

# 2022 Annual Investigation and Compliance Report

Investigation and Compliance

20 October 2022



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## **About the AFRC**

The Accounting and Financial Reporting Council is an independent body established under the Accounting and Financial Reporting Council Ordinance. As an independent regulator, AFRC spearheads and leads the accounting profession to constantly raise the level of quality of professional accountants and thus protects the public interest.

For more information about the statutory functions of the AFRC, please visit [www.afrc.org.hk](http://www.afrc.org.hk).

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## Foreword

We are pleased to share with the public our second Annual Investigation and Compliance Report, covering a reporting period of twelve months up to 31 March 2022. This report highlights the more common examples of non-compliance in listed entity financial statements and misconduct of their auditors that we have found or looked into during our investigations and enquiries, to which the management and audit committees of listed entities and their auditors should pay attention.

This report also provides an overview of the work of the investigation and enquiry functions in the year and a look forward at our plans for the coming year.

During the year, there has been a significant increase in reports received about allegations of potential misconduct or non-compliance, in particular from whistleblowers and other regulators, indicating public confidence in the AFRC to take regulatory actions as the independent auditor regulator. In addition, we have also started to receive referrals for investigations and enquiries from our inspection function.

The significantly increased level of reports and referrals received has led to more investigations being initiated in the year, some of which concern complex issues with significant public interest. In addition, the number of enquiries initiated has also increased due to our proactive effort in ensuring financial statements preparers are held accountable for financial reporting non-compliance. To enhance transparency in relation to our regulatory actions, we have made announcements of initiation of investigations and enquiries with significant public interest to maintain public confidence in our financial markets and independent auditor regulation.

As mentioned in our first Annual Investigation and Compliance Report, a backlog in our caseload has developed due to staff vacancies and the disruptive impact of the COVID-19 pandemic. During the year, we have taken some measures in streamlining our processes and prioritising the use of our resources in handling cases. Considering the higher number of reports received and investigations and enquiries initiated, given the same level of resources, the backlog situation remains a challenge for us.

In the coming year, we will be increasing our manpower resources and will continue to explore ways to further enhance the efficiency of our processes, which will enable us to address the backlog while maintaining agility in handling new cases with significant public interest.

## **Potential and actual non-compliance in listed entity financial statements**

Preparing high quality annual and interim financial statements is first and foremost the responsibility of the boards, audit committees, managements and professionally qualified accountants of listed entities (i.e. financial statements preparers).

The more common areas of financial reporting where we identify potential and actual non-compliance continue to relate to areas where preparers are required to make significant judgements or estimates which involve applying complex measurement techniques to assets, liabilities, income and expenses that result from or are influenced by complex and often inherently uncertain transactions, other events and conditions.

Such areas include (i) fair value measurement; (ii) impairment of financial and non-financial assets and cash generating units; (iii) classification of financial instruments; and (iv) going concern assessment and reporting.

## **Potential and actual misconduct by listed entity auditors**

Auditors are responsible for obtaining assurance as to whether the financial statements of listed entities were prepared in accordance with the applicable financial reporting framework and to express their opinion on this in their report. The quality of the auditor's work is not only affected by the professional competence and independence of the engagement team, but also by the effectiveness of the firm's quality assurance policies and procedures.

Similar to last year, our investigative work shows that the more common areas of actual or potential auditing irregularities involve (i) failing to properly conduct the audit to obtain sufficient appropriate audit evidence on which to base their opinion (80%); (ii) failing to exercise appropriate professional skepticism and professional judgement (68%); and (iii) aspects of the audit where preparers are required to make significant judgements and estimates (47%). In addition, in most of our investigation cases (87%), actual or potential auditing irregularities also include failing to perform the engagement quality control review adequately.

## **Our expectations of preparers and auditors**

Directors are responsible for the preparation of financial statements in accordance with the relevant financial reporting framework. They need to make sure that appropriately competent financial reporting resources are available for the proper application of the relevant financial reporting principles in preparing the financial statements, including obtaining assistance from or consulting appropriate internal or external experts when necessary.

Auditors need to evaluate the risks of material misstatement and ensure that they respond sufficiently and appropriately to those risks. Auditors are expected to take note of the key findings and observations set out in this report in relation to the key common auditing irregularities and take appropriate actions to make the necessary improvements to ensure that a robust audit approach is in place to deliver high quality audits.

