Florence Wong, Acting CEO

Key Message

The first four months of 2020 have been an exceptional and difficult period for auditors and listed entities. The COVID-19 pandemic and the subsequent travel restrictions have taken a toll on businesses and triggered a chain of reactions that call for concerns and necessitate special arrangements including those related to the potential delay of results announcements. In the February 2020 issue of our e-News, we highlighted some noteworthy issues and advice aimed at helping auditors and listed entities to deal with the unprecedented situation arising from the pandemic. We were pleased to learn that as a result of the timely responses and collaborative efforts among the financial regulators of Hong Kong, 1,304 among the 1,781 listed companies with December financial year-ends were able to issue their preliminary results by 31 March 2020[1].

While COVID-19 is beginning to show signs of abating in Hong Kong and the Mainland, the unfavourable impacts on businesses brought by the virus outbreak are still unfolding, including reduced business activities, pressure on business continuity, difficulty in financing and impairment of assets. These carry serious implications on the proper financial reporting process which require the fullest attention from auditors, listed entities and audit committees in the discharge of their respective responsibilities. In particular, directors are reminded that under the Companies Ordinance, the duty to prepare annual financial statements falls squarely on the directors, and that likewise under the Listing Rules, the board of directors is collectively responsible for the company's management and operation, which include the preparation of financial statements. Although delegation is permissible, directors remain primarily responsible. In discharging their duties, directors must also exercise reasonable care, skill and diligence.

As the independent auditor regulator of Hong Kong, the FRC has a duty to ensure that the quality, reliability and integrity of financial reporting will not be compromised or undermined and that investors' interest is safeguarded at this difficult time. In this issue of e-News, we will shed light on some salient issues and provide corresponding advice to the aforesaid stakeholders who play an integral part in maintaining audit quality and audit independence which has become all the more important at this challenging time. In particular, auditors should robustly assess the appropriateness of using the going concern assumption and challenge management judgement and assumptions. We will also provide advice on issues related to the resignation of audit firms as auditors of listed companies. The FRC strongly encourages auditors to pass this e-news to management and audit committees for their information.

[1] source: The Stock Exchange of Hong Kong Limited.

Issues and Advice

(1) Going concern

For preparers of financial statements

Directors are responsible for preparing financial statements that give a true and fair view in accordance with financial reporting standards. Going concern is a fundamental principle in the preparation of financial statements. HKAS 1 "Presentation of Financial Statements" requires preparers to assess an entity's ability to continue as a going concern.

Under the pandemic situation, uncertainties arise which might impact the availability of working capital due to the disruption of business operations, loss of customers, potential claims,

For auditors

HKSA 570 "Going Concern" requires auditors should robustly assess the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and whether a material uncertainty exists over the entity's ability to continue as a going concern.

In evaluating the cash flow forecasts prepared by management, auditors should maintain a questioning mind to critically challenge, rather than rationalising, the reasonableness of the breach of loan covenants or inability to obtain necessary finance. In assessing an entity's ability to continue as a going concern, forecasts should be prepared to assess if the entity's future cash flows can meet liabilities that fall due in the coming 12 months after the balance sheet date.

Management should reassess assumptions and their impact on the cash flow forecasts as those used in prior years may no longer be valid due to the current situation.

They should perform stress tests or sensitivity analysis to further assess the effect of the combination of pessimistic assumptions on the future cash flows in the coming 12 months after the balance sheet date.

If the going concern assumption is considered as not appropriate, management should choose accounting policies that will result in the most relevant and reliable financial information, such as on a "break-up" basis.

Material uncertainties that cast significant doubt on an entity's ability to continue as a going concern must be disclosed. Disclosure should be specific to the entity's situation, in particular how and when the uncertainties may key assumptions and judgement made by management, in particular, whether management has performed an appropriate sensitivity analysis over assumptions that may significantly affect the forecasted cash flows under the current situation.

Auditors should as soon as possible communicate with audit committee in respect of material uncertainty relating to going concern, including possible disagreement on the going concern assumptions, the extent of disclosure as well as the possible impact on the auditor's opinion.

