FRC Financial Reporting Council 財務匯報局

February 2019


## Chief Executive Officer's Key Message

The first three months of the year are a very active period for issuers and auditors. For many, your focus is on financial statement finalisation and audit completion. I would urge all preparers and their auditors to take the time to reflect on the areas which have given rise to the non-compliances with accounting requirements identified from recent cases. The most common failings arise in respect of revenue recognition, financial instruments classification and measurement, impairment decisions, and accounting estimates, including valuations. A summary of our recent findings is included below.

Issuers are reminded to thoroughly research the accounting standards in these areas, and document clearly their research and judgement decisions taken. These should then be discussed thoroughly with your auditors so that all aspects of relevant guidance on both accounting and disclosures are considered and documented.

Auditors should thoroughly question whether proper consideration has been given to all possible accounting treatments and relevant disclosures and that the accounting treatment and disclosures properly reflect all documentary evidence available. Often, auditing irregularities occur as a result of failing to identify the non-compliances with accounting requirements. The results of your research and decisions should also be clearly documented.

## Operations Achievements

I mentioned last year that, following a review of our detailed procedures, I expected an upturn in finalising cases in 2018. This indeed happened during the second half of the year and Council adopted the final reports in respect of 12 investigations and 1 enquiry. In this period alone, we completed more than in any full year previously. By the end of the year, we had achieved our targets in respect of closing investigations, enquiries, complaints and financial statement reviews. We were also within our targets for the average age of ongoing investigations and enquiries of approximately 2 years. This is a notable achievement and could not have been done without the dedication of our staff, for which I am extremely grateful.

Our dedicated team of staff work hard to achieve our operations targets

## International Recognition

I met with the UK FRC in July 2018 and it is clear that the efforts of our Government in introducing the Amendment Bill is being recognised internationally. The PRC Ministry of Finance paid us a visit in September 2018. We took the opportunity to update each other on our missions and roles and in particular we provided an update on the progress of the Amendment Bill. We also discussed a revised Memorandum of Understanding ("MOU") between us based on our future expanded role. I am optimistic we will reach agreement on this MOU in 2019.


The PRC Ministry of Finance pays a visit to the FRC in September 2018

## The Amendment Bill

Following the introduction of the Amendment Bill in January 2018, the Bills Committee held three further meetings in the period from July to December 2018. We attended all these meetings and provided support to Government, particularly in respect of the Committee stage amendments proposed by Government.

Before closing, I am delighted to confirm that the single most important event since the FRC was established took place on 30th January 2019 when the FRC (Amendment) Ordinance 2019 was enacted. Once it becomes effective the FRC will become the independent regulator of auditors to listed entities in Hong Kong. Our focus now is to develop the policies and procedures to put the Ordinance into effect and assist Government in meeting the promises made in respect of consultation and transparency. This is now in hand and I will report on our progress in my next newsletter.

I would like to take this opportunity to wish you all a happy and prosperous Year of the Pig!

## Summary of Completed Cases

Set out below is a summary of cases completed in the second half of 2018. This information is included in order to assist preparers and their auditors to understand the matters that have given rise to auditing irregularities and/or non-compliances so that similar deficiencies can be avoided in the future, thereby enhancing the quality of financial reporting in Hong Kong.

On receipt of a complaint or following a financial statement review, we often make enquiries to both the issuers and their auditors prior to deciding on any further action. Among the responses to these enquiries there exist excellent examples where the preparers clearly explained, with reasoned arguments, the appropriate accounting treatment and provided proper supporting evidence to demonstrate their thought process and conclusions reached. In addition, examples exist where the auditors provided clear documentation in support of their audit work demonstrating the appropriate level of challenge and scepticism. In such cases the relevant complaint or review is closed and no further action is considered necessary. These examples underline the importance of my opening key message to issuers and auditors about the steps they should take in relation to the preparation or the audit of financial statements, and the need to properly document such steps.


Newly-appointed members of the Financial Reporting Council Review Panel are briefed on their role in conducting an enquiry

The investigation results for the second half of 2018 continue to give cause for concern regarding auditors' application of professional scepticism in the performance of audits, particularly in the audit of accounting estimates including fair value measurement. There were situations where auditors placed excessive or apparently unquestioned reliance on management's representations and/or other expert reports and without adequately performing procedures to evaluate and challenge the relevance and reasonableness of the methodology and approach applied and the validity of source data used in estimations.

**Auditing accounting estimates**

A listed entity recognised revenue relating to variations in contract work and claims in its financial statements when there was lack of evidence that the relevant amounts could be reliably measured. The investigation revealed that the auditor placed significant reliance on management’s representations without adequately performing procedures to understand the nature of the variations, question management in respect of the basis of the estimations and evaluate the possible outcomes of the claims with reliable evidence to support the conclusion that the recognition and measurement of contract revenue in the relevant financial statements were appropriate.

In an audit of another listed entity's financial statements involving construction contracts, the investigation revealed that the auditor failed to design and perform appropriate audit procedures to ascertain the progress of the construction, evaluate whether the outcome of the construction contracts could be estimated reliably and challenge management's contention that no contract revenue and contract costs should be recognised in profit or loss over two financial years.

