

27 October 2022

Dear Public Interest Entity (PIE) Auditors,

### **Late changes in auditor appointments**

I am writing to express our growing concern over the surge in number of PIE auditors resigning just one month before or even after the end of the reporting period of a listed entity. A change in auditor before the end of their term of appointment may indicate issues in the financial statements of the listed entity or difficulties encountered in conducting the audit. We are concerned that audit quality may be compromised by late auditor resignations because the incoming auditor will have limited time to plan and conduct a proper audit in order to meet the listed entity's deadline to announce their audited results. This is even more concerning where the listed entity is larger.

### **Our observations and concerns**

We performed an analysis of the late changes in PIE auditor appointments for listed entities for the year ended 31 December 2021. Our analysis covered auditor resignations during the period from 1 December 2021 to 31 August 2022 and we compared the results to a similar analysis conducted for the year ended 31 December 2020.

Our analysis reveals that there has been a surge in the number of late PIE auditor resignations from 71 in 2021 to 107 in 2022. In around 60% of these cases, the listed entity made a generic statement that the resignation was due to the outgoing auditor's inability to agree the audit fee with the listed entity, and around 30% were due to unresolved audit issues.

The majority of the late PIE auditor appointments for listed entities with significant operations in Mainland China or overseas were taken up by PIE auditors whose relevant experience and available resources appeared disproportionate to these audits. Nevertheless, some of these listed entities were able to announce their audited annual results with an unmodified opinion within a timeframe that appeared to be disproportionate to the complexities of the audits.

In light of the prevalence of late changes in auditor appointments, we have concerns as to whether:

- (i) the incoming auditors possessed the necessary competence and adequate capabilities (including manpower, time and other resources) to perform quality audits within limited time frame, particularly where their experience of performing audits of larger listed entities and/or relevant industries may be limited or non-existent;
- (ii) there was appropriate communication between the incoming and outgoing auditors on the audit implications of the circumstances leading to the outgoing auditors' resignations; and
- (iii) the outgoing auditors had maintained an effective dialogue with the audit committees, with specific focus on the negotiation of audit fees and resolution of any contentious audit issues.

## Our expectations of outgoing auditors

The role of PIE auditors is to ensure quality financial reporting and thus enhance public trust in the Hong Kong capital market. It is therefore essential that high quality audits are performed to safeguard the public interest. Therefore, PIE auditors should proactively discuss with audit committees any contentious audit issues and seek their assistance to resolve any such issues with management. They should always endeavour to complete the audit rather than attempt to avoid the responsibility of adversely reporting on the financial statements by resigning.

Should the auditors decide to resign, they should ensure that they set out the precise circumstances leading to their resignation in their letter of resignation, instead of making a general statement to the effect that the resignation was due to their inability to agree the audit fee with management. The letter of resignation should also set out all key audit issues that, if not resolved, would have resulted in a negative impact on the audit opinion.

The outgoing auditors are also required to consider whether the market has been adequately informed of the circumstances leading to their resignation. Accordingly, the outgoing auditors should read the announcement made by the listed entity concerning their resignation and assess whether any matters reported in their resignation letter should be brought to the attention of the shareholders. If there are any such matters, the outgoing auditors should first write to the board of directors and the audit committee of the listed entity setting out those matters. If, in the view of the outgoing auditors, the action taken by the listed entity is inadequate, the outgoing auditors have a duty to report the matter to the Securities and Futures Commission (**SFC**) and The Stock Exchange of Hong Kong (**SEHK**). Auditors also have a duty to report timely to the AFRC if they have any concerns in relation to the matters leading to their resignations so that the AFRC can take appropriate actions to protect the public interest.

## Our expectations of incoming auditors

Incoming auditors should sufficiently understand and evaluate the audit implications of the circumstances leading to the outgoing auditors' resignation and critically assess whether those matters indicate any potential management integrity issues that may have an impact on their acceptance decisions as incoming auditors.

Incoming auditors should also critically assess their competence and capability to perform a quality audit before accepting any new client relationship and engagement and should exercise professional scepticism throughout the audit, particularly when the time to complete the audit is limited. More specifically, they should consider:

- (i) whether they have the appropriate skills, time and resources commensurate with the size and structure of the prospective client and the nature and complexity of their business operations;
- (ii) whether they have sufficient knowledge and experience of the relevant industries, and regulatory and reporting requirements;
- (iii) where they plan to use the work of component auditors for significant parts of the audit, whether they have evaluated the component auditors sufficiently to ensure that they

will comply with the relevant professional standards and regulatory requirements applicable to group audits, and whether they will be able to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence; and

- (iv) whether audit quality would be compromised by the level of proposed audit fee.

Moreover, to ensure a smooth transition between the incoming and outgoing auditors, the incoming and outgoing auditors should ensure that there is appropriate and effective two-way communication, together with audit committees, to discuss the nature and significance of any unresolved audit matters identified by the outgoing auditors. These matters should be best discussed without the presence of management. It is vital that the incoming auditors design and perform audit procedures to address these matters and obtain sufficient appropriate audit evidence to draw reasonable conclusions on which the audit opinion is based.

We urge all PIE auditors to maintain a close and effective dialogue with audit committees, which are charged with overseeing the financial reporting process and which play an important role in promoting and supporting audit quality. The [Guidelines for Effective Audit Committees – Selection, Appointment and Re-appointment of Auditors](#) that we issued in December 2021 could be used as a reference when engaging in discussions with the audit committees.

### Our actions

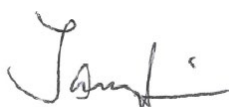
The AFRC will continue to monitor closely late changes in auditor appointments and the quality of the audits of the relevant entities. In order to safeguard the public interest, we will not hesitate to take appropriate follow-up action, including but not limited to:

- (i) conducting inspections;
- (ii) initiating an investigation of the audit firms;
- (iii) imposing conditions on the registration of audit firms as PIE auditors; and
- (iv) initiating disciplinary proceedings against audit firms.

We will continue to work with the SFC and SEHK to strengthen respective market discipline in relation to the appointments and resignations of auditors of the listed entities.

We encourage PIE auditors speak to us if they would like to discuss the matters raised in this letter.

Yours faithfully



Janey LAI  
Head of Inspection