



## Introductory Message from the CEO

It is my pleasure to introduce the third edition of our e-News for 2021-22 and to wish you and your families a happy Christmas and a healthy and prosperous 2022.

Since the publication of our last e-News, we have issued this month our second oversight report (Oversight Report) and our second policy and governance report, which comprises Guidelines for audit committees on the selection, appointment and reappointment of listed entity auditors (Guidelines). You can read more about our Oversight Report and the Guidelines below.

We are making use of the Guidelines to remind and educate key stakeholders about the importance of effective governance, the responsibilities of Boards, Management and Audit Committees for listed entity financial reporting and their respective roles in creating a governance environment and culture to promote high quality financial reporting.

We continue to face high profile matters, in relation to which we also judge that the potential impact of the matter on the public interest is high. In such cases, we publicly announce enquiries into non-compliance of listed entity financial reports or investigations into misconduct by listed entity auditors that we have initiated. Our purpose in doing so is to allay public concerns and to maintain public confidence in the system for independent auditor regulation.

With such enhanced transparency in our work, we have also seen a significant increase in pursuable complaints and referrals of cases to us. These have more than doubled in 2021-22 to date compared with the same period in 2020-21. A significant component of



the increase has been in the form of whistleblowing reports. In response to this welcome trend, we developed a new policy for handling whistleblower reports. The purpose was to give whistleblowers greater confidence that their personal identities will be protected, to address their fear of reprisals and to ensure an efficient flow of intelligence through this channel. We have launched the new policy publicly at the beginning of this month with a new webpage and secure route for on-line submission of whistleblowing reports. You can read more about this below.

One notable and encouraging development we have seen in the year to date is a significant reduction in the incidence and significance of certain types of deficiencies we identified in listed entity audit engagements compared with the previous year. This trend has continued since we reported it in our second interim inspection report published on 3 November 2021. This demonstrates that progress is already being made by listed entity auditors to address the issues we have raised.

The FRC deals with a wide range of deficiencies in audit quality by listed entity auditors. These vary from relatively minor breaches of requirements in the auditing standards to serious deficiencies that call into question the reliability or validity of the auditor's report. We have a full range of proportionate regulatory tools to enable us to address these. In relatively rare instances, the potential misconduct may be wilful and carry a risk that evidence could be destroyed or other actions taken to cover it up. Search operations may be justified as a proportionate response in such circumstances and are subject to authorisation by a Magistrate.

Since the last edition of e-News was published, we carried out a joint search operation with ICAC in a case of suspected misconduct and bribery, during which we searched the offices of a listed entity auditor. The joint operation signifies the FRC's determination to combat misconduct in Hong Kong's financial markets through collaboration with other regulatory bodies and enforcement agencies. The FRC will unhesitatingly use all the enforcement tools available to it when necessary to protect the interests of the investing public and maintain Hong Kong's reputation as an international financial centre.

There is no doubt that the most significant event for the FRC during the year to date has been the enactment of the Financial Reporting Council (Amendment) Ordinance 2021. This heralds in the transformation of the FRC to be the Independent Regulator of the

Accounting Profession in Hong Kong. The main body of this e-News below starts with a brief update on this further regulatory reform, which will be implemented in the coming year.

As the New Year begins, we will continue to play our role in ensuring that there is a smooth transition of the new FRC functions from the HKICPA to the FRC. We also welcome first signs of the opening up of the border with the Mainland and look forward to the opportunity this would bring for us to work even closer with the SEB and other relevant bodies in the Mainland.

## Update on Regulatory Reform

With the enactment of the Financial Reporting Council (Amendment) Ordinance 2021 completed, the next major task is the preparation of the subsidiary legislation that will set out the transitional arrangements for the transfer of functions to the FRC which is well under way.

When discharging its independent regulatory functions under the new regime, the FRC will also play the role of promoting the development of the profession through effective regulation, the nurturing of professionals and the strengthening of continuing professional development.

