Guidance Notes on Change of Auditors

Policy and Governance **September 2023**

Introduction

1. Changes of auditors amongst companies listed in Hong Kong have trended upward in the past ten years[1]. Such changes may arise from the retirement of auditors at the end of their term of appointments (including auditors not seeking reappointment and companies not reappointing their incumbent auditors), mandatory rotation, or the resignation of auditors during their tenure. In extreme cases, auditors may be removed by listed companies after obtaining shareholders' approval at a general meeting.

2. Well-managed changes of auditors at listed companies' annual general meetings may indicate good corporate governance. By contrast, sudden and unplanned changes of auditors may signal governance, financial reporting, and risk control issues. The closer the change of auditors is to the end of the company's financial reporting period, the less time is available for the incoming auditor to complete the engagement. Consequently, audit quality may be compromised because the incoming auditor will have limited time to plan and conduct a proper audit ahead of the deadline for announcing audited results. This is an area of ongoing concern for the AFRC[2].

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

[2] The AFRC issued an open letter on 27 October 2022 and a follow-up open letter on 11 January 2023 (the "Open letters") to express concerns relating to auditor resignations occurred from one month prior to the end of the financial reporting period.

3. These guidance notes articulate the AFRC's expectations of public interest entity (PIE) auditors and audit committees of listed companies in the event of a change of auditors. These expectations are in addition to the obligation to comply with applicable professional standards and legal and regulatory requirements[3]. The guidance notes provide guidance for:

   a. outgoing auditors, when resigning from audit engagements (Section A);

   b. incoming auditors, when accepting new engagements (Section B); and

   c. audit committees, when an auditor resigns (Section C).

4. The AFRC will continue to monitor auditor changes, in particular those that occur near the end of the financial reporting period. In such cases, the AFRC will follow up with PIE auditors as necessary. When there is a reasonable cause to believe that an audit engagement is not conducted in a way that is in the public interest, the AFRC will carry out necessary enforcement actions as set out in the publication, AFRC Addresses Concerns Surrounding Auditor Changes[4].

[3] This includes, but is not limited to, the Companies Ordinance (Cap. 622), the applicable Listing Rules issued by the Hong Kong Exchanges and Clearing Limited, and the Code of Ethics for Professional Accountants issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

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

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Section A – **Guidance for Outgoing Auditors When Resigning from Audit Engagements**

A1. Once appointed, auditors should strive to complete their audit engagements and express opinions on the financial statements of listed companies.

Expectations of auditors when encountering disagreements with management

A2. When auditors encounter a disagreement with management on the scope of audit, management's estimates and assumptions, choices of accounting policies, or financial statement disclosures as well as consequential implications of these matters on audit fees, they are expected to take the following actions.

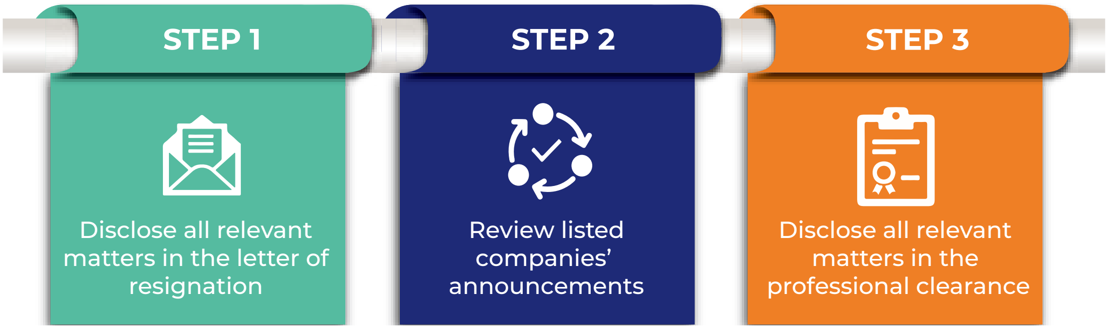
a. **Proactive discussions with relevant parties:** The auditor should discuss with the audit committee any disagreements between the auditor and management encountered during the audit and seek the committee's assistance in resolving such issues. If the disagreement relates to a contentious audit issue which, in the auditor's opinion, would have a material impact on the financial statements and/or the audit opinion, the auditor should report to the audit committee the nature and magnitude of the issue in a precise manner.

