

e-News

Florence Wong, Acting CEO

Key Message

Since our transformation to become the independent auditor regulator of Hong Kong from October 2019, the FRC has put in place new governance and organisation structures, hired more professional staff and implemented our strategies systematically and progressively to deliver the expected regulatory outcomes of enhancing the quality of financial reporting and investor protection. Audit quality and audit independence are even more important and vulnerable amidst the challenging financial and socio-economic situations including the lingering gloomy economic outlook, the threat of the novel coronavirus and the resignation trend of audit firms as auditors of listed companies.

In view of the current situations, the FRC has engaged in constant dialogue with auditors to understand their challenges, and to remind them of their duty to ensure audit quality and audit independence in response to those challenges. The FRC has also worked closely with other regulators to explore how audit quality and audit independence will not be compromised. We are pleased to note that on 4 February 2020, the Stock Exchange of Hong Kong Limited and the Securities and Futures Commission issued the [Joint Statement in relation to Results Announcements in light of Travel Restrictions related to the Severe Respiratory Disease associated with a Novel Infectious Agent](#), which helps to address the possible disruption to the disclosure of financial information or audit processes of certain listed entities.

Apart from the above, we are also including in this e-newsletter other important messages and note-worthy issues to auditors and listed companies which, we believe, would help promote audit quality and corporate governance at this critical moment. Readers would certainly take home some new perspectives and insights after going through this e-newsletter.

Issues and Advice

In view of the above-mentioned adverse conditions, we would like to draw the attention of the relevant stakeholders to a number of key issues and advice they should take heed of.

For auditors

Management may be under pressure to meet financial and operational goals such as earnings or revenue targets, financial ratio, loan covenants and others. Audit firms may be subject to the same pressure too. This may give rise to adopting practices which may be too aggressive or may not be in compliance with relevant laws or regulations and professional standards.

Under such circumstances, audit firms and audit engagement partners should recognise the importance of compliance with ethical requirements and remind the audit engagement teams of the same. They should ensure that their audit engagement teams are independent and exhibit objectivity and integrity at any time.

An audit engagement partner should be actively involved in risk assessment, planning, and in supervising and reviewing the work performed and should ensure that the engagement team has sufficient time to undertake the audit in an effective and robust manner in accordance with HKSA 220 “Quality Control for Audit of financial Statements”. It is even more important at the current situation that audit engagement team and the engagement quality control reviewer remain sceptical and objective and are prepared to challenge the management’s estimation and judgements, particularly those relating to impairment assessment of intangible assets including goodwill, revenue recognition, appropriateness of the going concern assumption and compliance with debt covenants. Other areas of focus include related party transactions and unusual transactions that may heighten the risk of improper accounting or disclosure. Hence, audit firms and audit engagement partners should arrange sufficient and appropriate resources and competent professionals to undertake necessary additional procedures to address the above risks.

Audit firms and the quality control system responsible persons should ensure their quality control systems provide an effective check and balance for compliance with professional standards and other relevant rules and regulations, and that audit quality is closely monitored and appropriate consequential action is taken where appropriate.

Other note-worthy issues are also included in the section ‘Reminder of key audit and accounting issues’.

For preparers of financial statements

The board of directors, being the preparers of financial statements, have ultimate responsibility for the integrity and accuracy of financial statements. They have the primary responsibility to ensure that the finance function is appropriately resourced and has suitably qualified staff to prepare financial statements that give a true and fair view in accordance with the applicable financial reporting framework. They must also put in place necessary internal control to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The delegation to the audit committee of the oversight of financial reporting and the fact that there is an external audit do not absolve the board of its obligations.

The current downward business environment may lead to rapidly deteriorating operating results and liquidity challenges for some companies, particularly those in the catering, retail, tourism and consumer-based industries. Directors, having a key responsibility to approve the assumptions adopted by the entity and the key areas of judgement and estimation applied in preparing the financial statements, need to exercise extra due care in these respects. In particular, when assessing the entity’s ability to continue as a going concern, they should take into account all available information (e.g. the global and local economic slowdown, the novel coronavirus, operating losses, suspension of operations, working capital deficiencies, loan defaults or denial of credit from suppliers) about the future which is at least, twelve months from the end of the reporting period. This assessment should be based on realistic but not overly optimistic assumptions.

