FRC Financial Reporting Council 財務匯報局

24/F, Hopewell Centre
183 Queen's Road East, Hong Kong
香港皇后大道東183號合和中心24樓

T電話 +852 2810 6321
F傳真 +852 2810 6320
E電郵 general@frc.org.hk

Press Release

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

On 15 June 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 the earnings per share **(EPS)** presented in the consolidated financial statements of the listed entity. This is the first 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 FRC had previously adopted, on 20 September 2019, an enquiry report in relation to the material misstatement of the EPS presented in the consolidated financial statements of the Listed Entity for the year ended 31 December 2015 (**2015 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 25 September 2019, the FRC required the Listed Entity to remedy the inclusion of the materially misstated EPS information in market disclosures about the Listed Entity by retrospectively adjusting the EPS of the relevant years as disclosed in the financial summary of the latest annual report to be issued, and the Listed Entity complied with the requirement in the annual report for the year ended 31 December 2019 issued on 30 March 2020.

The investigation and the enquiry were initiated in February 2018, following referral by a regulator in April 2017.

Why EPS is important to shareholders and potential investors

EPS is a key performance indicator of a listed entity's financial performance. It is a measure of the amount of a listed entity's profit that is attributable to each share of the company's capital (financial resources). As such, it is widely used by shareholders and potential investors in making investment decisions about the merits of buying, selling or holding shares in a listed entity relative to other investment opportunities. In essence, EPS is the ratio of the profit earned by a listed entity in a period (**numerator**) to the average number of shares in issue during the period (**denominator**).

The applicable financial reporting standard (IAS 33)[1] establishes the appropriate basis for measurement of the denominator. If properly applied, IAS 33 enhances the comparability of the financial performance of different entities in the same reporting period and between different reporting periods for the same entity.

A material misstatement in the EPS disclosure impairs such comparability and can lead shareholders and potential investors to make flawed investment decisions based on inappropriate comparisons.

Even though different entities may apply different accounting policies in measuring their profits, a consistently determined average number of shares in the measurement of EPS enhances the comparability of EPS between different reporting periods.

The material misstatement of the EPS made by the Listed Entity

The Listed Entity materially overstated the EPS in the 2015 Financial Statements because the average number of shares used as the denominator was understated. This understatement occurred because the Listed Entity failed to appropriately apply special considerations that should have been applied in determining the effect on the average number of shares of a bonus issue and an open offer of shares during the period.

The denominator in an EPS ratio is a proxy for a standard unit of an entity's capital available to generate profits throughout the period. When new shares are issued part way through the period in exchange for new capital, the new capital only contributes to profit generation for part of the period. Averaging the number of existing and new shares in issue according to their respective periods in issue takes account of the limited contribution the new capital makes to profit in measuring EPS.

However, if the amount of new capital raised for each new share is not proportionate to the capital relating to each existing share, special considerations are required to be applied in measuring the average number of shares to reflect the difference in the amount of capital raised by the new shares in accordance with the applicable financial reporting standard.

The audit quality failure of the Auditor

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 engagement partner conspicuously failed to apply a competent understanding of the applicable financial reporting standard, in particular the special considerations that should have been applied, and therefore failed to exercise appropriate professional judgement in concluding on the accounting for the EPS. The engagement partner did not consider this accounting issue to be a difficult or contentious matter and therefore did not consult appropriately on the matter.

As a result of failing to apply a competent understanding, the Auditor did not design and perform appropriate procedures to obtain sufficient appropriate audit evidence to evaluate the EPS presented in the 2015 Financial Statements. As a result, the Auditor also did not obtain the audit evidence necessary to draw their overall conclusion and

[1] International Accounting Standard 33 *Earnings per share*

ultimately to support their unmodified opinion on the 2015 Financial Statements. Had they done so, they could have identified the material misstatement and either ensured that the 2015 Financial Statements were corrected through discussion with management and the audit committee or qualified their opinion.

The engagement quality control reviewer also failed to recognise the EPS accounting as involving significant judgement and therefore failed to perform an objective evaluation of the judgement made 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.

Relevant technical standards

International Accounting Standard 33 *Earnings per Share* prescribes the principles and requirements for determination and presentation of EPS*.*

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 and the exercise of professional judgement by an auditor.

HKSA 220 *Quality Control for an Audit of Financial Statements* prescribes the consideration of appropriate consultation for a difficult or contentious matter by the engagement team. It also 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 500 *Audit Evidence* prescribes the overarching requirement to design and perform appropriate audit procedures to obtain “sufficient appropriate audit evidence” and sets out what constitutes such evidence.

HKSA 330 *The Auditor’s Responses to Assessed Risks* prescribes the design and performance of audit procedures that are responsive to particular risks of material misstatement and the need to conclude whether sufficient appropriate audit evidence has been obtained.

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. It also prescribes the need in forming the audit opinion to take into account the auditor's conclusion in accordance with HKSA 330 whether sufficient appropriate audit evidence has been obtained.

Our purpose in reporting publicly

The FRC announces the adoption of reports on audit investigations and enquiries into financial reporting of listed entities to promote continuous improvement in the quality of auditing and financial reporting by all our regulatees, to caution audit committee members to consider the implications of our findings for the financial reporting and audits of their listed entities and to maintain public trust and confidence in the capital market and the effective functioning of the FRC as an independent auditor regulator.

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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.

For media enquiries:
Celian Cheung
Associate Director, Corporate Communications
Financial Reporting Council
Tel: (852) 2236 6025
Fax: (852) 2810 6320
Email: celiancheung@frc.org.hk