HKSA 570 requires an auditor to conclude, based on the audit evidence obtained, whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern. If the use of going concern is inappropriate, the auditor should express an adverse opinion. If the use of going concern basis is appropriate but a material uncertainty exists, adequate disclosure about the material uncertainty must be made in the financial statements, otherwise, the auditor should consider modifying their opinion in accordance with HKSA 705 (Revised) "Modifications to the Opinion in the Independent Auditor's Report".

crystallise and their impact on the entity's resources, operations, liquidity and solvency. This is also an obligation under the provision of C.1.3 of the Corporate Governance Code.

For audit committees

Under the provision of C.3.3 of the Corporate Governance Code, audit committee is required to review listed entity's financial information and one of their focus is the going concern assumption. It is important for the audit committee to understand management's going concern assessment, in particular the basis of forming the key assumptions and judgement and how these assumptions and judgement are reflected in the cash flow forecasts. An audit committee should initiate a discussion with management and the auditor to assess the implication of COVID-19 on the use of the going concern assumption in the preparation of the financial statements as soon as possible and keep track of the ongoing development.

The audit committee must satisfy itself that in all reasonably possible scenarios, the entity has sufficient cash and liquidity to continue to meet its obligations as they fall due. It should discuss with the auditor the work the auditor performed to review the key assumptions and judgement used by management in the cash flow forecasts.

(2) Impairment of non-financial assets (including goodwill, other intangible assets, property, plant and equipment, investment properties (under cost model), right-of-use assets under lease contracts, interests in associates/jointly controlled entities.)

For preparers of financial statements

Preparers need to assess whether the impact of COVID-19 has led to the impairment of non-financial assets. HKAS 36 "Impairment of Assets" requires that goodwill and indefinite-lived intangible assets are tested for impairment at a minimum

For auditors

Since impairment assessment of non-financial assets involves using significant management judgement and estimates, auditors should exercise professional scepticism in their evaluation during the audit. Timely communications with the management, every year, and that other non-financial assets are tested for impairment whenever there is an indicator that those assets may be impaired.

Preparers should be mindful of the following areas in the impairment assessment of non-financial assets:

- Preparation of cash flow forecasts

  The pandemic crisis presents significant uncertainties and unprecedented challenge in projecting economic outcome (for example, the severity and duration of measures taken to curtail the spread of COVID-19 and the time taken for business operations or economic activity to resume or recover). When using an expected cash flow approach, the uncertainties due to COVID-19 and the impact on the expected cash flows, future growth rate and any terminal value should be properly considered.

- Determination of discount rate

  The discount rate used to discount the future cash flows of an asset or a cash-generating unit should reflect risks for which the future cash flow estimates have not been adjusted.

audit committee and professional valuer, if engaged, in relation to the impairment assessment and any significant difficulties are essential. Auditors should pay particular attention over the following areas:

- Key assumptions applied in cash flow forecasts

  Cash flow forecasts should be realistic and properly supported by the conditions in existence at the reporting date (for example, plant shutdown, shop closure, reduced sales and increase in the cost of raw materials, etc.) and approved by an appropriate level of management.

  Auditors should place more reliance on external market evidence (for example, industry forecasts) to assess if the terminal growth rate applied in the impairment assessment is reasonable and supportable.

- Discount rate

  Auditors should evaluate how the discount rate is determined. In particular, a decrease in the risk-free rate as a result of a decrease in the government bond yield may not automatically translate into decrease

- Disclosures in financial statements

  Entities should disclose the key assumptions used in the impairment assessment which are sensitive to the measurement of the recoverable amount. These key assumptions may include the expected growth rate in sales during the forecasted period, the terminal growth rate and the discount rate and how the outbreak of COVID-19 will affect these key assumptions. In the context of impairment assessment of goodwill and indefinite-lived intangible assets, HKAS 36 requires sensitivity disclosures if a reasonably possible change in a key assumption would cause the impairment.

- in the entity's discount rate because credit and/or other risk premiums in determining the discount rate may increase due to the entity's financial and liquidity positions.

  Disclosures in financial statements

  Disclosures should be specific to the entity's circumstances and consistent with the underlying key assumptions and judgement in the management's cash flow forecasts.