To ensure a smooth transition, the FRC will liaise with the Government to discuss the preparation for the new regulatory regime of the accounting profession, and work closely with the HKICPA in relation to the logistic arrangements for the transfer of functions. There will be further engagement with stakeholders including the profession regarding the subsidiary legislation and the implementation of the new regulatory regime for the accounting profession. Details are being prepared and will be released in the coming months. Watch this space for further news in 2022.

## New Whistleblowing Policy

In view of the importance of whistleblowing as a source of complaint and its growing attention from the public since the beginning of 2021, the FRC has launched a new Whistleblowing policy. The policy is designed to ensure protection of the personal identities

of Whistleblowers so as to increase their confidence in the security and secrecy of handling of their reports. A dedicated [Whistleblowing webpage](#) with an [online form](#) has been created for submission of Whistleblower reports about potential wrongdoing or misconduct in financial reporting or audits of listed entities.

Whistleblowers are typically individuals with an insider's view of listed entities or their auditors. They are therefore an important and highly valued source of intelligence to the FRC. Through our new policy, we aim to ensure an efficient flow of intelligence from this important channel. We encourage the public to come forward to report financial misconduct without fear and intervention. Confidence from whistleblowers is pivotal to our ability to take proactive regulatory action to protect the public interest.

## **Guidelines for Effective Audit Committees and Report on the FRC's Assessment of the HKICPA's Performance of Specified Functions**

On 16 December 2021, we issued two publications – the [Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors](#) (the Guidelines) and the [Report on the FRC's Assessment of the HKICPA's Performance of the Specified Functions](#) (the Report).

### **The Guidelines**

The FRC considers that the accuracy, integrity, and consistency of listed entity disclosures are essential to maintain investor confidence and the effective functioning of capital markets. Therefore, the FRC is strongly committed to:

- a) upholding the quality of financial reporting of listed entities to enhance protection of investors; and
- b) enhancing audit quality to ensure it serves the interests of the investing public and the wider public interest.

As a result, the FRC has a strategic focus on enhancing the quality of financial reporting and auditing through better corporate governance practices.

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

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



Dr Kelvin Wong, Chairman (middle), Mr Marek Grabowski, CEO (right), and Ms Florence Wong, Deputy CEO and Head of Oversight, Policy and Governance of the FRC present to media the Guidelines for Effective Audit Committee and Report on Assessment of the HKICPA's Performance of the Specified Functions.

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

Key factors for evaluating a potential auditor from an audit quality perspective:

- Governance and leadership of the audit firm
  - The governance arrangements safeguard the public interest in the audit function of the audit firm
  - Audit firm demonstrates its commitment to quality
- Compliance with relevant ethical requirements
  - The auditor demonstrates that it maintains high standards of integrity, objectivity and independence
- Industry knowledge and technical competence
  - Relevant knowledge and experience in the same industry and similar business
  - Expertise to handle specific technical matters efficiently and effectively
  - Experience of audit engagement partner and key team members
- Engagement performance
  - The audit methodology encourages the application of professional scepticism and exercise of appropriate professional judgement
  - The audit firm has established quality control procedures to ensure audit quality is monitored by proper direction, supervision and review by experienced staff

- Audit strategy provided by the audit firm demonstrates the firm's commitment to allocate sufficient appropriate resources to the audit engagement
- Communication and interaction with the audit committee
  - Timely communication of audit timetable and audit matters
- Monitoring process
  - Recent results from internal and external inspections
  - On-going regulatory actions against the audit firm and audit engagement team members

In evaluating an incumbent auditor for reappointment, an audit committee can leverage the information and experience gained from their initial assessment and interaction with the auditor. Audit quality is still the prime consideration. The key considerations to assess audit quality for the appointment of new auditors are generally applicable to the reappointment of incumbent auditors. In addition, further considerations may include:

- Audit effectiveness
  - Whether the incumbent auditor has appropriately identified the audit risks?
  - Whether the audit issues are addressed in a timely and effective manner?
  - Whether the incumbent auditor applied professional skepticism, and challenged management on the reasonableness of key management assumptions and business rationale/commercial substance for complex and unusual transactions?
  - Whether the incumbent auditor has completed the audit engagement according to the agreed timetable?
- Relationship between the auditor and management of the listed entity
- Interaction with the audit committee

- Other considerations, such as long association with the audited entity that may have implications for the auditor's independence of the entity.

