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Press Release

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FRC completes second investigation with working papers obtained under MoU with the Supervision and Evaluation Bureau of the PRC Ministry of Finance

On 12 August 2021, the FRC adopted an investigation report in relation to a failure by the auditor (**the Auditor**) of a listed entity (**Listed Entity**) to identify a material misstatement in relation to the impairment assessment of an available-for-sale equity investment (**the Investment**) in the consolidated financial statements of the Listed Entity for the year ended 31 March 2017 (**the 2017 Financial Statements**). This is the second investigation report completed using audit working papers obtained with the assistance of the Supervision and Evaluation Bureau (**SEB**) of the PRC Ministry of Finance under the FRC's Memorandum of Understanding with the SEB.

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 referral by a regulator in January 2018.

The material misstatement in relation to the impairment assessment of the Investment made by the Listed Entity

Hong Kong Accounting Standard (**HKAS**) 39 *Financial Instruments: Recognition and Measurement* (**HKAS 39**) was the applicable financial reporting standard at the material time.

HKAS 39 requires an entity to recognise an impairment loss on available-for-sale equity instruments if there is objective evidence of impairment. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is an objective evidence of impairment. Either a significant or a prolonged decline is sufficient to require the recognition of an impairment loss. The determination of what constitutes a significant or prolonged decline is a matter of fact that requires the application of judgement.

The Investment was measured at fair value based on the quoted market price of the investee's shares. The Investment's fair value as at the end of the reporting period was below its original cost by more than 50%. The Investment's fair value was also below its cost for more than twelve months.

The decline in the fair value of the Investment was both significant and prolonged which were objective evidence of impairment under HKAS 39. The Listed Entity however did not record an impairment loss on the Investment in the 2017 Financial Statements.

The Listed Entity developed internal guidance in determining what constituted a prolonged decline but failed to provide disclosure about the judgement it made in determining the existence of objective evidence in the 2017 Financial Statements in accordance with HKAS 1 (Revised) *Presentation of Financial Statements* (**HKAS 1**).

Deficiency in the audit

The Auditor failed to identify the above material misstatement and therefore issued an inappropriate audit opinion. The failure to identify the material misstatement occurred because the Auditor failed to properly interpret or apply the applicable financial reporting standard in evaluating the Listed Entity's accounting treatment of the impairment assessment of the Investment, and to exercise appropriate professional judgement in evaluating what constituted a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost.

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 impairment assessment of the Investment 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.

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.

HKAS 1 prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. It also prescribes the disclosure requirements for the judgments that the entity has made which have significant effect on the amounts recognised in the financial statements.

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 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control. It also requires the auditor to obtain an understanding of the applicable financial reporting framework.

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 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 700 *Forming an Opinion and Reporting on Financial Statements* prescribes the need for an auditor to evaluate in forming their audit opinion whether the financial statements are prepared in all material respects in accordance with the requirements of the applicable financial reporting framework.

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.

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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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