FRC Financial Reporting Council 財務匯報局

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Press Release

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FRC finds that auditor failed to appropriately address an identified misstatement and to appropriately exercise professional judgement in determining overall materiality

The FRC adopted an investigation report finding that the auditor (**the Auditor**) of a listed entity (**Listed Entity**) failed to:

(a) appropriately address an identified misstatement in the measurement of consideration payable for the acquisition of a subsidiary in the consolidated financial statements of a Listed Entity for the year ended 31 March 2017 (**the Relevant Financial Statements**); and

(b) appropriately exercise professional judgement in determining materiality for the financial statements as a whole.

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 6 September 2018, following referral by a regulator in March 2018.

The misstatement in relation to measurement of the consideration payable

HKAS 39 requires an entity to measure a financial liability at fair value when first accounted for and thereafter to account for the difference between that fair value and the total amounts payable at the effective interest rate.

The Listed Entity acquired a subsidiary for a cash consideration which was payable in several instalments. The last instalment of the consideration was due more than one year after the date of the acquisition (i.e. the Consideration Payable). The Consideration Payable was initially measured at the total amounts payable without taking into account the time value of money.

The audit quality failure of the Auditor

The Auditor identified the misstatement relating to the measurement of the Consideration Payable. The Auditor considered that the effect of the misstatement was not material and therefore did not request an adjustment to the financial statements and issued an auditor’s report with an unmodified opinion. As the misstatement was not “clearly trivial”, the auditor failed to:

- accumulate the misstatement relating to the measurement of the Consideration

Payable identified;

- request a written representation from management including or attaching a summary of the uncorrected misstatement; and

- communicate the item and include the communication to those charged with governance in their audit documentation.

In evaluating the effect of the above uncorrected misstatements on the financial statements, the Auditor applied the materiality they had determined for the financial statements as a whole. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

The auditor's determination of materiality is a matter of professional judgement. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both.

The Auditor calculated three potential levels of materiality using different benchmarks and percentages applied to the benchmarks. The Auditor chose revenue with a percentage of 1.5% applied as the basis for determining the materiality for the financial statements as a whole. The Auditor failed to justify why the chosen benchmark and the percentage applied were appropriate in the circumstances. In particular, the Auditor failed to justify how they reflected the needs and expectations of users of the entity's financial statements. The Auditor therefore failed to exercise professional judgement appropriately and to determine an appropriate materiality for the financial statements as a whole.

The engagement quality control reviewer failed to adequately perform an objective evaluation of the judgement made with respect to the materiality for the financial statements as a whole.

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.

Relevant technical standards

HKAS 39 establishes principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

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 220 *Quality Control for an Audit of Financial Statements* prescribes the performance by an engagement quality control reviewer of an objective evaluation of significant judgements made by the engagement team, and the conclusion reached in formulating the auditor’s report.

HKSA 260 *Communication with Those Charged with Governance* deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

HKSA 320 *Materiality in Planning and Performing an Audit* deals with the auditor’s responsibility to apply the concept of materiality in planning and performing an audit of financial statements.

Code of Ethics for Professional Accountants is a guidance on 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 —

About the FRC

The FRC is the full-fledged 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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