.3 A listed entity did not perform a proper impairment assessment of an available-for-sale equity investment in accordance with Hong Kong Accounting Standard 39 *Financial Instruments: recognition and Measurement* (**HKAS 39**) which was applicable at the material time.
- 4.6.4 HKAS 39 requires an entity to recognise an impairment loss on available-for-sale equity instruments if there is objective evidence of impairment. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is an objective evidence of impairment. Either a significant or a prolonged decline is sufficient to require the recognition of an impairment loss. The determination of what constitutes a significant or prolonged decline is a matter of fact that requires the application of judgement.
- 4.6.5 The listed entity's investment was measured at fair value based on the quoted market price of the investee's shares. The investment's fair value as at the end of the reporting period was below its original cost by more than 50% and the investment's fair value was also below its cost for more than twelve months.
- 4.6.6 The decline in the fair value of the investment was both significant and prolonged which provided objective evidence of impairment under HKAS 39. The listed entity however did not record an impairment loss on the Investment in the financial statements.

- 4.6.7 The listed entity developed internal guidance in determining what constituted a prolonged decline but also failed to provide disclosure about the judgement it made in determining the existence of objective evidence in the financial statements in accordance with HKAS 1 (Revised) *Presentation of Financial Statements*.

## 4.7 Impairment of investments

### *Impairment of investments in associates*

- 4.7.1 In two investigation cases, the management failed to properly assess the recoverable amount of their investments in associates for the purpose of impairment assessment. Investments in associates are accounted for using the equity method, i.e. stated initially at cost plus the investor's share of post-acquisition changes in the investee's net assets. After the application of the equity method, the investor is required to determine whether there is any objective evidence that its net investment in the associate is impaired.
- 4.7.2 In both cases, there was objective evidence of impairment which the entities failed to consider, including (a) continuous losses suffered by the associates; (b) significant delay in the launch of a new product experienced by one of the investees; and (c) adverse news on the operations of the associates.
- 4.7.3 For one of the above cases, our investigation revealed that the management failed to perform an impairment assessment in accordance with HKAS 36. Particularly, the management did not properly consider the impact of a number of unfavourable events and circumstances, including delay in the development and commercial release of a new product, on the estimated cash flows of the business for the purpose of impairment assessment.

### *Impairment of investments in subsidiaries*

- 4.7.4 Although inter-company balances within a group would be eliminated in the process of preparing the consolidated financial statements, it does not exempt a parent company from recognising an impairment loss on its interests in subsidiaries, if necessary, when presenting or reporting the parent company's financial position in the consolidated financial statements. Two of our investigations revealed that the management failed to identify objective evidence of impairment including (a) the consolidated net assets value of the group was substantially less than that of the parent's net assets; (b) continuous accumulation of funds was advanced from the listed entity to the subsidiaries without any repayment recorded in two financial years; and (c) the subsidiaries incurred continuous losses and were significantly short of cash and bank balances for repayment of liabilities. As a result, no impairment loss was recognised.

## 4.8 Non-compliances with disclosure requirements

4.8.1 Disclosures provide information necessary for readers of financial statements to understand the financial performance and position, cash flows condition and any risks or uncertainties surrounding the operations of an entity, and to assist them in making informed decisions. During our investigations and review of financial statements under the FSRP during the reporting period, non-compliances with disclosure requirements were identified which are summarised below.

### 4.8.2 HKFRS 15 *Revenue from Contracts with Customers*

- (a) We identified that disclosures relating to the timing of satisfaction of performance obligations and the related judgements were inadequate. For example, an entity disclosed that “*revenue was recognised when a performance obligation is satisfied*”, without disclosing information about when the performance obligation is considered as completed (e.g. upon shipment or delivery).
- (b) We observed that disclosures were not made in relation to (i) significant judgements made in evaluating when a customer obtains control of promised goods or services when performance obligations are satisfied at a point in time, and (ii) the method used to recognise revenue over time with an explanation of why such a method provides a faithful depiction of the transfer of goods or services.
- (c) When disclosing information relating to contract balances, we identified that entities only disclosed a reconciliation of the balances without providing explanations on how the timing of satisfaction of the performance obligations related to the typical timing of payment and the effect that those factors have on the contract asset and contract liability balances. Disclosure of the significant payment terms of the contracts or other relevant information that enable the readers to understand the movement of the balances should be made.
- (d) We also observed inconsistent/ inadequate disclosures relating to the application of practical expedients in HKFRS 15.