b. **Consensus on follow-up actions:** Where applicable, the auditor should agree on follow-up actions with the audit committee and management, aiming to resolve any disagreements. The agreed actions should be executed accordingly.

c. **Dedicated effort to complete the engagement:** Auditors should use their best efforts to seek ways to work towards completing the audits rather than resigning to avoid the responsibility of issuing a qualified or adverse opinion on the financial statements.

Expectations of outgoing auditors when resigning from an audit engagement

A3. In the event that an auditor decides not to continue with the engagement, the auditor is required to submit a letter of resignation to the audit committee and the board of directors of the listed company. The auditor must communicate with the audit committee regarding the reasons for resignation prior to resigning.



a. The outgoing auditor should set out in the letter of resignation the precise circumstances leading to the resignation, including the nature and significance of all disagreements with management and unresolved audit issues, as well as the results of the communication with the audit committee.

b. The outgoing auditor should also pay attention to the announcements made by the listed company concerning its resignation and assess whether the matters reported in the letter of resignation have been brought to the attention of shareholders. If the circumstances described in the announcements are materially different from the facts or do not contain sufficient details, the outgoing auditor needs to bring this matter to the attention of the audit committee and the board of directors.

c. In any case, when the incoming auditor approaches the outgoing auditor for professional clearance and enquires whether the outgoing auditor is aware of any unusual circumstances surrounding the resignation, the outgoing auditor is urged to disclose the unresolved matters to the incoming auditor through a letter of professional clearance with the same level of detail as in the letter of resignation. The outgoing auditor should also consider allowing the incoming auditor to review the audit working papers relating to the unresolved matters, in particular those matters of continuing accounting significance.

Practice notes for outgoing auditors

A4. Set out below are some practice notes to assist outgoing auditors in satisfying the aforementioned expectations.

a. In our observations, generic statements, such as “disagreement over audit fees” or “corporate governance considerations”, are commonly used as a reason for auditor resignations. The AFRC has expressed concern whether such statements are used to disguise the true reason for the resignation.

i. **Disagreements over audit fees** are often cited as the reason for resignations. However, auditors should discuss and agree with audit committees the proposed audit fees prior to seeking a reappointment at the annual general meeting. In view of this, any disagreement over audit fees following the auditor reappointment can be attributed to a change in audit scope that gave rise to a change in audit fees. Therefore, circumstances leading to the change in audit scope should be disclosed in the letter of resignation.

ii. **Corporate governance considerations** are cited as the reason for some auditor resignations that occurred near the end of the listed companies' financial reporting periods. A proper change of auditors should take place at the annual general meeting instead of mid-cycle, providing shareholders with the ability to scrutinise and question the selection and appointment of the incoming auditor. Outgoing auditors should make the utmost effort to be transparent and not be misleading, to prevent speculation as to whether the true reason of the late resignation was due to unresolved audit issues, discovery of a suspected fraud, malpractice or mismanagement.

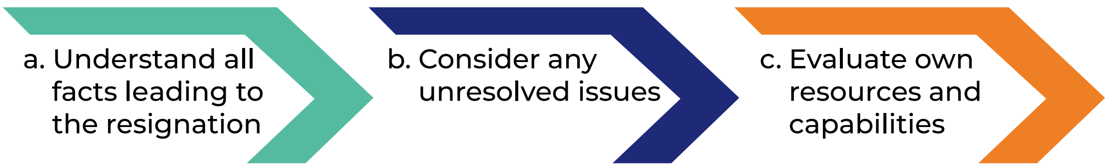
b. There are also instances where auditors have been requested to resign as a result of audit issues. This could be an indication that some listed companies are reluctant to resolve issues with auditors, or more worryingly, an indication of possible opinion shopping. If, in the view of the outgoing auditor, the actions taken by the listed company involve potential misconduct, the outgoing auditor is urged to report on a timely basis to the AFRC or other relevant authorities through whistleblowing or complaint mechanisms.