Audit committees of listed entities have the responsibility of overseeing management's preparation of the financial statements and the auditor's performance of the external audit. The role of the audit committee is therefore crucial to hold management and auditors accountable for their role respectively in ensuring high quality financial reporting is provided and audit quality is maintained. They should challenge the management as to whether they have applied appropriate accounting policies in accordance with the relevant financial reporting standards in relation to areas where significant judgements and estimates are required to be made in preparing the financial statements. They should also consider the auditing deficiencies identified in the report and challenge their auditors as to whether and how they have addressed such deficiencies in their audits.

## **Further reform**

Under the further reform of the accounting profession, the remit of our investigatory function is expanded to cover all practice units and certified public accountants. We have made preparations and have liaised with the HKICPA for a smooth transition of the expanded functions.

We will continue to enhance our processes and procedures to enable us to discharge our expanded statutory duties efficiently and effectively.

## **Department of Investigation and Compliance**

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# Section 1

## Introduction

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### 1.1 Purpose of this report

- 1.1.1 This is our second report to share findings and observations arising from our operations of the investigation and enquiry functions of the AFRC.
- 1.1.2 Following the publication of the first Annual Investigation and Compliance Report, a number of seminars and workshops organised by professional and other bodies were held to share our findings on areas of misconduct and non-compliance with financial reporting requirements. The seminars and workshops were well received by different stakeholders.
- 1.1.3 Our findings of misconduct and financial reporting non-compliances continue to form a significant part of this report for the attention of auditors and boards, audit committees, and management of listed entities to avoid recurrence and to enhance the quality of their financial reporting and audits. This report also provides an overview of the operations and new developments of the investigation and enquiry functions of the AFRC.
- 1.1.4 This report includes:
- (a) An overview of the remit and powers, the work processes and the oversight mechanism of the investigation and enquiry functions (section 2, Appendix 1 and Appendix 2);
  - (b) A review of the progress of our work in the year in obtaining and handling evidence of potential misconduct and non-compliances and conducting investigations and enquiries (section 3);



We detect potential misconduct and non-compliances through our proactive and reactive market monitoring. In terms of reactive sources, we encourage and respond to complaints from members of the public, whistleblower reports, and referrals by other regulators. Proactively, we also monitor announcements by listed entities and other public sources of information and comments on financial reports and audits of listed entities. In addition, our proactive inspection function and our proactive Financial Statements Review Programme (**FSRP**) are designed to detect potential misconduct and non-compliance.

- (c) A summary of non-compliances with financial reporting requirements (section 4) and key findings and observations on auditing irregularities (section 5); and
- (d) Highlights of key aspects of our plans to further strengthen our investigation and enquiry functions in the coming year (section 6).

## **1.2 Expectations and roles of listed entities, auditors and audit committees of listed entities**

- 1.2.1 High-quality financial reporting by Hong Kong's listed entities is key to maintaining Hong Kong's status as a leading international financial centre and as a leading international capital market for IPO fundraising. Investors and other stakeholders in the market rely on the financial information of listed entities to make informed investment and other decisions. It is therefore pivotal that the financial information presented should be accurate, relevant and sufficient for such decision-making purposes.
- 1.2.2 Board of directors has the primary responsibility to prepare financial statements that give a "true and fair view" of the financial performance and position of a listed entity.
- 1.2.3 Auditors are responsible for obtaining assurance as to whether the financial statements of listed entities were prepared in accordance with the applicable financial reporting standards and to express their opinion on this in their report.