### 4.8.3 HKFRS 13 *Fair Value Measurement*

- (a) We observed that certain disclosures were omitted, such as:
  - description of the valuation techniques and the key inputs used in Level 2 and Level 3 fair value measurements;
  - quantitative information about the significant unobservable inputs used in the Level 3 fair value measurement;

- reconciliation of the opening balance to the closing balance for recurring fair value measurements categorised within Level 3 of the fair value hierarchy;
  - description of the valuation processes and policies used by the entities for Level 3 fair value measurement; and
  - sensitivity analysis on changes in the unobservable inputs, e.g. discount rates used in determining the fair value.
- (b) For the disclosures on the significant unobservable inputs used in the Level 3 fair value measurement, sufficient details should be made to allow users of the financial statements to understand and evaluate an entity's valuation technique and the impact of the underlying inputs on the performance and financial position of the entity. For example, for unlisted equity investments, other than stating that the investments were measured using the "income approach", qualitative information on the significant inputs (and the respective sensitivity analysis), including growth rates, margins, discount rates and any other adjustments, should be disclosed.

#### 4.8.4 HKFRS 7 *Financial Instruments: Disclosures*

The disclosure on how an entity has responded to risks arising from financial instruments is another area where we have identified disclosure deficiencies:

- (a) There was a lack of disclosure on how the credit risk for different types of financial assets was managed. In certain cases, only a general description of the credit risk policies that applied to all financial assets was disclosed without disclosing separately the specific risk exposures for financial instruments that were subject to different risk profiles, e.g. financial guarantee contracts, related party balances and other significant receivables etc.
- (b) In relation to disclosures relating to expected credit loss, there was inadequate disclosure on credit risk exposure, credit risk management and sensitivity analysis on significant inputs.
- (c) For liquidity risks disclosure, the maturity analysis of financial liabilities was presented based on discounted contractual cash flows rather than undiscounted contractual cash flows as required under HKFRS 7.

#### 4.8.5 HKFRS 3 *Business Combinations*

- (a) In the cases where the purchase consideration included contingent consideration, there was a lack of description of the details of such arrangement to allow readers to understand the nature and the financial impact of the contingent consideration. The disclosures should also

include the terms of the arrangement, method of valuation and key assumptions applied.

- (b) We noted in several cases when a significant amount of goodwill or gain from bargain purchase was recognised in a business combination, the qualitative description of the factors that make up the goodwill recognised or a description of the reasons why the transaction resulted in a gain was not disclosed.

#### 4.8.6 HKFRS 16 Leases

HKFRS 16 came into effect on 1 January 2019 which introduces extensive disclosure requirements. Disclosure deficiencies were identified in the following areas:

- (a) For lessee: The total cash outflows related to leases should be disclosed. Such disclosures should include cash outflow within:
  - operating cashflow (e.g. expenses related to leases of low-value assets and short-term leases);
  - investing cashflow (e.g. payments for right-of-use assets or additions of leasehold properties); and
  - financing cashflow (e.g. payments of lease liabilities)
- (b) For lessor: The disclosures for assets subject to an operating lease should be made separately from those related to owned assets held and used by the lessor as required by HKAS 16 *Property, plant and equipment*.

The maturity analysis of finance lease receivables should present the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The reconciliation of undiscounted lease payments to the net investment in the lease should identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.