Section B –
Guidance for Incoming Auditors When Accepting New Engagements

B1. Listed companies need to appoint incoming auditors to fill the vacancy following auditor resignations. Incoming auditors should complete their client and engagement acceptance procedures with due care and rigour prior to making acceptance decisions.

Expectations of incoming auditors when accepting new engagements

B2. An incoming auditor should exercise professional scepticism in carrying out the client and engagement acceptance procedures, especially when the resignation of the outgoing auditor was triggered by disagreements with management or unresolved issues.



a. The incoming auditor should take all reasonable steps to identify the relevant facts and circumstances leading to the outgoing auditor's resignation. These include obtaining the outgoing auditor's letter of resignation from the listed company, obtaining a letter of professional clearance directly from the outgoing auditor, and having a meeting with the outgoing auditor and the audit committee of the listed company.

b. When there are unresolved audit issues, the incoming auditor should consider performing additional procedures to review all underlying documents relating to the unresolved issues, including but not limited to correspondence between the outgoing auditor and the listed company, and the outgoing auditor's audit evidence and working papers on the issues. This will allow the incoming auditor to obtain a more thorough understanding of the issues and reasonably ask themselves how such issues could be resolved by them. In any event, if the incoming auditor becomes aware that the listed company continues to refuse to carry out an independent investigation proposed by the outgoing auditor, the incoming auditor should consider whether it is possible for them to address such issues in the absence of an independent investigation. All these matters may be an indication of potential integrity issues.

c. The incoming auditor should also rigorously assess their competence and capabilities to perform quality audits before making acceptance decisions, and should maintain professional scepticism throughout the audit, particularly when the time to complete the audit is limited. The assessment undertaken by the incoming auditor should include, but not be limited to, their knowledge and previous experience of the prospective client's industry; the regulatory and reporting requirements; the nature and complexity of the engagement; whether the incoming auditor has expertise in areas such as valuation and information technology; the requisite human resources with reference to their planned audit scope and whether such resources are commensurate with the size and structure of the prospective client.

B3. In our recent analysis, more than half of the listed companies who changed auditors experienced a fee reduction[5]. While lower audit fees may make it easier to win clients in the business world, incoming auditors are reminded that audit fees should be set at a level that will allow appropriate resources to be assigned and a quality audit to be performed.

Practice notes for incoming auditors

B4. Set out below are some practice notes to assist incoming auditors in addressing the AFRC's ongoing focus on audit acceptance.

a. In some announcements of listed companies relating to auditor appointments, the identity of incoming auditors was disclosed before their client and engagement acceptance procedures have been duly completed. A premature announcement could be construed as providing inaccurate and misleading information to the market. If the incoming auditor discovers that the circumstances described in the announcements are materially different from the facts, they should promptly notify the listed company and request public clarification. If the listed company refuses to clarify the matter publicly, the incoming auditor needs to bring this matter to the attention of the audit committee and the board of directors.

b. Auditors should avoid accepting audit engagements for which the audit timetable appears to be disproportionately short relative to the complexity of the audits. Incoming auditors are urged to negotiate with listed companies a reasonable audit timetable before making an acceptance decision.

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

c. In our regular monitoring of auditor changes, we identified instances where incoming auditors accepted engagements with significant operations in other jurisdictions, even when they had limited experience and resources in those jurisdictions. Incoming auditors should evaluate whether they have sufficient resources and capabilities to conduct audits in other jurisdictions according to their planned audit scope.

d. When a decision is made to involve component auditors or individuals from external providers in Hong Kong or other jurisdictions to perform audit procedures, incoming auditors are reminded that they remain responsible for the overall quality of the audit. It is also the responsibility of the incoming auditors to ensure that the component auditors[6] and the individuals from external providers[7] have appropriate professional competence and capabilities to perform the audit work assigned to them in accordance with applicable financial reporting and auditing standards, and they understand and will comply with applicable professional and regulatory requirements, such as ethics and auditor independence. Incoming auditors must put in place proper monitoring and assessment processes given the heightened risks.