For audit committees

The audit committee should remind management that the impairment assessment should be prepared on a timely basis such that the auditor has sufficient time to undertake the review. The audit committee should discuss with management on the assessment process and the key assumptions adopted and judgement made in the impairment assessment to ensure that relevant factors and market conditions have been properly considered.

The audit committee should challenge the impairment assessment has been properly performed, by management and:

- whether the auditor has demonstrated a sufficient understanding of the business environment, business operations and risk areas which are relevant to the entity, and

- be able to critically assess management's assessment of impairment of non-financial assets; and

  whether the auditor has robustly challenged the key assumptions and judgement adopted by management and sufficient and appropriate audit evidence has been obtained to support the conclusion.

(3) Fair value measurement

For preparers of financial statements

Fair value under HKFRS 13 "Fair Value Measurement" is market-based measurement. The impact of COVID-19 to fair value measurement could be substantial and in certain cases observable market transaction or information might become unavailable. Preparers should be mindful of the following areas:

- Whether quoted prices in an active market are available and whether an adjustment is needed to an observable input to reflect facts and circumstances, or whether an observable input has to be replaced with an unobservable input.
- Unobservable inputs used in fair value measurement should reflect the effect of COVID-19.
- A change in valuation technique or its application might be needed to arrive at a fair value in the circumstances.

For auditors

Auditors should maintain an independent mindset on evaluation of the fair value measurement and focus on (a) uncertainties inherent in fair value measurement, in particular, the effect of COVID-19, (b) the appropriateness of the assumptions and inputs used in fair value measurement, (c) whether the source data used by management is relevant and reliable, and (d) adequate disclosures have been made in the financial statements.

Auditors need to communicate with management, audit committee and professional valuer, if engaged, about complex estimates and those with high estimation uncertainty in fair value measurement.

- Disclosures about the key assumptions, sensitivities and major sources of estimation uncertainty should be expanded in the financial statements to enable the users of financial statements to understand the impact of COVID-19 on the fair value measurement.

For audit committees

Fair value measurement of assets and liabilities is inherently complex and subjective. COVID-19 further increases the measurement uncertainties. The audit committee should satisfy that management has the necessary skills and experience to value the relevant assets or has used external experts as appropriate. In addition, the audit committee should question the work performed by the auditor in obtaining sufficient evidence to support the unobservable inputs in the fair value measurement.

(4) Revenue recognition

For preparers of financial statements

The COVID-19 pandemic may affect the amount and the timing of revenue recognition under HKFRS 15 "Revenue from Contracts with Customers" of which preparers should be aware of:

- Amount of revenue recognition

  An entity should include only the amount of variable consideration in the transaction price if it is highly probable that doing so would not result in a significant reversal of cumulative revenue recognised when

For auditors

The pandemic may adversely affect the financial performance of an entity and create pressure on management to conduct fraudulent sale transactions to meet the entity's revenue or profit targets. In assessing whether to rely on an entity's internal controls on sales, auditors should satisfy themselves that the internal controls are operating as intended throughout the accounting period under audit and management has not overridden otherwise effective controls. For example, auditors should be mindful whether there are changes in

- the uncertainty related to the variable consideration is resolved. Rebates, volume discounts, refunds for product returns and price concession will affect the measurement of variable consideration in a customer contract, which in turn will impact revenue recognition.

Timing of revenue recognition

Preparers should be mindful that the timing of revenue recognition is based on the transfer of control of goods to the customer and preparers should refer to the five indicators of HKFRS 15 to identify the point at which control has been transferred. While transport restrictions and closure of customers' facilities may prevent physical delivery, the timing of the recognition of revenue may not necessarily be impacted.

approval processes for sale transactions and whether those controls have been followed.

Auditors should carefully evaluate whether sale returns, additional price concessions, volume discounts or penalties for late delivery (collectively variable consideration) are contract modifications and have been properly accounted for under HKFRS 15.

Auditors should also pay attention to unusual revenue transactions and critically assess their business rationale. Among other audit procedures, auditors may perform background checks on new material sales to new customers at or near the end of the reporting period, to verify the genuineness of transactions.

For audit committees

The outbreak of COVID-19 may adversely affect the business operation of entities. The audit committee should be vigilant to indicators suggesting that management is under pressure to meet revenue and profit targets which may cause inappropriate behaviour, including engaging in fraudulent sale transactions or manipulating the timing of revenue recognition.