- 1.2.4 Based on the observations in our handling of investigations and enquiries, the more common areas of financial reporting where we identify potential and actual non-compliance continue to relate to areas where preparers are required to make significant judgements or estimates, such as fair value measurement, impairment assessment and going concern assessment and reporting.
- 1.2.5 In respect of auditor misconduct, the five key common areas of auditing irregularities identified remain the same as those in our first report. However, there was a slight decrease in the number of cases involving two areas of auditing irregularities identified, namely sufficient appropriate audit evidence and professional skepticism and professional judgement. In contrast, there were more cases involving the remaining three key common areas of auditing irregularities, namely (i) engagement quality control review; (ii) audit of accounting estimates; and (iii) using the work of an auditor's expert. Our observations concerning auditing irregularities are in line with those identified in inspections carried out by the AFRC.
- 1.2.6 It is important for boards of listed entities to ensure that their financial reporting function is professionally competent and properly resourced, including obtaining assistance from external experts when considered necessary. External experts may be engaged to advise the management of listed entities about the accounting or financial reporting issues or to assist the audit committee in the effective monitoring of the financial reporting process.
- 1.2.7 Auditors of listed entities should ensure that they have the relevant knowledge and expertise to identify and deal with financial reporting issues arising from their audits. They should have a thorough understanding of the relevant financial reporting requirements for a competent application to the circumstances of the listed entity. In certain instances, an auditor may need to use the work of experts who have expertise in areas other than accounting and auditing, for example, valuation and specialised industry expertise.
- 1.2.8 Audit committees of listed entities have a significant role to safeguard the quality of both the financial reporting function of the listed entity and the performance of its auditor. The audit committee is also vested with the power to make recommendations to the board of a listed entity on the selection, appointment and reappointment of the auditor with the aim to ensure the quality of the audit. *Guidelines for Effective Audit Committee – Selection, Appointment and Reappointment of Auditors* issued by the AFRC on 16 December 2021 provides further guidance in this respect.

- 1.2.9 The board of directors and the audit committee of a listed entity should be satisfied with the competence of their auditor. They may require the auditor to demonstrate that they have the relevant expertise, experience and sufficient and appropriate resources in dealing with specific financial reporting matters relevant to their circumstances. The audit committee should also have sufficient and timely communication with the auditor about key issues of interest and their responsibilities.
- 1.2.10 We urge the boards, management and audit committees of listed entities to take note of the key findings and observations in respect of financial reporting non-compliances, and listed entity auditors and audit committees to take note of those relating to auditing irregularities, set out in sections 4 and 5 of this report respectively. Appropriate actions should be taken to avoid these matters arising in their financial reporting processes and audits.

### **1.3 Operations statistics**

Operational statistics for investigations and enquiries (i.e. cases) and for complaints, reports and referrals from which they have been sourced (i.e. sources) are provided below for the year, with comparatives for the previous 18 month period ended 31 March 2021 and nine month period ended 30 September 2019 due to a change of the financial year-end to 31 March under the regulatory reform in 2019.

**Table 1: Five-year operations statistics**

	April 2021 to March 2022 (12 months)	October 2019 to March 2021 (18 months)	January to September 2019 (9 months)	2018	2017
<b>Financial statements reviews</b>					
Opening (In progress)	30	39	31	25	12
Financial statements selected for review	75	62	47	50	48
Cases <sup>1</sup> initiated	(2)	(4)	(5)	(9)	(2)
Advice letter issued	(16)	(37)	(10)	(21)	(7)
Closed without further action	(60)	(30)	(24)	(14)	(26)
Closing (In progress)	27	30	39	31	25
<b>Reports of matters</b>					
Opening (pursuable <sup>2</sup> )	29	23	11	14	14
Reports <sup>3</sup> received <sup>4</sup>	101	67	48	35	25
Cases <sup>1</sup> initiated	(31)	(19)	(6)	(9)	(12)
Advice letter issued	(3)	(2)	-	-	-
Referred to specified enforcement agencies	-	-	(1)	(2)	(3)
Closed without further action	(28)	(40)	(29)	(27)	(10)
Closing (pursuable)	68	29	23	11	14
<b>Investigations</b>					
Opening (In progress)	58	42	43	40	37
Initiated	32	23	11	19	14
Referred to the Hong Kong Institute of Certified Public Accountants (HKICPA)	(7)	(7)	(12)	(16)	(11)
Closed without further action	(1)	-	-	-	-
Closing (In progress)	82	58	42	43	40
<b>Enquiries</b>					
Opening (In progress)	3	1	3	2	2
Initiated	14	2	1	2	-
Non-compliance removed	(1)	-	(2)	(1)	-
Non-compliance not yet removed <sup>5</sup>	-	-	(1)	-	-
Closing (In progress)	16	3	1	3	2

1 A case is an investigation or enquiry.

2 Reports are not pursuable if the subject matter of the reports is outside the remit of the FRC.

3 These include complaints received from members of the public, whistleblower reports and referrals from other regulators.