[6] Relevant requirements are set out in the Hong Kong Standard on Auditing 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors), issued by the HKICPA.

[7] Relevant requirements are set out in the Hong Kong Standard on Quality Management 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements, issued by the HKICPA.

Section C –
Guidance for Audit Committees When an Auditor Resigns

Expectations on audit committees

C1. Audit committees of companies listed in Hong Kong must comprise a minimum of three members, at least one of whom is an independent non-executive director ("INED") with appropriate professional qualifications or accounting or related financial management expertise[8]. The role of the INEDs is to ensure that audit committees can provide objective oversight of the listed companies' financial reporting and the performance of external auditors.

C2. Audit committees are responsible for reviewing and monitoring auditor performance, making recommendations to boards of directors on the appointment, reappointment, and removal of auditors, and reviewing the financial information of listed companies. Through overseeing the processes relating to both financial reporting by listed companies and auditing by auditors, audit committees can better discharge their fiduciary obligations, uphold and maintain audit quality, and ensure the compliance of listed companies with relevant legal and regulatory requirements.

C3. Several stakeholders, including boards of directors, shareholders, investors, the AFRC and other regulators, place high expectations on audit committees to handle all issues relating to the audit process, in particular when such issues lead to resignations or removals of auditors. In a survey of listed companies conducted by the AFRC in 2022, 97% of audit committee respondents agreed that they play a key role in overseeing how auditors enhance and maintain audit quality[9].

[8] Rule 3.21 of the Main Board Listing rules and Rule 5.28 of the GEM Listing rules issued by the Hong Kong Exchanges and Clearing Limited.

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

C4. In this regard, audit committees are urged to follow the recommendations in Section 2 of the Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors[10] (the "AC Guidelines") in discharging their responsibilities regarding auditor appointments, and Section 5 of the AC Guidelines regarding auditor resignation and removal. Audit committees are reminded not to recommend the reappointment of incumbent auditors as a matter of course and should follow the recommendations in Section 3 of the AC Guidelines regarding reappointments of incumbent auditors.

When audit committees are notified of an audit issue

C5. Audit committees are obligated to address any issues raised by auditors on a timely basis. Therefore, when an auditor notifies the audit committee of disagreements with management (including unresolved audit issues), the audit committee should take the following steps to understand and investigate the disagreement between the auditor and management.

a. The audit committee should hold separate meetings with the auditor and management of the listed company to understand the circumstances that led to the disagreement. These discussions should be open and honest in order to allow the audit committee to understand and form an independent view of the underlying causes of the disagreement.

i. **Unresolved audit issues:** When the disagreement relates to a contentious audit issue, the audit committee should understand, based on their discussion with the auditor, the nature and details of the disagreement and unresolved issues, as well as the potential impact of the issues on the financial statements and the audit opinion. In some circumstances, the audit committee may also consider hiring external consultants with specialised expertise, such as forensic accounting or legal professionals, to investigate the underlying issues or to provide an independent opinion on the contentious issue. However, the audit committee should prevent management from requesting the auditor to resign because of unresolved issues.