The audit committee should also enquire if there are unusual revenue transactions carried out by the entity and understand the accounting treatment and business rationale for them. The audit committee should discuss with the external auditors the procedures performed to satisfy themselves of the occurrence and measurement of material sale transactions.

(5) Trade receivables

For preparers of financial statements

Business disruption as a result of the outbreak of COVID-19 may lead to customers experiencing liquidity and credit quality issues and consequently affect the measurement of expected credit loss (ECL) of trade receivables under HKFRS 9 "Financial Instruments". Preparers should pay attention to the following areas in the measurement of ECL:

- The data used in measuring ECL should be sufficiently recent and reliable.
- Models used to measure ECL should be reviewed to assess their appropriateness under current economic conditions.
- Reasonable and appropriate estimates of future macroeconomic conditions should be considered in measuring ECL.

Where measurement models are not sufficiently responsive to appropriately reflect the change in economic conditions, management should

For auditors

Auditors should exercise their professional scepticism when auditing the ECL of trade receivables and should:

- understand and evaluate the management processes on how the information about the credit quality of trade debtors is gathered.
- understand and evaluate how the credit quality of trade debtors is reassessed in measuring ECL as a result of the outbreak of COVID-19.
- identify if there has been any change in key management judgement involved in ongoing credit evaluation and financial forecasts in measuring ECL. Auditors should critically assess whether the change in management judgement is reasonable, appropriate and properly supported by business rationale and/or external evidence and challenge management where such change is inconsistent with other audit evidence. In addition, the auditor should evaluate whether the disclosures reflect the details of changes in key judgement, in

consider applying an adjustment to reflect the impact of COVID-19 in measuring ECL.

Disclosures in the financial statements should reflect the factors that are specific to the entity, in particular how COVID-19 affects the credit risks of trade debtors and how such impacts have been incorporated in the measurement of ECL of trade receivables.

particular how the forward-looking information has been incorporated into the ECL measurement.

For audit committees

It is important for the audit committee to understand management systems and procedures in measuring ECL and assess whether internal controls on such systems and procedures are properly in place, in particular under the situation of COVID-19.

The audit committee should also challenge the key management judgement and estimates involved in measuring ECL of trade receivables and whether the auditor has exercised professional scepticism in the audit of measurement and completeness of ECL of trade receivables.

(6) Disclosure outside the financial statements

For preparers of financial statements

Management should consider whether additional disclosures are required to enable stakeholders to understand the impact of COVID-19 on the entity, its plans to mitigate the effects, and the entity's outlook.

Investors and other stakeholders are expected to have a particular interest in

For auditors

The auditor should discuss with the audit committee and management on COVID-19 related disclosures outside the financial statements, and assess whether those disclosures are consistent with the financial statements and the auditor's knowledge of the entity as required under HKSA 720 "The Auditor's Responsibilities Relating to Other the entity's resilience and to understand critical assumptions and judgment made by the entity when assessing uncertainties and preparing the financial statements. They are also interested in the availability of financial resources, through existing and potential financing facilities, to support the company's continued operation especially when there is a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

In addition to the information contained in the financial statements, management should consider expanding the analysis of the entity's principal risks and uncertainties to include a qualitative and quantitative assessment on their business activities, financial situation and economic performance.

Information".

For audit committees

The audit committee should work with management to ensure sufficient and appropriate disclosures are made both inside and outside the financial statements to fulfil stakeholder needs, in particular the entity's future outlook, its plans to mitigate the effects of COVID-19, and the level of financial resources available to support continued operations.

Additional considerations by auditors

In addition to the abovementioned areas, auditors should also pay attention to the following areas when planning and performing the audit in response to the outbreak of COVID-19:

- *Travel restrictions and application of alternative procedures*

  Auditors may have difficulties in accessing an entity's premises for performing audit procedures. Under such circumstances, auditors may consider other alternatives such as the use of technology to examine evidence so long as the sufficiency and appropriateness of the evidence are assessed.

  The assessment on the sufficiency and appropriateness of audit evidence obtained through the use of technology should be documented on the file, and it should include an evaluation on how the auditor satisfies itself that the quality and reliability of evidence are not compromised. Such evaluation should be performed on a case by case basis based on the facts and circumstances specific to the situation.

