

# e-News

## Key Message

The first half of 2019 has gone by very fast. In the past 6 months, the FRC calendar has been filled with encouraging developments and memorable events amid our usual business of investigations. We would like to invite you to take some time to read this e-newsletter which will not only give you an overview of our activities but also insightful and educational information in relation to major issues identified in our investigations.

## Preparing for the New Regime

As mentioned in our last e-newsletter, the Financial Reporting Council (Amendment) Ordinance (the Amendment Ordinance) was enacted on 30 January 2019 with the effective date to be announced. Under the Commencement Notice, the Amendment Ordinance will take effect on 1 October 2019.

Since the enactment of the Ordinance, the FRC has been busy making preparation for the new auditor regulatory regime.

To meet the needs of our future expanded operations, we are developing a new governance and organisation structure that will facilitate us to discharge our statutory duties as the independent listed entity auditor regulator for Hong Kong effectively and efficiently. We have also set up guidelines and procedures in relation to our expanded functions, in particular, sanctions guidelines for imposing pecuniary and non-pecuniary sanctions.

### **Overwhelming Support for the Sanctions Guidelines**

We conducted a consultation from 13 March to 17 April on the proposed [Sanctions Guidelines](#) (the proposed guidelines) which are required to be published for the FRC to impose any pecuniary penalty. During the consultation, we arranged a total of 15 meetings with audit firms that audit listed entities and professional bodies whereby we explained the proposed guidelines in details and clarified on issues of concerns.



Meeting with representatives from audit firms that audit listed entities during the consultation.

Our [consultation conclusions](#) showed that a majority of respondents were highly supportive and positive about the [proposed guidelines](#). We are very thankful to those who have made their [submissions](#) and contributed their insights which helped shape the comprehensive [Sanctions Guidelines](#) that we now have.

All these could not have been achieved without the staunch support of the Financial Services and the Treasury Bureau (FSTB) given to the FRC over the years.

In deepest appreciation of his staunchest support and resourceful contribution to the FRC and the new auditor regulatory regime of Hong Kong, Dr Kelvin Wong, Chairman of the FRC, presented a memento to Mr Andrew Wong, Permanent Secretary for Financial Services and the Treasury (Financial Services) on 29 August 2019 and wished him all the best on his retirement.

Dr Kelvin Wong (left), Chairman of the FRC, presented a memento to Mr Andrew Wong, Permanent Secretary for Financial Services and the Treasury (Financial Services).



## Memorandum of Understanding with the PRC's Ministry of Finance

Over the years, the FRC has been in regular and constructive dialogue with the PRC's Ministry of Finance (MoF) with a shared goal of strengthening cross-boundary audit regulatory collaboration and enhancing investor protection.

Our efforts came to fruition when we signed the Memorandum of Understanding (MOU) on cooperation in respect of audit regulation with the Supervision and Evaluation Bureau (SEB) of the MoF at the Signing Ceremony on 22 May in Hong Kong.



Dr Gao Jinxing (front, left), Director General of the SEB and Ms Wincey Lam (front, right), Acting CEO of the FRC signed the MOU in the presence of Mr James Lau (back, centre), Secretary for Financial Services and the Treasury of the HKSAR Government, Ms Song Wei (back, left), Deputy Director, Coordination Department of the Liaison Office of the Central People's Government in the Hong Kong Special Administrative Region and Dr Kelvin Wong (back, right), Chairman of the FRC.

The MOU aims to enhance the quality and reliability of listed entities' audits in order to protect the interests of investors and the public, and strengthen public trust in financial reporting and investors' confidence in capital markets, thereby reinforcing Hong Kong's position as an international financial centre. It facilitates the FRC's ability to gain access to audit working papers located in the Mainland through an effective mechanism and clear procedures, thereby enhancing our efficiency in discharging our duties in respect of inspection and investigation as an effective independent auditor regulator.

## Experience Sharing with International Regulators

With a view to connecting and sharing experience with international auditor regulators, we have participated in various regional and international conferences. In March, we took part in the Regional IFRS Workshop for Regulators in Singapore whereby we had an in-depth discussion on the implementation and practical issues of IFRSs in particular those that involve the exercise of judgements with other workshop participants. We also attended the 7th ASEAN Audit Regulators Group (AARG) Inspection Workshop on 2 April and gave a presentation on the latest development of the FRC.



Ms Wincey Lam (first from left) met with representatives of other regulators at the 7th AARG Inspection Workshop.

From 30 April to 2 May, the FRC had been invited as an observer to attend the Plenary Meeting of the International Forum of Independent Audit Regulators (IFIAR) in Rhodes, Greece. The meeting provided us with an invaluable opportunity to build ties with IFIAR's members well before our application to become a member when the Amendment Ordinance takes effect later this year.

The events and meetings above have not only deepened the mutual understanding with our international counterparts but also paved the way for the FRC to further expand the scope of cooperation when we become an independent auditor regulator for Hong Kong.

## Summary of Cases

During the first half of the year, we completed two enquiries and six investigations. Our investigations identified concerns regarding the application of professional scepticism and judgement in challenging management's financial reporting treatments and fair value measurement. The following is a brief summary of the findings of our investigations.