10 AFRC, Guidelines for Effective Audit Committees—Selection, Appointment and Reappointment of Auditors , December 2021, https://www.afrc.org.hk/en-hk/policy-and-governance-publications/guidelines-for-effective-audit-committees/

ii. **Disagreement over audit fees:** When the disagreement relates to audit fees, the audit committee should understand the underlying reason for the disagreement. As audit fees are expected to be agreed prior to the auditor reappointment, the audit committee should seek to clarify the position and rationale from both parties, and form an independent view on the reasonableness of the fees.

iii. **Corporate governance considerations:** When corporate governance considerations are cited as the reason for the change of auditors after the incumbent auditor accepts the reappointment, the onus is on the audit committee to explain in an announcement of the listed company why the change of auditors did not happen at the annual general meeting at which the reappointment was approved. Any proposed change of auditors because of corporate governance considerations, except for the extreme circumstances described in paragraph C6(d) below, should be considered in advance and discussed at the annual general meeting to provide shareholders with an opportunity to scrutinise and question the selection and appointment of the incoming auditor.

b. Audit committees should seek to resolve disagreements between auditors and management by agreeing on follow-up actions. They should also monitor the execution of the follow-up actions, and use their best efforts to assist auditors in completing the audit.

c. In any case where management does not agree with the recommendations proposed by the audit committee to resolve the disagreements, the audit committee should bring this matter to the board of directors for further deliberation. The members of the audit committee are urged to report to the relevant authorities through whistle-blowing or complaint mechanisms if, in their view, the actions taken by the listed company involve potential misconduct.

When audit committees receive notice of an auditor's resignation

C6. In the event that the auditor decides not to continue with their engagement, the audit committee should carefully review the letter of resignation submitted by the outgoing auditor, in particular the reasons for resignation.

a. While the outgoing auditor is obligated to disclose in the letter of resignation the precise circumstances leading to the resignation, the audit committee should ensure that the disclosures are complete and accurate, especially in relation to unresolved audit issues and disagreements with management.

b. The audit committee should review the announcements made by the listed company concerning the resignation and ensure the announcements have disclosed the matters reported in the letter of resignation, as well as the view of the audit committee on such matters. The audit committee should take a proactive role in ensuring that the listed company provides the details of the resignation. The use of generic statements such as "disagreement over audit fees" or "corporate governance considerations" is inadequate. Not only would proper disclosures enhance the transparency and credibility of the audit committee, but it will also demonstrate a high degree of openness and accountability of the board of directors.

c. When an audit committee becomes aware that the management of the listed company is reluctant to resolve issues with the incumbent auditor and indicates the intention to request the incumbent auditor to resign, or in some cases attempt to seek an opinion that is favourable to the management despite outstanding issues, the audit committee should report the matter to the board of directors.

d. More importantly, the audit committee should refrain from recommending a removal of auditors to avoid a qualified or adverse opinion on the financial statements as this would be in breach of their duties as directors[11]. The audit committee should only recommend the board of directors to remove an auditor in extreme situations, such as when the auditor is in breach of ethical requirements or when they are unable to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements.

When audit committees are in the process of selecting a new auditor

C7. When an auditor resigns from an engagement, the audit committee has to kick-start the process of selecting and appointing a new one to fill the vacancy. It is incumbent on the audit committee to make recommendations to the board of directors based on the ability of an audit firm to deliver a high-quality audit.

[11] Rule 3.08 of the Main Board Listing rules and Rule 5.01 of the GEM Listing rules issued by the Hong Kong Exchanges and Clearing Limited stated that every director must act honestly and in good faith in the interests of the company as a whole and for proper purposes.

C8. The audit committee should follow Section 2 of the AC Guidelines and ensure that the incoming auditor possesses the necessary competence and capabilities to perform a high-quality audit and properly resolve outstanding audit issues, if any, within the limited timeframe.

a. **Evaluate auditor capabilities:** The audit committee should evaluate all factors that may affect the quality of the audit, including but not limited to the potential incoming auditor's governance and leadership structure, ability to comply with relevant ethical requirements, technical competence in the entity's industry and experience in the regulatory and reporting requirements; the audit scope and resources allocated by the potential incoming auditor to the engagement; communication plan with the audit committee; as well as its monitoring process over engagement quality.