For audit committees

To discharge its responsibility of overseeing financial reporting processes effectively, the audit committee should focus its efforts on emerging risks and challenge management’s judgements and assumptions which may have significant impact on financial reporting, such as changes in internal control; challenges, risks and opportunities facing the entity; key judgements and estimates made in preparing the financial statements (e.g. forecasts and underlying assumptions used in impairment and going concern assessments); and significant subsequent events.

There is a clear relationship between audit fees and audit quality. In light of the recent

economic environment, we expect a downward pressure on audit fees. An audit committee should be mindful of the appropriateness of the audit fees after considering the size, complexity, and risk profile of the entity. It is important to strike the right balance between on the one hand the level of audit fees, and on the other efficiency and effectiveness of the audit process and audit quality. In particular, the audit fees should be a realistic amount such that the auditor is able to undertake a proper and thorough audit in accordance with auditing standards.

Given the current situation and in light of the Joint Statement, the audit committee should initiate discussion with management and the auditor to assess the implication of the novel coronavirus on the year-end audit. In particular, professional issues may include whether the incident has any significant impact on the entity that requires adjustments and disclosure in the financial statements; whether the auditor has sufficient time and resources to complete the audit by 31 March 2020 where the company has a December year-end; and what are the specific and practical impediments that would lead to an expected delay in the completion of the audit that are not capable of resolution. If the last-mentioned situation occurs, we urge the audit committee to have an independent discussion with its auditor in the absence of the management to ensure that the auditor is not under undue pressure from management to complete the audit. This should help ensure audit that quality would not be compromised.

FRC's Plans in 2020

As an effective financial regulator, the FRC stays vigilant of the social and economic developments and will adjust our strategies appropriately. Taking into consideration the potential deferral of audit work due to the situation arising from the novel coronavirus, we will appropriately adjust our inspection visit plan and focus our inspection work on the above mentioned areas which are more vulnerable to changes in the economic environment (e.g. management's judgements and assumptions applied in impairment assessment, revenue recognition and auditor independence and scepticism). Regarding investigation, we will critically review the selection criteria of our in-house financial statements review programme.

New Face of the FRC

New governance structure in place

To fully and effectively discharge our expanded functions, the FRC has a new governance structure in place. The Board, being the ultimate governing body of the FRC, is comprised of 15 members including the Chairman who is non-executive, 13 non-executive directors and an executive director. They are all non-practitioners with more than one-third (i.e. 8 members) of

the Board having knowledge and experience in PIE engagements.

Five committees have been established, namely the Inspection Committee, the Investigation and Compliance Committee, the Oversight, Policy and Governance Committee, the Finance and Corporate Affairs Committee and the Compensation and Nomination Committee to advise the Board on matters in relation to different functions of the FRC. These committees, comprising Board Members and Honorary Advisers with a wide spectrum of expertise, provide invaluable advice on different affairs to the FRC.

Increased number of competent professional staff

With the receipt of the seed capital of \$400 million in August 2019, the FRC has launched a phased recruitment programme to cater for our increasing workload and expanded operational needs. We are pleased to report that many senior positions for the new functions have already been filled by highly qualified and competent professionals. Currently, the FRC has hired 41 full-time staff (of which 28 are qualified professionals). The FRC will continue to expand its talent pool to meet its first phase of human resources requirement of 52.

New office and housewarming cocktail reception

To cater for the need of our expanding operations, the FRC has moved to the new office on the 24/F of Hopewell Centre on 2 December 2019. To celebrate this ‘big move’, a housewarming cocktail reception was held on 13 December 2019. The event was graced by the presence of Ms Michelle Li, Permanent Secretary for Financial Services and the Treasury as the Guest of Honour who performed the auspicious roast pig-cutting ceremony together with Dr Kelvin Wong, Chairman, and Board Members of the FRC.