### **Multiple auditing irregularities**

We received complaints on a listed entity's financial statements in relation to potential auditing irregularities on a number of financial statement areas. As a result of our investigation, we identified the following auditing irregularities:

- a. In relation to the listed entity's available-for-sale investment, there were changes in the original terms of acquisition and the business model of the investee in response to certain decisions of an overseas investment authority. The investigation revealed that the auditor failed to properly plan and perform the audit in relation to the effects of the changes and the impairment assessment of the available-for-sale investment. The future cash flows from the investment were substantially based on management estimations and assumptions which the auditor failed to question their reasonableness and to obtain sufficient corroborative evidence. The auditor also failed to identify that the disclosures relating to the investment in the relevant financial statements were incorrect and incomplete.
- b. Following the changes of the acquisition terms of the above available-for-sale investment, certain convertible notes and conversion shares previously approved by independent shareholders for the original acquisition were used as consideration for management services to be provided to the investee in future periods. The investigation found that the auditor failed to perform procedures in relation to the change in use of the financial instruments and to assess whether HKFRS 2 *Share-based Payment* had been properly applied in the relevant financial statements.
- c. At the year-end the net asset of the group, substantially represented by the interests in subsidiaries, was significantly less than that of the company level and

the group incurred loss during the year. The investigation found no evidence that the auditor had performed audit procedures during the audit in relation to the impairment assessment of the listed entity's interests in its subsidiaries.

- d. The investigation also revealed that the auditor failed to alert that the impairment losses of trade receivables were related to the sales recognised in the immediate preceding financial year and design and perform audit procedures to evaluate whether the revenue recognition in prior year was in compliance with the relevant financial reporting standard.

### **Impairment assessment**

In an investigation relating to an impairment assessment of goodwill in the year of acquisition, we found that the auditor did not sufficiently challenge and evaluate the reasonableness of certain key assumptions and estimates used in the cash flow projections of the acquired business that was in the early stage of development and failed to obtain adequate audit evidence in this respect in accordance with applicable auditing standards.

### **Business combinations and nature of business acquired**

In another investigation, we noted that the listed entity completed a "very substantial acquisition" in relation to the acquisition of a hotel business. Before and after the acquisition, the operations of the hotel were licensed to a hotel management company which operated, managed and maintained the hotel and received all the revenue generating from the hotel operations, while the listed entity received a monthly income consisted substantially of a fixed amount and a variable royalty fee from the hotel management company. The hotel was accounted for as an owner-managed hotel under HKAS 16 *Property, Plant and Equipment*. The investigation found that the auditor failed to (a) properly plan and assess risks of material misstatement in relation to the accounting of the acquisition; and (b) perform or adequately perform procedures in relation to the fair value measurement of identifiable assets acquired and the recognition of a gain on bargain purchase arising from the acquisition. The auditor also failed to properly consider the substance of the licensing arrangement and evaluate whether the accounting treatment of the acquired hotel in the relevant financial statements was appropriate.

## **Financial instruments**

1. A listed entity recognised an option to issue convertible bonds within a year granted by a subscriber as a financial asset at fair value through profit or loss and measured the option based on an external valuation. Our investigation found that the auditor relied on the valuation provided by the management's expert as part of their audit evidence. However the auditor failed to (a) obtain an understanding of the rationale for the subscription arrangement and the relationship between the subscriber and the listed entity; (b) adequately evaluate the work of the external valuer in respect of the assumptions used, including the credit risk and other non-performance risks of the subscriber and the future volatility of the share price, in the fair value measurement of the option; and (c) identify the omissions of disclosures in relation to financial risks and fair value measurement relevant to the option which was significant to the relevant financial statements.
2. HKAS 32 Financial Instruments: Presentation requires issuer of financial instrument, on initial recognition, to classify the instrument or its component parts as a financial liability, a financial asset or an equity instrument based on the substance of the contractual arrangement and their definitions. Investigations were initiated on two sets of financial statements of a listed entity which issued convertible note with mandatory conversion feature but subject to contingent cash settlement provisions upon the occurrence of certain events which were beyond the control of the listed entity and the holder of the convertible note.

Our investigations found that (a) the auditor in the year of issuance of the convertible note failed to critically consider all the relevant terms of the convertible note and exercise proper professional judgment to evaluate the management's accounting treatment of the convertible note; and (b) the successive auditor failed to perform relevant procedures on the opening balances in relation to the convertible note including review and consideration of the prior year's financial statements, the terms of the convertible notes and the relevant provisions of HKAS 32 to evaluate the appropriateness of the accounting treatment of the convertible note. The listed entity subsequently corrected the non-compliance with accounting requirements by retrospectively restated prior year financial statements in the year when the convertible note was matured.

### **Engagement Quality Control Review**

In each of the above completed investigations, we also found that there were deficiencies in relation to the engagement quality control review. In particular, there was a lack of evidence that key matters were considered by the engagement quality control reviewer (EQCR) and how the EQCR concluded on the reasonableness of the significant judgments reached by the engagement team during the respective audits.

## **Key Operations Statistics**

	Jan to Jun 2019	Jan to Jun 2018
Pursuable complaints received	34	68
Investigations / Enquiries completed	8	7
Investigations initiated	8	13

## **Contacts**

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

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