## Section 5

### Findings and observations on auditing irregularities

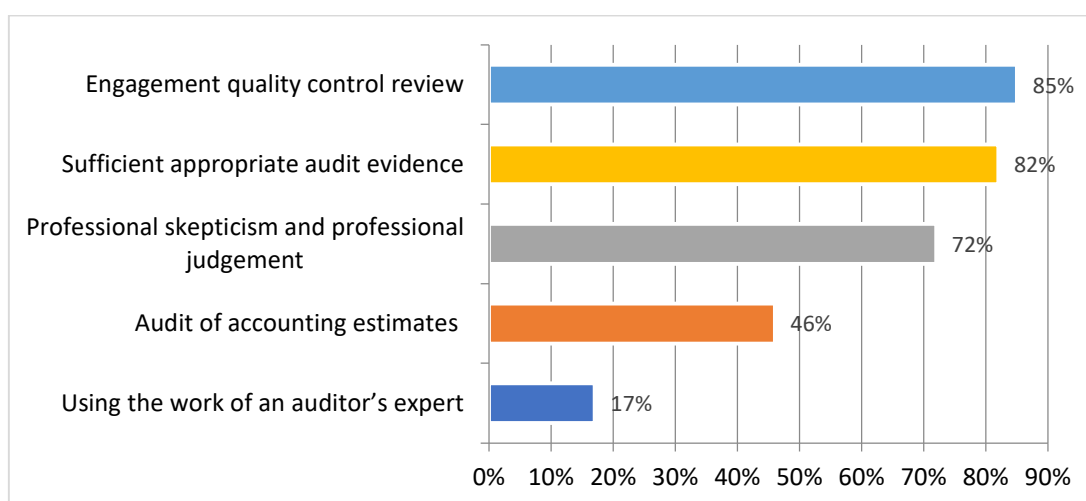
#### 5.1 Introduction

5.1.1 Hong Kong Standard on Auditing (**HKSA**) 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing (HKSA 200)* sets out the overall objectives of the auditor which are to:

- (a) obtain reasonable assurance to enable the auditor to express an opinion about whether the financial statements are prepared materially in accordance with an applicable financial reporting framework; and
- (b) report on the financial statements, and communicate the auditor's findings.

5.1.2 The chart and table below show the most common areas where auditing irregularities or potential irregularities were identified in the seven completed investigations and 58 ongoing investigations handled during the reporting period.

**Chart A: Key areas of auditing irregularities**





**Table L: Detailed nature of auditing irregularities**

| Auditing areas   |   | Number of cases |
|--|---|-----------------|
| <b>Engagement quality control review (HKSA 220)</b>                  | Failure of the engagement quality control reviewer to perform an objective evaluation of the significant judgements made by the engagement team, and the conclusions reached in formulating the auditor's report, which involves: review selected audit documentation relating to the significant judgements that the engagement team made and the conclusions it reached | 55              |
| <b>Sufficient appropriate audit evidence (HKSA 500)</b>              | Failure to obtain sufficient appropriate audit evidence   | 53              |
|  | Failure to evaluate the appropriateness of the management's expert's work to be used as audit evidence for the relevant assertions  | 23              |
| <b>Professional skepticism and professional judgement (HKSA 200)</b> | Failure to exercise professional skepticism or to maintain a questioning mind   | 19              |
|  | Failure to exercise proper professional judgement   | 16              |
|  | Failure to achieve the overall objective of an auditor  | 28              |
| <b>Audit of accounting estimates (HKSA 540)</b>                      | Failure to properly evaluate whether the accounting estimates are either reasonable in the context of the applicable financial reporting framework or are misstated   | 29              |
|  | Failure to test the accounting estimates appropriately  | 13              |
|  | Failure to evaluate the reasonableness of significant assumptions used by management or management's intent and ability to carry out specific actions   | 13              |
| <b>Using the work of an auditor's expert (HKSA 620)</b>              | Failure to evaluate the adequacy of the auditor's expert's work and perform additional audit procedures for inadequate work   | 12              |

- 5.1.3 For each of the auditing areas listed in Table L above, the requirements of the relevant auditing standards and examples of allegations found or being investigated are set out below.

## 5.2 Engagement quality control review

5.2.1 Engagement quality control review is a quality control procedure required for audits of listed entities' financial statements in accordance with HKSA 220 *Quality Control for an Audit of Financial Statements*.

5.2.2 The purpose of an engagement quality control review in an audit is to serve as an evaluation of the work performed and decisions made by an engagement team. More specifically, the engagement quality control reviewer (**the reviewer**) is required to evaluate the significant judgments made by the engagement team and conclusions reached in formulating the auditor's report. The reviewer does so through:

- (a) discussion of significant matters;
- (b) review of the financial statements, the auditor's report, and the relevant audit documentation relating to significant judgments; and
- (c) evaluation of the appropriateness of the auditor's report.

5.2.3 In our investigations, we found that engagement quality control reviewers only completed the standard review checklist but did not adequately review the audit working papers, critically challenge the nature and extent of audit procedures performed and evidence obtained during the audit and objectively evaluate the conclusion reached by the engagement team.