4 Excluded 163, 50 and 101 pursuable complaints of a vexatious, abusive or unreasonably persistent nature for the years 2021-22, 2018 and 2017 respectively which were not taken further.

5 Issued notice to remove the non-compliance, however the subject entity was subsequently delisted and the non-compliance has not yet been removed.

## Section 2

# Overview of operations

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### 2.1 Introduction

- 2.1.1 The AFRC has the statutory power to investigate possible misconduct committed by public interest entity (**PIE**) auditors or reporting accountants and to enquire into possible non-compliance with accounting requirements in the financial reports of PIEs.
- 2.1.2 The AFRC regulates PIE auditors through a system of registration and recognition, and through inspection, investigation and disciplinary action.
- 2.1.3 Both investigation and enquiry are important AFRC regulatory functions:
- (a) Investigations ensure that potential misconduct on the part of PIE auditors and registered responsible persons detected through our reactive and proactive monitoring activities (see paragraph 1.1.4(b)) are responded to timely and adequately so that appropriate follow-up action can be taken. Such follow-up action may include the imposition of sanctions or referral to other regulators or law enforcement agencies for conduct falling within their remit.
  - (b) Enquiries ensure that potential non-compliance with financial reporting requirements in the financial reports of PIEs identified are rectified timely and appropriately so that investors and other stakeholders are not misled by misstatements contained in financial reports of PIEs.
- 2.1.4 Details of the remit and powers of the investigation and enquiry functions are set out in Appendix 1.
- 2.1.5 On 22 October 2021, the Financial Reporting Council (Amendment) Ordinance 2021 (**the Amendment Ordinance 2021**) was passed with a view to further enhance the independence of the regulatory regime for the accounting profession in Hong Kong (**the Further Reform**). The commencement date of the Amendment Ordinance 2021 is 1 October 2022.

- 2.1.6 After the Further Reform, the regulatory powers of the AFRC, including the power to investigate and enquire, will be expanded to cover professional persons, i.e. certified public accountants and practice units, in addition to its existing regulatory powers over PIE auditors and registered responsible persons of registered PIE auditors.
- 2.1.7 The Financial Reporting Council Ordinance as in force immediately before 1 October 2019 continues to apply to investigations of PIE engagements completed before 1 October 2019.

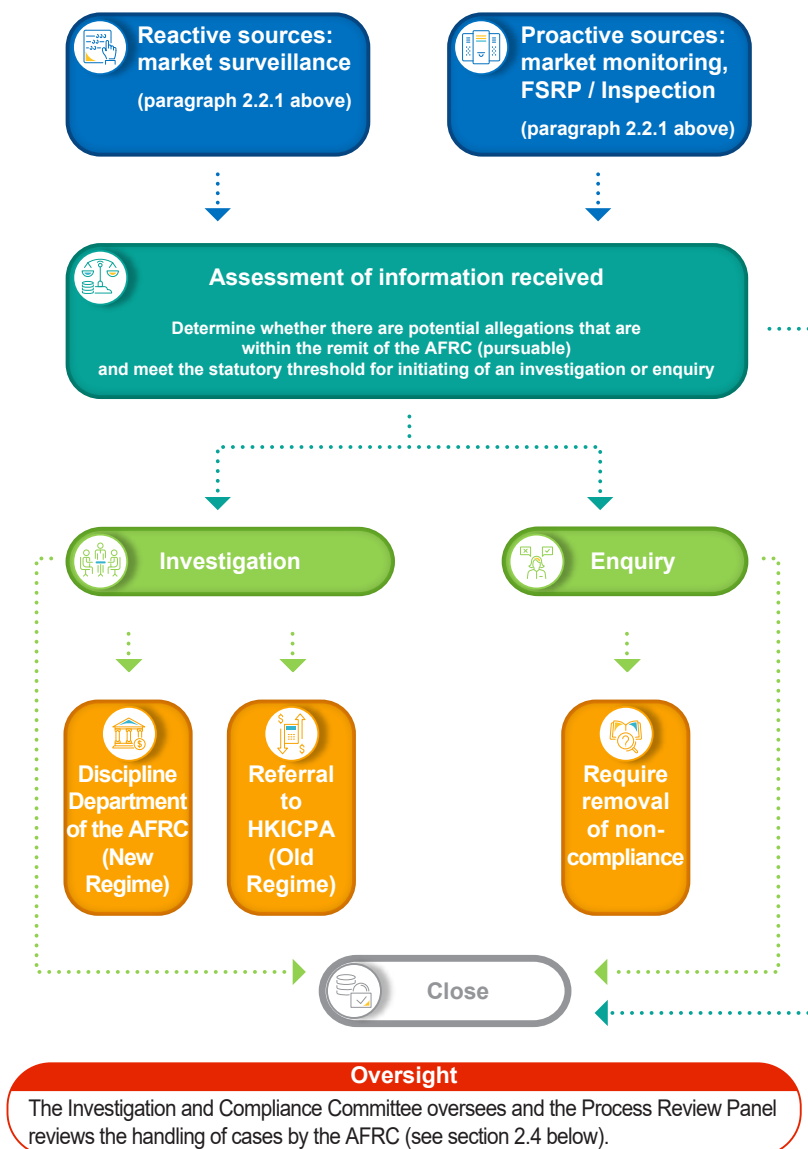
## **2.2 Acquiring information about potential misconduct or non-compliance**

