

e-News

Paul F. Winkelmann Chief Executive Officer

Chief Executive Officer's Key Message

Retaining Legal Advisors

It has come to our attention that many audit firms postpone engaging legal advisors until very late in the investigation process, often as late as on receipt of the investigation report from us which is the final outcome of the investigation. This often leads to a protracted finalisation process. I would like to urge all firms to consider engaging legal advisors once the first requirement is issued in an investigation. This will benefit the firm as legal advice will have been obtained at an early stage in the process and you will have the benefit of the FRC considering the arguments well before drafting our preliminary findings. The earlier legal advisors are retained, the smoother the process will be for all parties.

Requests for Extension of Time

With regard to requests for extension, while the FRC is very mindful of the need to provide adequate time to respond under the concept of natural justice, in many cases requests are being made without demonstrably clear reasons. We have examined our procedures in respect of setting deadlines for responses and we will in future be setting deadlines having regard to the complexity or otherwise of the requirements such that adequate time would be provided. Consequently, requests for extensions will only be considered when demonstrably reasonable grounds exist.

Staunch Support for the Amendment Bill

I mentioned in my last newsletter that the Government introduced the Amendment Bill into the Legislative Council in January 2018. I and my senior management have been vigorously supporting the passage of this Bill, which is in the best interest of Hong Kong.

On 19th March 2018 we held a press conference to introduce our Annual Report and our views on the Amendment Bill.

Our press conference was followed up with media interviews by our Chairman, together with briefing sessions to which all firms who audit listed companies were invited. I thoroughly enjoyed the briefing sessions and understood much more about the background to the views of practitioners and I hope clarified some misunderstandings.



The FRC hosts a press conference on 19th March 2018 to introduce the 2017 Annual Report and our views on the FRC (Amendment) Bill



Briefing sessions with audit firms

In addition, we exchanged views with certain academics, some of whom I am delighted to see expressed their views in relevant articles on the Bill. In the meantime, I and one of my senior directors have been invited to attend each Bills Committee meeting where the Bill is scrutinised clause by clause and we are assisting the Bills Committee by answering questions about our current and expected processes and procedures.



Mr Paul F. Winkelmann (right), CEO of the FRC, exchanges views on the FRC (Amendment) Bill with Dr Billy S.C. Mak (left), Associate Professor, Department of Finance and Decision Sciences, Hong Kong Baptist University

Fostering Relationships with International Organisations

We were delighted to receive a courtesy visit from the Executive Director of the International Forum of Independent Audit Regulators (IFIAR), Mr Carl Renner. This provided us with an opportunity to update him on the progress of the Amendment Bill and seek his support in assisting us with our application to join IFIAR once the Bill is enacted. In return we learnt a good deal about the IFIAR processes, timetables and current administrative direction.

A body called the Monitoring Group is currently examining the process of setting international auditing standards in the public interest. We were privileged to have Mr Mark Babington from the UK FRC, who is coordinating the project, come to visit us and update us on its progress. We also took the opportunity to express our views on the topic.



Mr Carl Renner (2nd from left), Executive Director, International Forum of Independent Audit Regulators (IFIAR) pays a courtesy visit to the FRC on 28th June 2018



Courtesy visit from Mr Mark Babington (right)

Summary of Completed Cases

The following is a summary of issues that we have found in our investigations. In general the key message is that auditors need to demonstrate scepticism in accepting management's financial reporting treatments, ask the right questions of management and fully assess how reliable their audit evidence is.

A listed entity reclassified part of its quoted investment portfolio from "fair value through profit or loss" category to available-for-sale investment. The accounting standards allow

such reclassification only under rare circumstances and impose additional disclosure requirements when such reclassification takes place. Our findings demonstrated that the auditor failed to (a) actively challenge management regarding the basis for the reclassification; (b) properly analyse whether “rare circumstances” existed, and carry out a proper evaluation of the appropriateness of the reclassification, supported by reliable audit evidence; and (c) identify that the financial statements omitted the required disclosures in relation to the reclassification. These findings are particularly disappointing as there is an enormous amount of technical guidance on this matter including clarification by IASB.

In another case, a listed entity recognised a general provision for inventory obsolescence with reference to an ageing of the inventories at the year-end. It was found that the auditor failed to (a) properly perform sampling tests on the measurement of the inventories; (b) appropriately project misstatements found in the sample to a population; and (c) evaluate the reasonableness of the provision. This is a good example where an enquiring mindset would have identified the misstatement in the financial statements.

In a situation where the auditor identified that the making of cut-off adjustments in relation to sales of goods was one of the significant accounting and auditing issues, it was found that the auditor failed to (a) properly assess the risks of material misstatement in revenue recognition; (b) address the potential for inappropriate recognition of revenue from sales of goods; and (c) properly evaluate and consider additional procedures in relation to exceptions identified in substantive tests.

Another investigation revealed that the auditor failed to properly perform procedures to resolve inconsistencies in audit evidence which might affect the accounting for a business combination which therefore affected the recognition and measurement of goodwill. The auditor also failed to properly evaluate whether the evidence that they had obtained in the prior year’s audit was of continuing relevance.

The purpose of an engagement quality control review in an audit is to serve as a meaningful check on the work performed and decisions made by an engagement team. In many cases engagement quality control reviewers failed to identify significant audit

deficiencies. This may have been caused by (a) over-reliance on review checklists; (b) the absence of critically reviewing the working papers supporting significant judgements made by the audit team; and (c) a failure to adequately challenge and document the challenges made and the basis on which the issues were resolved.

Letters of Advice

For the purpose of improving the quality of financial reporting, FRC issues letters of advice to listed entities and auditors on matters identified either during financial statements reviews or in conjunction with our other work. Examples include:

1. HKFRS 13 categorises the inputs used to measure fair value into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. In relation to fair value measurement of investment properties with reference to recent market transactions of similar properties in the same location, the inputs should not be categorised within Level 1 fair value hierarchy for financial reporting.
2. In respect of fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy in HKFRS 13, i.e. observable inputs other than quoted prices in Level 1 and unobservable inputs respectively, preparers of financial statements are reminded to provide descriptions of the valuation techniques and inputs used in the valuations. Beside, when there is a change in valuation technique, the issuer is required to disclose that fact and the reason for such change.
3. When management is aware of any material uncertainties relating to events or conditions which might cast significant doubt on the reporting entity's ability to continue as a going concern, relevant and adequate disclosures should be made on those uncertainties and management's plans to deal with these events or conditions and such disclosures should be within the discussion on going concern rather than in another separate location in the financial statements.

4. Issuers are required to disclose a summary of significant accounting policies that are used in preparing the financial statements. Preparers of financial statements are reminded to correctly disclose the measurement bases of relevant financial statement items as these bases would affect the readers' analysis and understanding of the judgements behind the financial reporting.

Key Operations Statistics

	Jan to June 2018	Jan to June 2017
Persuable complaints received	68	116
Investigations completed	7	11
Investigations initiated	13	8

Note: Detailed operations statistics are available in the “Operations Statistics” section of our website.

Contacts

If you have any enquiries or comments, please feel free to contact us.

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