5.2.4 Examples of deficiencies in engagement quality control review include:

- (a) The reviewer failed to discuss significant matters with the engagement team in relation to a business combination including the assessment of risks of material misstatements, the responses to the assessed risks, the results of the substantive procedures performed and the significant judgement made.
- (b) The reviewer failed to select and review audit working papers to evaluate whether the engagement team had obtained sufficient appropriate audit evidence to support the impairment assessment of an intangible asset with indefinite useful life which involves significant judgements. The reviewer therefore failed to evaluate the engagement team's work and the conclusion reached.
- (c) The reviewer failed to identify that the engagement team had not sufficiently planned, reviewed or supervised the audit work performed by a component auditor that involved inventory rollback procedures relating to a prior year audit qualification to ensure that the relevant matters subject to the prior year qualification had been resolved in the current period.

- (d) The reviewer assessed the audit work performed in relation to the recoverable amount of a significant associate of a listed entity but failed to identify that the engagement team's procedures were limited to an inquiry of management's assumptions and re-calculation of the significant estimates which were inadequate for the purpose of obtaining sufficient appropriate audit evidence.

### 5.3 Sufficient appropriate audit evidence

- 5.3.1 HKSA 500 *Audit Evidence* requires the auditor to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. Evidence must be relevant to the audit assertions that the auditor is testing. The quality of the audit evidence obtained by the auditor depends on its relevance and reliability (i.e. appropriateness) in addition to its sufficiency.
- 5.3.2 When forming an opinion on the financial statements, auditors are required to conclude as to whether reasonable assurance has been obtained about whether the financial statements are free from material misstatement, whether due to fraud or error. Such a conclusion should take into account whether sufficient appropriate audit evidence, whether such evidence corroborates or contradicts management's assertions in the financial statements, has been obtained. Failure to obtain sufficient appropriate audit evidence would result in failing to obtain reasonable assurance and therefore failing to meet the overall objectives of an auditor and may result in the auditor giving an inappropriate audit opinion on the financial statements.
- 5.3.3 More assurance is ordinarily obtained by obtaining consistent audit evidence from different sources or of different natures than from considering items of audit evidence individually. Information from sources independent of the entity generally provide more reliable evidence than that obtained internally or from the entity.
- 5.3.4 The following are instances where the auditor did fail/or may have failed to obtain sufficient appropriate audit evidence:
  - (a) In relation to the opening balance of inventories, the auditor relied on "rollback" procedures performed by a component auditor to resolve an inventory matter that was qualified in the prior year's audit due to a scope limitation. Rollback procedures involve a physical count of inventories attended by the auditor at a specified date and an examination of the reconciliation of inventory movements during the intervening period in order to verify the balance of inventories at the balance sheet date. However, the auditor did not consider the limitations encountered in the prior year and the availability of adequate reliable records when accepting the use of "rollback" procedures on the

opening inventories. Such procedures did not provide the auditor with reliable evidence to address the relevant matter.

- (b) In an investigation, the auditor was aware of a difference between the value of the convertible bonds recognised in the financial statements and the fair value determined by the management's engaged valuation expert. The auditor accepted the management's explanation that the expert's valuation was "inaccurate", without understanding the rationale for the management's conclusion or obtaining further evidence, including discussion with the valuer, to evaluate the appropriateness of the measurement of the convertible bonds and to resolve the contradictory evidence.
- (c) In relation to a listed entity's investment in an associate, our investigation found that the auditor failed to perform procedures to obtain sufficient evidence to resolve the inconsistency between different audit evidence obtained in relation to the measurement of the investment.
- (d) The auditor relied on information produced by the entity without testing the accuracy and completeness of such information to ensure its reliability and evaluating whether the information is sufficiently precise and detailed for the purpose of the audit.
- (e) When auditing significant management judgments, the auditor relied solely on responses obtained from management. Evidence from inquiry alone is not enough to support the validity of the management's representations.
- (f) In two investigations, the auditors accepted management's conclusion that interests in subsidiaries were not impaired in the parent's financial statements without properly performing procedures to obtain sufficient appropriate audit evidence to support this conclusion.

## **5.4 Professional skepticism and professional judgement**

5.4.1 Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. It is part of the skill set of an auditor and is essential (together with professional judgement) to maintain audit quality. Situations that did/or may indicate that the auditor failed to maintain professional skepticism include:

- (a) Reliance on management's representations or explanations on identified variances or exceptions found in audit tests without attempting to obtain evidence from other sources and to perform an independent evaluation.

