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Press Release

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FRC concludes that a listed entity failed to properly account for the interests in two investees and its auditor failed to identify the misstatements

On 14 April 2022, the FRC adopted an investigation report which found that the auditor (**the Auditor**) of a listed entity (**the Listed Entity**) failed to identify material misstatements in relation to:

(a) the accounting of the Listed Entity's equity interest in an investee (**Investee A**) in the consolidated financial statements for the years ended 31 December 2013 (**the 2013 Financial Statements**) and 31 December 2014 (**the 2014 Financial Statements**); and

(b) the non-consolidation of a wholly-owned subsidiary (**Investee B**) which carried on a referral business (**the Referral Business**) in the 2014 Financial Statements.

Under the transitional provisions of the amended FRC Ordinance, since the relevant audits were 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 FRC had previously adopted, on 16 January 2019, an enquiry report in relation to the material misstatements of the Group's interests in Investee A and Investee B in the 2013 Financial Statements and the 2014 Financial Statements. We did not issue a press release at that time to avoid prejudicing the related ongoing investigation. In light of the findings of the enquiry, on 21 January 2019, the FRC required the Listed Entity to remedy the misstatements by retrospectively adjusting the opening balances and the comparative figures of the Listed Entity in the latest consolidated financial statements to be issued. The Listed Entity was subsequently delisted and has not since published any financial statements.

The investigation and the enquiry were initiated in September 2016, following a referral by a regulator in April 2016.

Accounting for an interest in an investee

Hong Kong Financial Reporting Standard 10 *Consolidated Financial Statements* (**HKFRS 10**) sets out the principles in identifying whether an investor controls an investee and therefore must consolidate the investee in its financial statements. HKFRS 10 specifies that an investor controls an investee if the investor has, among others, power over the investee, i.e. the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns (defined as *"relevant activities"* in HKFRS 10).

Under HKFRS 10, the control analysis requires an understanding of all arrangements which govern the way decisions about the relevant activities are made, for example, appointment of the key management personnel of the investee.

Hong Kong Accounting Standard 28 *Investments in Associates and Joint Ventures* (**HKAS 28**) prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates.

Under HKAS 28, an associate is an entity over which the investor has significant influence. The existence of significant influence by an entity is usually evidenced by having representation on the board of directors of the investee or participating in the investee's financial and operating policy decision-making.

Accounting for the equity interest in Investee A

The Listed Entity established Investee A with a third party (**Shareholder A**). The Listed Entity injected its internet business and cash into Investee A in exchange for a 60% equity interest in Investee A.

The Listed Entity accounted for Investee A as its subsidiary and the results of Investee A were consolidated into the 2013 Financial Statements on the ground that it held the majority shareholding in Investee A and there was a mutual understanding between the Listed Entity and Shareholder A that the management of Investee A was left to the management team nominated by the Listed Entity.

In 2014, the management team of Investee A no longer acted in accordance with the instructions of the Listed Entity. The Listed Entity considered that it had lost control over Investee A. Therefore, Investee A ceased to be treated as a subsidiary in the 2014 Financial Statements.

However, according to the Articles of Association of Investee A, Shareholder A had the majority votes in Investee A's board meetings in which significant operating decisions were made. In addition, there was no confirmation from Shareholder A in respect of the mutual understanding or the surrender of their rights set out in the Articles of Association. Based on the facts and circumstances, the Listed Entity did not have unilateral ability to direct Investee A's relevant activities. Therefore, the Listed Entity did not control Investee A and Investee A should not have been accounted for as a subsidiary in the 2013 Financial Statements and the 2014 Financial Statements.

The Listed Entity had the right to appoint two out of five members of the board of Investee A which evidenced its significant influence over Investee A. Even when the management team of Investee A who were the Listed Entity's representatives on the board were not cooperating, the Listed Entity had substantive voting rights to remove its old representatives and appoint new ones to the board of Investee A, so as to allow the Listed Entity to exercise its power to participate in the financial and operating policy decisions of Investee A. Accordingly, Investee A should have been accounted for as an associate of the Listed Entity since its establishment.

Accounting for the equity interest in Investee B

Investee B started the Referral Business in 2014. The Listed Entity did not consolidate the assets, liabilities and results of Investee B in the 2014 Financial Statements, on the ground that it did not have the practical ability to direct the operations of the Referral Business due to the non-cooperation of the management team who was responsible for the daily operation of the Referral Business.

However, it was found that Investee B was a wholly-owned subsidiary of the Listed Entity. Through its power to appoint directors of Investee B, the Listed Entity had the current ability to direct the relevant activities of Investee B, including the Referral Business. In the circumstances, there was a non-compliance with HKFRS 10 in respect of the non-consolidation of Investee B in the 2014 Financial Statements.

The audit quality failure of the Auditor

The investigation revealed that the Auditor failed to:

(a) obtain sufficient appropriate audit evidence, e.g. the Articles of Association of Investee A, on which to base its conclusion on the accounting treatment of the Group's interest in Investee A;

(b) evaluate management representations with sufficient professional skepticism;

(c) properly apply the applicable financial reporting standards in evaluating the accounting treatment of the Group's interests in Investee A and Investee B; and

(d) communicate the accounting treatment of the Group's interests in Investee A and Investee B with those charged with governance as the determination of the treatment involved significant management judgment.

As a result of the above failures, the Auditor issued an inappropriate unmodified audit opinion on each of the 2013 Financial Statements and the 2014 Financial Statements.

The engagement quality control reviewer also failed to adequately perform an objective evaluation of the judgement made in relation to the accounting treatment of the Group's interests in Investee A and Investee B and the conclusion reached by the engagement team on the matters.

Accordingly, the engagement partner and the engagement quality control reviewers 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 10 establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

HKAS 28 prescribes the accounting for investments in associates.

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, and the maintenance of professional skepticism by the auditor throughout the audit.

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 500 *Audit Evidence* 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 705 *Modifications to the Opinion in the Independent Auditor's Report* deals with the auditor's responsibility to issue an appropriate report in circumstances when the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

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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