b. **Consider recent inspection results:** In the process of evaluating a prospective auditor's competence, the audit committee should review the auditor's performance in previous engagements. In this context, the results of recent external and internal inspections, and whether the AFRC has imposed any conditions or sanctions on the auditor, can provide the audit committee with a direct and objective measure of the auditor's capability and track record.

c. **Set adequate audit fees:** The audit committee should also ensure that audit fees proposed by potential incoming auditors are at a level that enables sufficient audit resources to be allocated to perform the requisite audit procedures. In the absence of any significant changes in the audit scope, the audit committee should probe the reasons why the potential incoming auditor is able to charge lower audit fees than the outgoing auditor. This may require a deeper understanding of the areas of audit focus and the breakdown of audit fees.

d. **Focus on audit quality:** While audit fee levels are important, they should not be the only consideration when selecting an auditor. The consideration of audit quality should outweigh that of audit fees.

C9. The audit committee should also assist potential incoming auditors in understanding any unresolved issues and obtaining the necessary information for their audit plans.

a. The audit committee should facilitate communication between the outgoing and potential incoming auditors to discuss the unresolved audit issues and the circumstances that led to the resignation. The audit committee should assist in obtaining all necessary information on audit issues from the outgoing auditor and management of the listed company for the potential incoming auditor to develop their audit plan.

b. The audit committee should ensure that potential incoming auditor plans sufficient appropriate audit procedures to address the outstanding audit issues. For example, if the outgoing auditor requests the listed company to carry out an independent investigation but the listed company refuses to do so, the audit committee should request the potential incoming auditor to provide an explanation on how they could address such issues in the absence of an independent investigation. The audit committee should also evaluate the impact of these outstanding issues on audit quality and form a view on whether they agree with the potential incoming auditor's approach to address them.

c. When the potential incoming auditor plans to involve component auditors or individuals from external providers in Hong Kong or other jurisdictions to perform audit procedures, the audit committee should review the auditor's monitoring procedures and quality controls for the audit work performed by these resources and their compliance with professional standards and applicable legal and regulatory requirements.

C10. Where the change of auditors happens around the end of the financial reporting period of the listed company, the audit committee should perform the following steps, even within a limited timeframe:

a. understand and form an independent view of the underlying causes of the resignation according to paragraphs C5 to C6 above;

b. take necessary steps to select and appoint an appropriate incoming auditor according to paragraph C8 above;

c. resolve outstanding issues, if any, with the incoming auditor, as recommended in paragraph C9 above; and

d. evaluate whether the audit timetable proposed by management is reasonable and sufficient for the incoming auditor to complete all necessary audit procedures.

Practice notes for audit committees

C11. Following the Open Letters in October 2022 and January 2023, the AFRC has observed an improvement in the quality of disclosures by listed companies regarding auditor changes, with more details on the facts and circumstances leading to an auditor's resignation. However, the AFRC remains concerned about the completeness and accuracy of some disclosures. Set out below are some practice notes to assist audit committees when reviewing the disclosures made by listed companies.

a. The AFRC is concerned about some recent instances where the controlling shareholder of a listed company has requested the listed company to appoint the same auditor of the parent, which was the reason for the change of auditors disclosed in the announcement of the listed company. In such case, the audit committee should ensure that the announcement includes sufficient disclosures on whether the audit committee has evaluated the need for a change of auditors, how they have formed an independent view on the matter, and their recommendation to the board of directors.

b. While there are no specific disclosure requirements, audit committees are urged to ensure that the basis for selecting the incoming auditor is disclosed in sufficient detail in the corporate governance report and/or the announcement of change of auditors in accordance with Section 6 of the AC Guidelines.

c. In certain instances, the identity of the potential incoming auditor was disclosed prior to the completion of the auditor's client and engagement acceptance procedures. A premature announcement may be perceived as providing inaccurate and misleading information to the market. As best practice, an announcement should only be made after the incoming auditor has formally accepted the engagement. The audit committee has an obligation to ensure that the disclosure of auditor appointment in the announcement is factually correct and not misleading.