- *Group audit*

  The group auditor should reassess the determination of components that are financially significant and those that contain significant risks to the financial statements under HKSA 600 "Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)", and the relevant impact on the scope of work to be performed by component auditors.

  The auditor should also remain alert to the possible changes in the group financial reporting process and control procedures, and adjust the audit procedures accordingly.

- *Audit risk assessment*

  The auditors should revisit their risk assessments in light of COVID-19, especially for the financial statement areas which are material or highly judgmental. They should also perform additional procedures concerning fraud or other accounting irregularities, as internal controls may not have functioned as planned at a time when the company is under increased pressure.

- *Additional quality control procedures*

  The auditor should consider putting in place additional quality control procedures in response to the heightened risk, for example, requiring further internal consultation in areas where judgment and conclusions are likely to be affected by COVID-19 issues and expanding the scope of engagement quality control reviews to cover significant judgment being made by management and audit team because of COVID-19 including the appropriateness of going concern assumption.

- *Key audit matters*

  While COVID-19 may not be a key audit matter in itself under HKSA 701 “Communicating Key Audit Matters in the Independent Auditor’s Report”, it is expected to be a key consideration on auditor’s determination of a key audit matter.

  The auditor should consider disclosing the incremental risks arising from COVID-19 and the additional procedures performed to address the increased subjectivity and uncertainty caused by COVID-19. The auditor should avoid boilerplate key audit matter disclosures and ensure relevant information that is specific to the entity’s circumstances are being disclosed.

Advice in relation to the resignation of auditors of listed entities

As an independent auditor regulator, the FRC is concerned with the maintenance of audit quality and that this quality is not affected by any changes in the appointment of auditors. The FRC would like to remind auditors and listed entities the importance of ensuring audit quality by paying attention to the following key areas so that investors’ confidence in financial reporting will not be hampered.

1. An audit committee is charged with the responsibility for the appointment of an auditor. It should ensure that a discussion with its auditor is initiated in good time regarding the terms of engagement, including the audit fee and the scope of the audit services to be performed.

2. Should there be any changes to the client continuance policy or other considerations of the incumbent auditor that might lead to its resignation as an auditor of a listed company, the auditor should discuss its intentions with the audit committee as soon as possible. This will also give the audit committee sufficient time to find another suitable auditor where the incumbent auditor does decide to resign. The audit committee should enquire in depth the reasons for the resignation of the outgoing auditor (such as unresolved audit issues) and consider whether any action is required.

3. To ensure that the market is kept fully informed, an outgoing auditor is required, under section 300 of the Code of Ethics for Professional Accountants, to prepare a letter to the audit committee and the board of directors setting out the circumstances leading to its resignation or termination, i.e. all occurrences that, in the opinion of the outgoing auditor, affect the relationship between the listed company and the outgoing auditor.

4. Regarding the appointment of the incoming auditor, the audit committee should have a transparent and robust procedure for the selection of candidates to ensure that the incoming auditor is independent, and has sufficient competency and resources to undertake the audit engagement, and that the proposed audit fee is reasonable in light of the scope of the audit services to be performed.

5. An incoming auditor should carefully consider at least the following before deciding to accept the appointment:

   a. the integrity of the client, including indications of an inappropriate limitation in the scope of work and the reasons for the proposed change of auditor;
   b. whether it has the required expertise, time and resources for the engagement; and
   c. whether it can comply with relevant ethical requirements.

The outbreak of COVID-19 has brought about many unexpected difficulties and disruptions to normal businesses worldwide. At this volatile time, different stakeholders of the financial industry should remain resolute in maintaining the required professional standards, ethics and work quality. The FRC hopes that by highlighting the pressing issues arising from the pandemic and providing practical advice to the audit profession, the listed entities and other relevant stakeholders, potential pitfalls can be avoided and the consequent negative impacts minimised. We believe that with a heightened sense of self-discipline and swift responses to the changing demands, the audit profession will be able to rise to the challenge. At the time of this pandemic, the FRC will closely monitor the latest developments and make adjustments to our inspection and investigation plans to deliver an effective regulatory outcome.

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