- (b) In areas involving significant management judgments and estimates, the auditor failing to (i) question the appropriateness of the methodology and approach applied, and challenge the reasonableness of the significant underlying assumptions used for the estimations; or (ii) in certain cases, failing to remain alert to and further question contradictory or potentially inconsistent information obtained, including information that might indicate management bias.

5.4.2 HKAS 200 requires auditors to exercise professional judgment in planning and performing an audit of financial statements. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report. Instances where the auditors failed to exercise appropriate professional judgement include:

- (a) the auditor failed to properly consider the substance of the contractual arrangements and the rights of the relevant parties under the Articles of Association and the mutual agreements of an investee in determining whether a listed entity had control or significant influence over its investee.
- (b) the auditor failed to consider whether the decline in the fair value of a listed entity's available-for-sale investment was significant or prolonged and accordingly should be regarded as an objective evidence of impairment.

## **5.5 Audit of accounting estimates**

5.5.1 Accounting estimates, including fair value measurements, involve significant judgments, assumptions and estimates and is an area where audit deficiencies were often found. Areas often include complex accounting estimates:

- (a) business combinations in relation to acquisition-date fair value measurement of purchase consideration including contingent consideration, intangible assets acquired and previously held interests in an acquiree;
- (b) fair value measurements of financial instruments (e.g. convertible bonds, financial assets at fair value through profit or loss) and biological assets; and
- (c) impairment assessments of assets (e.g. determination of recoverable amounts of non-financial assets and interests in subsidiaries and associates, and expected credit losses for receivables).

5.5.2 HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* requires auditors to perform audit procedures and obtain sufficient appropriate audit evidence to evaluate the reasonableness of the accounting estimates. Accounting estimates are required to be made by management when the monetary amounts cannot be directly observed. The determination of accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management. This can give rise to inherent uncertainty and considerable complexity in measurement, thereby increasing the risk of material misstatement.

5.5.3 Observations on deficiencies in auditing accounting estimates include:

(a) Failure to challenge management's assumptions

In one investigation, the auditor obtained a cash flow forecast of the subsidiaries over a period of five years for the purpose of impairment testing. Despite the fact that the financial results of these subsidiaries varied significantly in the past, the forecast was based on an average of the past five years' data and assumed that the same amount of cash flows would continue in the next five years. The auditor accepted such information without questioning the reasonableness and appropriateness of the assumptions on which the forecast was based.

(b) Failure to consider indications of impairment and challenge management's assumptions

In relation to an impairment assessment of a listed entity's interest in an associate, the auditor placed reliance on a valuation report of the associate which was prepared on an income approach. The valuation was principally based on management's forecast of future cash flows of the associate's business which was in the development stage. The auditor accepted management's representation on the assumptions used in the forecast, including in relation to the forecast development in various overseas markets without obtaining additional evidence. Even though there were events and circumstances that had adversely affected the development and launch of the product, which was delayed, the auditor failed to challenge management's assumptions used in the valuation and to perform adequate procedures on their reasonableness.

(c) Failure to evaluate the application of the applicable financial reporting framework

A listed entity settled the purchase consideration of a business combination partly by issuance of its own shares and measured these consideration shares at the price set out in the sale and purchase agreement instead of the acquisition-date fair value with reference to the quoted price. The auditor failed to understand the requirements of

the applicable financial reporting framework relevant to the measurement of the consideration shares.

## **5.6 Using the work of an auditor's expert**

- 5.6.1 In auditing accounting estimates, auditors might engage experts in a field other than accounting or auditing, to assist them to obtain sufficient appropriate audit evidence. We observed that auditors often failed to adequately evaluate the work of an expert in accordance with HKSA 620 *Using the Work of an Auditor's Expert* when using their work as audit evidence.
- 5.6.2 In addition to assessing the competence and objectivity of the auditor's expert, HKSA 620 requires evaluation of the adequacy of the expert's work for the auditor's purpose. Auditors are required to consider:
- (a) the source data, assumptions and methods used by the expert in their work and their consistency with prior periods; and
  - (b) whether the results of the expert's work are consistent with the auditor's overall knowledge of the business and the results of other audit procedures performed. Such discussion should be properly documented in the audit file.
- 5.6.3 Our observations include:
- (a) Inadequate communication with the auditor's expert, including failure to evaluate whether the scope of work of the expert and the assumptions and methods applied in the circumstances are relevant and reasonable.
  - (b) Reliance on the work of the auditor's expert without performing additional work, such as considering the relevance or testing the reliability of the source data used by the expert in their work.
  - (c) Failure to properly consider and respond to the findings or comments of the expert and consider their implications for the audit, particularly when the expert has excluded from their work any conclusions on the reasonableness of certain assumptions or accounting treatments.
  - (d) Failure to consider inconsistencies between the results of the work of the auditor's experts and the auditor's overall knowledge of the matter and their impact on the audit.