In her remark, Ms Li wittily concluded the four statutory functions of the FRC namely, inspection, investigation, discipline and oversight as ‘IIDO’, which in speech is ‘I I Do’. Echoing Ms Li’s remark, Dr Wong said that the FRC will always discharge its duties in this ‘I Do’ spirit to uphold the quality of financial reporting of listed companies in Hong Kong.

Ms Michelle Li (6th from left), Permanent Secretary for Financial Services and the Treasury performed the auspicious roast pig-cutting ceremony together with Dr Kelvin Wong (6th from right), Chairman, and Board Members and management of the FRC.



Dr Kelvin Wong (6th from left, back row), Chairman, and Dr John Poon (5th from left, back row), former Chairman of the FRC, shared a happy moment with staff at the housewarming cocktail reception.

Ms Sophia Kao (right), the founding Chairman and Dr P M Kam (left), former CEO, of the FRC with Dr Kelvin Wong at the office tour.



International connection

In the past few months, the FRC has made its presence felt by meeting with international financial regulators and professional bodies. Our established connection with international counterparts enables us to stay ahead of the evolving financial and auditing regulatory landscape.

On 26 September 2019, the FRC met with the International Valuation Standards Council (IVSC) to gain an understanding of the consultation on proposed standards and professionalism framework for business valuation in the Hong Kong market. Subsequent to the meeting, the FRC expressed the following views on the consultation:

- Welcomed the proposals made by the IVSC in promoting the valuation profession in Hong Kong.
- Concerned about how the competencies should be assessed before business valuers become qualified for the Hong Kong market and which professional bodies (existing ones or a new one) would be responsible for such assessment to ensure a rigorous and standardised system for the assessment would be established.
- Suggested that further work should be done to cover the valuation of financial instruments after the business valuation framework is established.



Sir David Tweedie (centre), Chair, International Valuation Standards Council (IVSC) Board of Trustees and Mr Nick Talbot (2nd from right), CEO of IVSC, paid a courtesy visit to the FRC.

The FRC has been proactive in sharing views and comments on issues related to the developments of international accounting and auditing standards. For example, on 19 November 2019, we met with Mr Len Jui, Board Member of the International Auditing and Assurance Standards Board and shared our views on their project in relation to the proposed revision of International Auditing Standard 600 on audits of group financial statement which would have a significant impact on PIE engagements.

On 4 and 5 December 2019, two Directors of Inspection attended an international conference on audit regulation organised by the Public Company Accounting Oversight Board (PCAOB) in Washington, the United States. We gained insightful information from the conference on the future of auditor oversight, audit quality risks associated with evolving technologies, developments and challenges in cross-border regulation, challenges of increasingly global audits and investor perspectives on future audit. The conference also provided us with the valuable opportunity to build ties with other international auditor regulators.

Since the signing of the Memorandum of Understanding with the PRC's Ministry of Finance (MOF) on 22 May 2019, the FRC has been engaging in constant dialogue with the MOF to explore further areas of collaboration. On 15 January 2020, the FRC held a meeting with the Supervision and Evaluation Bureau (SEB) of the MOF in Beijing to discuss future cooperation in inspection with a shared goal of enhancing audit quality.



Dr Gao Jinxing (4th from left), Director General of SEB met with Ms Florence Wong (4th from right), Acting CEO, FRC to discuss future cooperation.

Reminder of key audit and accounting issues

Impairment of assets

Uncertain economic environment globally and locally increases the likelihood of impairment of both financial and non-financial assets. Management should prepare cash flows/profit forecasts which are reasonable and supportable and represents management's best estimate of the economic circumstances. Auditors are reminded to exercise professional scepticism and challenge management on key assumptions, in particular, when management's judgements and estimates appear to be "too good to be true".