A listed entity omitted to recognise certain consultancy fees relating to a property development project. The error was retrospectively adjusted in the subsequent financial statements and the entire amount of consultancy fees was capitalised as part of the construction costs. The investigation found that the auditor relied on management’s representation without inspecting the underlying agreement and other supporting evidence which resulted in an understatement of liabilities being undetected. In the subsequent year, it was found that the auditor failed to properly consider the nature of the consultancy fees and question management as to whether capitalising the entire amount of the consultancy fees was in compliance with the relevant accounting requirement. The investigation also revealed that the auditor substantially relied on management's representation and failed to sufficiently evaluate the recoverability of a receivable and the disclosure of related party transaction and balances.

A listed entity amortised an intangible asset acquired in an acquisition over the remaining short term contractual period. For the purpose of impairment assessment, the listed entity used cash flow projections over a significantly longer period to determine the recoverable amount of the intangible asset. The investigation found that the auditor failed to adequately perform procedures, including the consideration of relevant contractual terms, management's plans, expectations and assumptions, and events after the end of the reporting period, to assess the reasonableness of the amortisation period. The auditor also failed to sufficiently document the details of the nature and extent of their audit procedures.

In another investigation we found that the auditor failed to critically evaluate and challenge management on the reasonableness of the forecast period, the expected timing of production and sales, and the volume and pricing of the expected transactions in determining the recoverable amounts of certain rights and related goodwill for the purpose of year-end impairment assessment, given that the then market condition was unfavourable and, consistent with earlier years, the production operations had been suspended for a prolonged period of time.

**Revenue**

A listed entity failed to properly recognise the sales proceeds of the unutilised portions of prepaid service contracts as deferred revenue. Two separate investigations found that the auditors failed to properly consider the substance of the contractual arrangements in planning and performing audit procedures to test the prepaid service contracts to ensure the recognition of revenue was in compliance with the applicable accounting requirements.

In a case where the listed entity recognised a very significant trading transaction in a financial year with a single and new customer, the investigation found that the auditor failed to obtain sufficient evidence in respect of the transaction, the customer and the supplier which evidence should have raised significant concerns to the auditor, and properly evaluate the transaction and its payment terms. The investigation revealed that the auditor failed to (a) properly plan the audit; (b) maintain a questioning mind to critically assess the evidence obtained; (c) properly assess the risks of material misstatement in relation to the transaction and plan the audit accordingly; (d) properly perform various substantive procedures to obtain sufficient appropriate audit evidence in relation to the transaction and relevant account balances; and (e) discuss the relevant transaction with those charged with governance.

In another audit, although the auditor identified revenue recognition from retail sales as one of the significant accounting and auditing issues, the investigation found that the auditor failed to properly design and perform audit procedures to address the assessed risks. The auditor also failed to understand the nature and causes of the identified errors, consider extending the tests, including the effects on opening balance and comparatives, and ascertain whether the adjustments to the relevant financial statements were appropriately determined.

**Financial instruments**

A listed entity issued convertible notes to settle an amount due to a director who was also a substantial shareholder. The convertible notes were recognised in equity and measured at the amount due to the director. The investigation discovered that the auditor failed to (a) properly plan and assess the risks of material misstatement relating to the accounting treatment of the transaction; (b) document their evaluation on the appropriateness of the classification of the convertible notes; (c) perform adequate procedures on the initial measurement of the convertible notes; and (d) question the appropriateness of the accounting treatment of the transaction.

A listed entity's wholly owned subsidiary issued a number of preferred shares which resulted in a deemed disposal with the listed entity's interest being reduced to less than 50%. The listed entity continued to account for the investee as a subsidiary. The terms of the preferred shares included specific events and conditions that might trigger the repayment of the principal amount of the preferred shares and accrued dividends and required the consent of the holders of the preferred shares on a number of matters. The investigation found that the auditor failed to properly consider the substance of the contractual arrangements, definitions of financial liability and equity in accordance with the relevant accounting standard and the impact of the rights provided to the holders of the preferred shares on the Group's ability to control the investee following the deemed disposal.

**Other findings**

In an investigation of the audits of a listed entity's financial statements for three consecutive years, it was found that the auditor failed to comply with the requirements of a number of auditing standards relating to the performance of substantive procedures in various financial statement areas including turnover, trade receivables and trade payables, related party transactions, and consolidation of financial statements.

A listed entity granted share options to certain directors and staff and recognised the entire amount of services, measured by reference to the fair value of the equity instruments granted, in the financial statements as an expense rather than recognising the share options over the one-year vesting period. The investigation found that the auditor failed to properly evaluate the effect of the uncorrected misstatement relating to the recognition of share option expense, which individually exceeded the materiality level determined by the auditor for the relevant audit.

## Key Operations Statistics

| | Jan to Dec 2018 | Jan to Dec 2017 |
|---|---|---|
| Persuable complaints received | 85 | 126 |
| Investigations completed | 16 | 11 |
| Investigations initiated | 19 | 14 |

Note: Detailed operations statistics are available in the “Operations Statistics” section of our website.

## Contacts

If you have any enquiries or comments, please feel free to contact us.

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