## 5.7 Audit documentation

- 5.7.1 Although audit documentation has not been identified as one of the key areas of auditing irregularities, insufficient audit documentation can undermine the effectiveness of the performance of an audit because it may not allow for appropriate supervision and review of the work of less experienced members of the team by more experienced members.
- 5.7.2 Audit documentation provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor and that the audit was planned and performed in accordance with HKSA's and applicable legal and regulatory requirements.
- 5.7.3 In reviewing the audit working papers, we found that auditors failed to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
- (a) the nature, timing and extent of audit procedures performed;
  - (b) the results of the procedures performed and the audit evidence obtained; and
  - (c) significant matters arising during the audit and significant judgements and conclusions made by the engagement team.
- 5.7.4 Examples of deficiencies include:
- (a) In documenting substantive procedures, the auditors only stated that "*we have checked the key terms*" without documenting the timing and extent of audit procedures performed during the audit, audit evidence obtained from the procedures and how to arrive at the conclusion;
  - (b) in documenting procedures when using the work of a valuer, the auditor only stated that "*we have assessed the competency of the management expert*" and "*we have discussed the assumptions with the valuer and no exception was noted*", but did not include any details in the audit working papers on the results of the audit work and significant judgements made in reaching the conclusion.
- 5.7.5 Inadequate audit documentation has also been found in the process of engagement quality control review. Our investigations found that engagement quality control reviewers frequently only signed off review checklists but did not adequately document what audit documentation was reviewed, questions that had been asked, matters that had been discussed and how they were resolved.



## Section 6

### Looking ahead

#### 6.1 Introduction

- 6.1.1 This section highlights key aspects of our plans to further strengthen our investigation and enquiry functions in the coming year.

#### 6.2 Enhance processes and procedures

- 6.2.1 During the reporting period, we have taken opportunities to enhance the efficiency of our processes to address the backlog of cases as explained in paragraph 3.4.2 above.
- 6.2.2 Building on the efforts taken during the reporting period to address the backlog of cases (paragraph 3.4.2 above), we will continue to further enhance the efficiency of our processes in order to enable us to address the backlog of cases whilst enhancing our ability to respond with agility to new significant public interest cases.
- 6.2.3 The plan for the coming year includes:
- (a) To further streamline our processes for handling potential allegations of misconduct or non-compliance to ensure that those with the greatest potential for harm to significant public interest are identified early and appropriate and timely follow up actions are taken.
  - (b) To prioritise the use of our resources in conducting cases for which the potential public harm is greater so as to deter improper conduct and behaviour of our regulatees more promptly and enhance public confidence in listed entity financial statements and audits.
  - (c) To enhance the collaboration and co-ordination between the investigation, the inspection and the disciplinary functions to ensure that cases are resolved in the most efficient and effective manner.

#### 6.3 Revamp the FSRP

- 6.3.1 Given the importance of our proactive monitoring activities in detecting potential misconduct and non-compliance thereby creating a deterrent for such behaviour and incentive for listed entities to prepare high quality financial reports and their auditors to perform high quality audits, we aim to revamp the

FSRP. The purpose of the revamp is to enhance its effectiveness in identifying potential misconduct and non-compliance.

- 6.3.2 The revamp will include increasing the number of financial statements selected for review, and reassessing aspects of our selection approach such as our selection criteria and the scope of individual reviews. In doing so, we will consider best practices internationally.

## **6.4 Enhance transparency and stakeholder engagement**

- 6.4.1 Transparency of our operations and of the progress and outcome of our work and promoting continuous improvement in the preparation of financial statements and conduct of audits of listed entities based on insights from the analysis of our findings is important to achieving our regulatory mission and establishing and maintaining public trust in our work. Following the publication of this Annual Report, we plan to conduct outreach activities with our audit firm regulatees and listed entities to communicate our findings and expectations of them. In addition, we will take opportunities to share our findings and observations with the investing public for educational purposes through other channels such as our press releases, e-news issues and through professional or other bodies' workshops or seminars.