Breach of bank covenants and going concern

In the event of breach of bank covenants, the related borrowings may be reclassified under current classification at the balance sheet date, which will impair the entity's ability to continue to use the going concern basis of accounting in the preparation of the financial statements. Auditors should robustly challenge the assumptions underlying management's assessment and should not be biased towards obtaining audit evidence that may be corroborative to management's representation. In particular, audit procedures should cover whether management's plans in relation to the debt repayment is feasible under the entity's circumstances; and whether such assumptions are consistent with related assumptions used in other areas of the entity's business activities (for example, impairment of assets) based on auditors' knowledge obtained in the audit. Auditors should evaluate the overall audit evidence obtained and modify the auditor's report where appropriate.

Revenue recognition

Revenue recognition should reflect the substance of business transactions. Where the entity has complex revenue arrangements, for example license arrangements of intellectual property, barter transactions, contracts with multiple elements, and contracts with milestone payments, auditors should perform an in-depth analysis to understand the substance of the arrangements to ensure that revenue recognition of these transactions are properly accounted for in accordance with Hong Kong Financial Reporting Standard 15 Revenue from Contracts with Customers.

Unusual transactions

Significant transactions that are outside the normal course of the entity's business may provide opportunities for management to engage in fraudulent financial reporting or conceal misappropriation of assets. Auditors should exercise professional skepticism in evaluating the business rationale for such transactions and the appropriateness of accounting treatment and disclosures in the financial statements. Where appropriate, auditors should communicate with audit committees about such transactions on a timely basis so that audit committees can act accordingly.

Operations Review

Inspection

Since the operation under the new regime, we have deployed noticeable efforts in establishing policies and procedures for carrying out inspections, developing our inspection plan for the first inspection cycle and recruiting professional staff of high calibre.

The objectives of our inspection are to monitor and promote audit quality. Our inspection focuses on how a PIE auditor conducted PIE engagements and on the effectiveness of the PIE auditor's quality control system to determine whether the applicable professional standards and legal and regulatory requirements have been complied with. Consistent with international practices, we have adopted a three-year inspection cycle. That means all PIE auditors will be subjected to our inspection at least once every three years. The first inspection cycle commenced on 1 October 2019, the date when we were empowered by the FRCO to carry out inspections on PIE auditors, and will end on 31 December 2022. We plan to carry out inspections on at least 18 registered PIE auditors in the first year of our first inspection cycle. The first inspection is expected to commence in late March 2020.

We already started engaging with the registered PIE auditors to explain our inspection approach and clarify on matters they concerned. We have scheduled a total of 11 meetings and briefing sessions with the registered PIE auditors. Through these outreach activities, we wish to create opportunities for sharing views with an aim to enhance the audit quality of the registered PIE auditors in Hong Kong. We received positive responses from the PIE auditors we met and they considered the meetings useful, informative and productive.

Oversight, Policy and Governance

Pursuant to the Statement of Protocol on Oversight Arrangements between the FRC and the HKICPA, representatives from the FRC would sit on the respective committees of the HKICPA responsible for the specified functions (i.e. registration, setting standards for ethics and auditing and assurance practices and requirements for continuing professional development in relation to PIE auditors) as an observer. Since 1 October 2019, the representatives from the FRC observed four meetings.

Upon the FRCO taking effect on 1 October 2019, non-Hong Kong auditor intending to carry out a PIE engagement for an overseas listed entity is subject to a system of recognition. Since 1 October 2019, the FRC received 78 recognition applications from overseas listed entities for 25 overseas auditors. The review of these applications had been completed. The auditors concerned were recognized by the FRC as recognized PIE auditors and their names are contained in the Register of PIE Auditors maintained by the HKICPA.

In addition to the statutory duties under the FRCO, the FRC will also conduct policy research on auditing and financial reporting issues and where appropriate, publish guidance with an ultimate aim to promote the quality of financial reporting, auditing and corporate governance. The FRC will conduct a research on key facts and trends in accounting profession and develop a guide on the effective role of audit committees.