- 2.2.1 The AFRC aims to acquire information about potential misconduct or non-compliance through conducting market surveillance and market monitoring activities. The AFRC may do so:
- (a) Reactively, through market surveillance activities that encourage and/or scan for complaints, reports and referrals of misconduct or non-compliance (Allegations) from:
    - (i) members of the public;
    - (ii) whistleblowers; and
    - (iii) other regulators; or
  - (b) Proactively, through our risk-based market monitoring activities:
    - (i) Inspections of PIE auditors (see our most recent Annual Inspection Report); and
    - (ii) Reviews of financial statements of PIEs under the FSRP (see section 3.2).
- 2.2.2 The AFRC provides a platform for members of the public and whistleblowers to make complaints or provide information about possible misconduct or non-compliance they are aware of.

## 2.3 Processes

2.3.1 A high-level overview of the process of handling complaints and other reports about potential misconduct or non-compliance and in conducting cases, i.e. investigations or enquiries, is set out in the diagram below.

**Diagram 1 – Overview of our process**



*Refer to Appendix 2 for further details of the process*

## Transitional arrangements about disciplinary decisions

- 2.3.2 For investigations involving audits of PIE engagements completed before 1 October 2019 (Old Regime), the investigation findings are referred to the HKICPA for consideration of appropriate follow-up actions.
- 2.3.3 Upon the commencement of the Amendment Ordinance 2021, which will take effect on 1 October 2022, the AFRC will assume the investigation and discipline of all certified public accountants, certified public accountants (practising) and practice units registered with the HKICPA. Accordingly, starting from 1 October 2022, investigation findings involving audits under the Old Regime will be considered by the AFRC's discipline function.

## 2.4 Oversight

### Investigation and Compliance Committee

- 2.4.1 The Investigation and Compliance Committee (**ICC**) is a committee set up by the AFRC under the AFRCO comprising AFRC Board members and Honorary Advisers. The ICC advises the AFRC Board on matters concerning the investigation and enquiry functions and related activities to acquire, assess and obtain information about potential allegations of misconduct or non-compliance. It also provides advice on the development of strategies, guidelines and procedures and in setting selection criteria for the FSRP.
- 2.4.2 In addition, the ICC performs an annual review (both procedural and substantive) of the performance of the handling processes for the reactive and proactive sources of allegations. The ICC selects for review completed cases which were closed without further action, using a set of selection criteria which is set annually by the ICC (**ICC Review Programme**). The ICC reports their findings and recommendations to the AFRC Board.
- 2.4.3 The scope of the ICC Review Programme covers the assessment of the following:
- (i) **Procedural review** – Compliance with internal procedures in handling the completed cases as contained in the operations manual; and
  - (ii) **Substantive review** – Reasonableness of the justification for closing the case without further action with reference to financial reporting standards, auditing and assurance standards, other relevant financial reporting guidelines and statutory disclosure requirements.