## **6.5 Strengthen cooperation with other regulators**

### *Hong Kong*

- 6.5.1 The FRC has recently signed new MoUs with other regulators in Hong Kong, namely SFC, ICAC, HKEX and HKICPA, to enhance collaboration which includes case referrals, joint operation and exchange and use of information. We will work more closely with these regulators to foster a coordinated regulatory effort on matters in which we have a common interest in ensuring the quality of financial reporting and audit.

### *Mainland China*

- 6.5.2 Given the significance of PIEs with operations in the Mainland to the capital markets in Hong Kong and the significance of the audits of these operations to our regulatory remit (see paragraph 2.5.2 above), we will build on the successful implementation of our MoU with the Supervision and Evaluation Bureau of the PRC Ministry of Finance to further strengthen the cross-boundary cooperation and collaboration in relation to the investigation function, including by further streamlining the process for accessing audit working papers located in the Mainland.

## Appendix

### Summary of remit and powers

#### A1 Remit and powers – investigations

##### *Remit*

- A1.1 Under sections 23 and 23A of the FRCO, the FRC may direct an investigation to be carried out where the FRC:
- has **reason to inquire** into whether there has been misconduct on the part of a PIE auditor or registered responsible person;
  - has **reasonable cause to believe** that a non-PIE auditor has committed a practice irregularity;
  - has **reasonable cause to believe** that a PIE auditor or registered responsible person may have contravened a provision of the FRCO; or
  - has **reasonable cause to believe** that a PIE auditor has carried out a PIE engagement completed on or after 1 October 2019 in a way which is not in the interest of the investing public or in the public interest.
- A1.2 Under sections 37A and 37B of the FRCO, “misconduct” by a PIE auditor or a registered responsible person includes:
- a “practice irregularity” (see A1.3 below);
  - contravention of a provision of the FRCO;
  - contravention of a condition imposed in relation to the registration or recognition of the PIE auditor;
  - contravention of a requirement imposed on a PIE auditor or registered responsible person under a provision of the FRCO; and
  - conduct in relation to a PIE engagement which, in the opinion of the FRC, is or is likely to be prejudicial to the interest of the investing public or the public interest.
- A1.3 Under section 4 of the FRCO, a “practice irregularity” is committed in relation to a PIE engagement and examples include:
- failing or neglecting to observe, maintain or otherwise apply a professional standard (such as an auditing standard);
  - negligence in the conduct of profession;
  - professional misconduct;
  - act or omission which would reasonably be regarded as bringing or likely to bring discredit on the auditor, the Hong Kong Institute of Certified Public Accountants (i.e. the HKICPA) or the accountancy profession;
  - falsifying a document; and

- f. making a statement in respect of a document which is material, knowing the statement to be false or not believing it to be true.

A1.4 Under Schedule 1A of the FRCO, a PIE engagement is the preparation of :

- a. an auditor's report on a PIE's annual financial statements required by the Companies Ordinance (Cap 622), the relevant rules of The SEHK or the relevant code issued by the SFC of Hong Kong (i.e. the annual report);
- b. a specified report required to be included in a listing document for the listing of a corporation's shares or stocks or for the listing of a collective investment scheme (i.e. listing prospectus); or
- c. an accountant's report required under the Listing Rules to be included in a circular to be issued by a PIE for a reverse takeover or a very substantial acquisition completed on or after 1 October 2019.

### *Powers*

A1.5 An investigation may be carried out by an Audit Investigation Board (i.e. **the AIB**) or an employee of the FRC (**an investigator**). Under section 22 of the FRCO, the Chief Executive Officer of the FRC is an ex officio member and chairperson of the AIB.

A1.6 In determining whether there is sufficient evidence of misconduct or a practice irregularity by exercising power under section 25 of the FRCO, the AIB or an investigator has the power to require any person who is relevant to the matter under investigation or any person who the investigator has reasonable cause to believe is in possession of a relevant record or document or the relevant information to:

- a. produce any record or document relevant to the investigation;
- b. provide an explanation or further particulars in relation to a record or document produced;
- c. provide an answer in writing to a question to be raised by the investigator relevant to the investigation;
- d. attend before the investigator to answer questions relevant to the investigation; or
- e. provide any other assistance in connection with the investigation which a person so required is reasonably able to give.