Investigation

From July to December 2019, the FRC received 22 pursuable complaints, completed 6 investigations and 1 enquiry and initiated 7 investigations and 1 enquiry. The key operations statistics are shown in the table below:

	July to December 2019	July to December 2018
Pursuable complaints received	22	17
Investigations completed	6	12
Enquiries completed	1	1
Investigations initiated	7	12
Enquiry initiated	1	0

Our investigations identified concerns regarding the application of professional scepticism and judgement in challenging management's financial reporting treatments, fair value measurement and impairment assessment. The findings of our investigations are summarised below:

Impairment assessment

1. 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. In the subsequent year, the development of the acquired business was further delayed. The investigation found that, the auditor's procedures were principally limited to enquiries with management or technician and failed to (a) critically assess the status of the business development, (b) question the reliability of the key estimates and assumptions applied in the valuation including the expected business growth rate and the consideration of other market conditions, and (c) obtain further evidence to corroborate with management's representation.
2. In another case, the annual report clearly stated that due to the prolonged unfavourable economic and market conditions, the listed entity had suspended certain of its production plants and construction project, and the Group incurred a gross loss. The investigation revealed that the auditor (a) failed to properly assess the risks of material misstatement in respect of the impairment assessment of the production plants; (b) substantially relied on management's representation and failed to critically evaluate and question the assumptions and estimates used in the profit forecasts provided by the management in arriving at the recoverable amounts of the relevant assets at the year end; and (c) failed to evaluate the work of the auditor's expert in respect of the discount rate adopted in the profit forecasts.
3. When valuation provides a range of significantly different estimates, auditor should understand the reasons for the differences and evaluate the appropriateness of the key assumptions and estimates as well as the method selected. In an investigation of an audit relating to impairment assessment of certain intangible assets and exploration and evaluation assets, it was found that the auditor concurred with management, without

critically evaluate the reasonableness of adopting the high end of the range of valuations in determining the recoverable amounts of the assets. Had a lower range of estimates been adopted, a significant impairment loss would have been recognised. The investigation further revealed that the auditor failed to challenge management and valuer on a number of key assumptions including the estimation of the production and sales volume, future prices and discount rate used in the valuation.

4. In another case, despite the auditor assessed certain biological assets, land lease payments and energy production technology as “high risk” matters, the investigation found that the auditor failed to design and perform audit procedures to address the assessed risks. In relation to the determination of the fair value or recoverable amount of these assets, the investigation further revealed that the auditor failed to adequately perform procedures on the key assumptions and discount rate applied, and the source data used in the valuations. The auditor also failed to obtain reliable evidence in relation to the ownership of the biological assets.

Business combinations

In an investigation that involved a “very substantial acquisition”, the listed entity acquired a business involving the development of products relating to telecommunication and information technology. In the annual financial statements, significant amounts of intangible assets were recognised and a substantial part of these intangible assets was determined to have indefinite useful life. The investigation found that the auditor failed to perform or adequately perform audit procedures on the acquisition-date fair value measurement of the intangible assets acquired in the acquisition. Specifically, in evaluating the external valuation, the auditor failed to consider the valuation method, assess and question the reasonableness of the assumptions and estimations used in the profit forecast provided by management despite the fact that the business was in the infant stage and subject to various uncertainties and risks. The auditor also failed to properly consider the reasonableness of the useful lives of the intangible assets and evaluate the recoverable amount of the intangible assets for the purpose of impairment assessment at the year end. The investigation also revealed that the auditor failed to properly evaluate the classification and measurement of the contingent consideration in the acquisition in accordance with the applicable accounting standards.

Financial instruments

In one investigation similar to the above, an option to issue convertible bond was granted by a substantial shareholder of a listed entity. The investigation found that the auditor failed to (a) properly assess the risks of material misstatement including the rationale of the arrangement; (b) obtain and assess evidence on the fair value measurement of the option at its initial recognition; (c) adequately evaluate the assumptions applied on the valuation of the option at the year end; and (d) identify the omission of required disclosures in relation to the option in the financial statements.

Contacts

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

Financial Reporting Council

24/F, Hopewell Centre,
183 Queen's Road East,
Hong Kong

Tel: (852) 2810 6321

Fax: (852) 2810 6320

Email: general@frc.org.hk

Website: www.frc.org.hk