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Press Release

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FRC finds that an auditor failed to obtain the evidence needed to evaluate the measurement and impairment assessment of goodwill arising from an acquisition

On 14 April 2022, the FRC adopted an investigation report finding that the auditor (**the Auditor**) of a listed entity (**Listed Entity**) failed to obtain sufficient appropriate evidence to evaluate the measurement and impairment assessment of goodwill arising from an acquisition **(Acquisition)**, which was included in the consolidated financial statements of the Listed Entity for the year ended 31 December 2016 **(2016 Financial Statements)**. The Listed Entity fully impaired the concerned goodwill in the year ended 31 December 2017.

Under the transitional provisions of the amended FRC Ordinance, since the relevant audit was completed before 1 October 2019, the investigation report has been referred to the Hong Kong Institute of Certified Public Accountants to determine if any disciplinary actions are warranted. Names of the relevant parties are being withheld at this time to avoid prejudicing any related disciplinary proceedings.

The investigation was initiated on 12 July 2018, following referrals by other regulators in December 2017 and May 2019.

Fair value measurement of identifiable assets acquired and liabilities assumed in the Acquisition

HKFRS 3 requires an entity to recognise:

- the identifiable assets, liabilities and non-controlling interests of the acquiree at their acquisition-date fair values; and
- the goodwill as at the acquisition date as the excess of the aggregate of the consideration and non-controlling interests, over the aggregate of the acquisition-date fair values of the identifiable net assets acquired.

The Listed Entity measured the fair values of two buildings owned by the acquiree **(Buildings)** for the accounting of the Acquisition but did not measure the acquisition-date fair values (defined by HKFRS 13) of other identifiable assets acquired and liabilities assumed in the Acquisition, which would have had a consequential effect on the measurement of the goodwill and the non-controlling interests at the acquisition date.

Impairment assessment of goodwill

HKAS 36 requires a reporting entity to conduct an annual impairment assessment of goodwill. The Listed Entity disclosed in the 2016 Financial Statements that it had determined that the acquiree was a cash-generating unit **(CGU)**. Since the management of the Company considered that the recoverable amount was higher than the carrying amount of the net assets of the acquiree, no impairment of goodwill was needed. The Listed Entity appointed a valuer to estimate the fair value of the equity interest in the acquiree **(Acquiree's Fair Value)** for the purpose of the impairment assessment.

The Investigation found that:

(a) The Acquiree's Fair Value was overstated as it included both the fair value of the Buildings (as non-operating assets) and the projected cash flows from continuous use of the Buildings (for the planned business of the acquiree in the projection period);

(b) Certain key parameters in relation to the acquiree's planned business that were adopted in the estimation of the Acquiree's Fair Value, including but not limited to, the projected revenue, profit margin, costs, working capital and capital expenditures, were not reasonable nor supported; and

(c) The impairment assessment did not take into account the goodwill attributable to the non-controlling interests as required by HKAS 36.

The above issues led to a material misstatement in the measurement of the goodwill as at 31 December 2016.

The audit quality failure of the Auditor

The Auditor appointed a valuer **(Auditor's Expert)** to conduct a review of the Acquiree's Fair Value. The investigation found that there was no written agreement for such review and the Auditor's Expert did not address the aforesaid issues regarding the impairment assessment of goodwill in its review. The Auditor also did not identify these deficiencies in the work of the Auditor's Expert.

The Auditor did not obtain evidence about the fair value less costs of disposal and value in use of the CGU, the higher amount of which is the CGU's recoverable amount for the purpose of the impairment assessment under HKAS 36.

The Auditor failed to identify the aforesaid issues that led to a material misstatement and therefore issued an inappropriate unmodified audit opinion. This occurred because the Auditor failed to:

(a) properly interpret or apply the applicable financial reporting standard; and

(b) exercise appropriate professional skepticism in evaluating the recoverable amount of the CGU.

The engagement quality control reviewer failed to adequately perform an objective evaluation of the engagement team's decisions on the extent and nature of work performed and the evidence obtained and the conclusion reached by the engagement team on this matter. As a result, the engagement quality control reviewer also did not identify the material misstatement.

Accordingly, the engagement partner and the engagement quality control reviewer failed or neglected to observe, maintain or otherwise apply the fundamental principle of professional competence and due care in the Code of Ethics for Professional Accountants.

Our purpose in reporting publicly

The FRC announces the adoption of reports on audit investigations and enquiries into financial reporting of listed entities:

(a) to promote continuous improvement in the quality of auditing and financial reporting by all our regulatees;

(b) to encourage audit committee members to consider the implications of our findings for the financial reporting and audits of their own listed entities; and

(c) to maintain public confidence in the system for independent auditor regulation.

END

Relevant technical standards

HKFRS 3 *Business Combinations* prescribes the financial reporting by an entity when it undertakes a business combination, including but not limited to the recognition of the acquired identifiable assets and liabilities at their acquisition-date fair values, and the goodwill and non-controlling interests arising from a business combination.

HKFRS 13 *Fair Value Measurement* defines fair value *as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"*.

HKAS 36 *Impairment of Assets* prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount.

Hong Kong Standard on Auditing **(HKSA)** 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* prescribes the application of a competent understanding of the applicable financial reporting framework in the exercise of professional judgement by an auditor.

HKSA 500 (Clarified) *Audit Evidence* explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and HKSA 330 *The Auditor's Responses to Assessed Risks* and other relevant HKSAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

HKSA 620 (Clarified) *Using the Work of an Auditor's Expert* deals with the auditor's responsibilities relating to the work of an individual or organization in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.

Code of Ethics for Professional Accountants is a guidance on ethics for professional accountants.

About the Financial Reporting Council

The FRC is the independent listed entity auditor regulator for Hong Kong. We are committed to upholding the quality of financial reporting of listed entities of Hong Kong so as to enhance investor protection and strengthen investor confidence in corporate reporting.

For more information about the statutory functions of the FRC, please visit www.frc.org.hk.

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