It is important for any person issued with a requirement under section 25 to comply with it. Failure to do so without reasonable excuse amounts to an offence under section 31 of the FRCO and is punishable upon conviction by a fine and/or imprisonment.

*Transitional arrangements*

- A1.7 Sections 92 and 93 of the FRCO set out that investigations on audits of PIE engagements completed before 1 October 2019 should be conducted as if the 2019 Amendment Ordinance had not been enacted (**the Old Regime**). That is, the Financial Reporting Council Ordinance (cap 588) in effect immediately before 1 October 2019 (**Pre-amended FRCO**) continues to apply to such investigations.
- A1.8 Key differences between the Old Regime and the New Regime for conducting investigations are as follows:

|   | Old Regime   | New Regime  |
|---|--|---|
| <b>Regulated person</b>                   |  | Includes the quality control system responsible person of a PIE auditor   |
| <b>Subject matter for investigation</b>   | Relevant irregularities  | Misconduct, apart from relevant irregularities (now called practice irregularities), also includes: <ul style="list-style-type: none"> <li>▪ contravention of a provision of the FRCO;</li> <li>▪ contravention of a condition imposed in relation to the registration or recognition of the PIE auditor;</li> <li>▪ contravention of a requirement imposed under a provision of the FRCO; and</li> <li>▪ conduct which is or is likely to be prejudicial to the interest of the investing public or the public interest</li> </ul> |
| <b>Basis to initiate an investigation</b> | There are “circumstances suggesting” (under section 23(1) of the Pre-amended FRCO) or “reasonable cause to believe” (under section 23(3) of the Pre-amended FRCO) that a relevant irregularity has occurred. | There is “reason to inquire” or “reasonable cause to believe” that a misconduct has been committed (under section 23 of the FRCO).  |

|                          |   |   |
|--------------------------|---|---|
| <b>Follow-up actions</b> | Investigation findings will be referred to the HKICPA for consideration of appropriate follow-up actions. | Investigation findings will be referred to the FRC's department of discipline for consideration of sanctions. |
|--------------------------|---|---|

## A2 Remit and powers – enquiries

### *Remit*

- A2.1 The FRC has the power to initiate an enquiry if it appears that there is or may be a question whether or not there is a relevant non-compliance in relation to a relevant financial report published by a PIE.
- A2.2 For a PIE (other than a listed collective investment scheme), a relevant financial report generally refers to its financial statements which comprise its annual and interim financial statements as required under the Companies Ordinance or the Listing Rules. It also includes accountants' reports required for a listing document, for example, a prospectus.
- A2.3 In relation to a listed collective investment scheme, a relevant financial report generally refers to the financial statements of the scheme published for the purposes of the relevant SFC Codes or guidelines or Listing Rules. It also includes accountants' reports required for a listing document.
- A2.4 The enquiry may be conducted by the staff of the FRC under the delegated powers from the FRC Board under section 40(1)(a). Alternatively, the FRC may appoint a Financial Reporting Review Committee (i.e. the FRRC) to conduct the enquiry under section 40(1)(b) of the FRCO.
- A2.5 An FRRC consists of a Panel Convenor as Chairman and at least four other members of the Financial Reporting Review Panel (the FRRP). Members of the FRRP are appointed by the Financial Secretary under the delegated authority from the Chief Executive of the HKSAR, in consultation with the FRC, because of their experience in accounting, auditing, finance, banking, law, administration or management, or because of their professional or occupational experience.

### *Powers*

- A2.6 Once an enquiry is initiated, the FRC or the FRRC may, in writing, require certain persons such as auditors, listed entities and their officers or employees to produce records or documents and to give information or explanation under section 43(1) of the FRCO.

- A2.7 Where the FRC finds that there is a relevant non-compliance, based on a report on the findings of the FRC or the FRRC in an enquiry, the FRC may give a notice to the listed entity concerned to remove the non-compliance in the manner and within a period as specified in the notice.
- A2.8 In the event that a listed entity does not rectify the relevant non-compliance (which relates to a breach of an accounting requirement as provided in the Companies Ordinance (Cap 622)) within a specified period, the FRC may apply to the Court of First Instance for a declaration that there is a relevant non-compliance and an order requiring the director of the listed entity to cause the relevant non-compliance to be rectified under section 50(2) of the FRCO.

The FRC may take any other action as it considers appropriate including referral to the appropriate regulatory body for follow-up action.