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

A tender process encourages competition and may stimulate innovation and help ensure a transparent and fair selection process. Therefore, we recommend audit committees conduct audit tenders periodically. The Guidelines outline the key stages of the audit tender process and provide guidelines on how to run an effective audit tender.

In view of the upward trend in changes in auditors of listed entities between 2011 and 2019, the Guidelines outline some key issues and procedures that audit committees should consider or perform when auditors resign or when audit committees are considering whether to remove auditors. For example:

- Audit committees should hold separate private meetings with the outgoing auditors and management of the listed entities to understand all the circumstances surrounding the resignation of auditors; and
- Audit committees should not remove auditors in order to avoid a qualified opinion on the financial statements.

In order to promote transparency of audit committees' work on selection, appointment and reappointment of auditors, audit committees are encouraged to disclose in the corporate governance report at least: the reasons for a change in auditors, the selection process and criteria and the basis of their decisions; or the process and factors considered in evaluating the incumbent auditors and the basis for the reappointment.

## The Report

We have also completed our second assessment of the performance of the specified functions of the HKICPA and a report outlining our findings and recommendations was published on 16 December 2021.

This year, we evaluated the HKICPA's policies and procedures for the performance of the specified functions in addition to assessing performance against those policies and procedures, and also evaluated the follow-up actions taken by the HKICPA in response to our recommendations from our first assessment.

### Highlights of our findings

Four of our nine recommendations from last year were satisfactorily followed up by HKICPA designing and implementing appropriate policies and procedures. Those recommendations were:

- Regular review of terms of reference for the committees responsible for the performance of the Specified Functions, and communication amongst committee members;
- Development of additional policies and guidelines regarding the determination of conditions for PIE auditor registration;
- Regular review of policy documents; and
- Ensure local constituents are consulted on requirements proposed by the relevant international standard setters.

While policies and procedures had also been developed by HKICPA to address four of the remaining recommendations we raised in our last assessment, we found that there was room for further improvement. Accordingly, we made the following additional recommendations in the Report to re-address those recommendations from last year.

- Criteria for determining the composition of the Registration and Practising Committee (**RPC**) should be specified in the HKICPA's documentation
- Performance of chairperson and members of the RPC should be evaluated based on the performance evaluation criteria set by the HKICPA

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- Deficiencies in design and performance of policies and procedures relating to the update of CPD requirements and Standards on Professional Ethics, and Auditing and Assurance Practices should be addressed
  - The policy for post-implementation review of standards/requirements should be enhanced

Regarding our finding and recommendation on prescription of specific CPD requirements for registered PIE auditors, we found that no follow-up actions had been taken in our current assessment. We have therefore repeated and strengthened this recommendation in the Report, highlighting that the HKICPA have added similar requirements to those we are recommending for registered responsible persons of listed entity auditors (albeit limited ones) to address specific CPD requirements for Designated Specialists.

We have also made three recommendations relating to registration based on new findings from our second assessment, as follows:

- An orientation should be provided to new committee members responsible for registration of PIE auditors

In response to our recommendation, HKICPA will arrange an induction session for any new RPC members to be appointed for 2022.

- At least some CPD compliance audit should be performed before the renewal of HKICPA membership to strengthen safeguards against unqualified persons being registered.
- The HKICPA should check underlying documents sufficiently to verify the completion of CPD activities including attendance and hours.

The HKICPA is addressing our recommendations and we will continue to engage with them to ensure satisfactory resolution of the issues identified.

## Contacts

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

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