2.4.4 The ICC has completed its second review cycle under the ICC Review Programme covering the period from 1 April 2021 to 31 March 2022. The ICC selected 16 out of 107 completed cases of complaints, whistleblower reports, referrals and financial statements reviews that were closed without initiating an investigation or enquiry (representing 15% of the total number of completed cases). The ICC concluded that all the selected cases had been handled in accordance with the operations manual and the decisions to close the cases without initiating an investigation or enquiry were reasonable.

### Process Review Panel

2.4.5 The Process Review Panel (**PRP**) for the AFRC is an independent non-statutory panel established by the Chief Executive of the HKSAR in 2008 to review cases handled by the AFRC and to consider whether actions taken by the AFRC are consistent with its internal procedures and guidelines.

2.4.6 The PRP has completed its review of nine out of 98 cases handled by the investigation and enquiry functions in 2020<sup>6</sup>. The PRP concluded that the AFRC had handled its cases in accordance with its internal procedures. The PRP also made recommendations to the AFRC to enhance the process of handling complaints and investigations.

2.4.7 In response to the recommendations, the investigation and enquiry functions have developed plans to enhance its operational efficiency collaborations and referrals among different functions internally, and coordination with other regulators in sharing information of common interest and exchanging feedback on case referrals.

## 2.5 Cooperation with other regulators

### Hong Kong

2.5.1 Misconduct in the financial markets might simultaneously involve offences under regulations within the jurisdiction of different regulators and law enforcement agencies (**LEA**).

2.5.2 Over the years, the AFRC has been fostering effective collaboration with other regulatory and professional bodies and LEAs in Hong Kong, including the Securities and Futures Commission (**SFC**), The Stock Exchange of Hong Kong Limited (**SEHK**) and the HKICPA, under memoranda of understanding with an aim of enhancing investor protection.

<sup>6</sup> 2021 Annual Report of PRP for the Financial Reporting Council.

- 2.5.3 The collaboration between the AFRC, other regulators and LEAs ensures the effective use of all enforcement tools available to combat misconduct which are threatening or harmful to the investing public and other stakeholders in the markets.
- 2.5.4 The investigation and enquiry functions of the AFRC collaborate with other regulators through regular liaison meetings, cross-referrals and sharing of knowledge and information of common interest.
- 2.5.5 In June 2021, the AFRC signed a new Memorandum of Understanding (**MoU**) with SEHK to further strengthen collaboration between the two organisations, in order to ensure the upholding of quality financial reporting by listed entities and their auditors.
- 2.5.6 In September 2021, the AFRC also entered into a MoU with the Independent Commission Against Corruption (**ICAC**) for closer collaboration between the AFRC and the ICAC to maximise the concerted efforts in combating corruption, illicit activities and malpractice in the financial market, strengthening governance of listed entities and enhancing conduct of the accounting professionals.
- 2.5.7 Under the arrangement of the MoU between the AFRC and the ICAC, the AFRC conducted a joint operation with the ICAC in November 2021. The operation involved a search of the offices of a PIE auditor and the premises of other relevant parties for the suspected misconduct of the relevant PIE auditor and registered responsible persons under the FRCO.

## **Mainland China**

- 2.5.8 Mainland enterprises comprise H share companies, red chip companies and Mainland private enterprises. They represent a significant proportion of all listed entities in Hong Kong (around 53% by number and 79% by market capitalization). For effective regulation of these listed entities, it is important to develop a strategic relationship with Mainland authorities, in particular the Supervision and Evaluation Bureau (**SEB**) of the Ministry of Finance (**MoF**) of the People's Republic of China.
- 2.5.9 The MoU between the SEB and the AFRC has facilitated our ability to gain access to audit working papers located in the Mainland for our investigations with the assistance of the SEB through an effective mechanism and clear procedures.

2.5.10 During the year, we have reviewed the process in obtaining access to audit working papers located in the Mainland and are in regular discussions with the SEB with an aim to enhance the efficiency of the process.

2.5.11 Details and progress of the requests for assistance of the SEB in relation to investigations are set out in paragraphs 3.4.7 to 3.4.9 of this report.

## Section 3

# Our work of the year

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### 3.1 Introduction

- 3.1.1 This section provides a review of our work of the year in relation to the FSRP, the assessment of complaints, reports and referrals about potential allegations of misconduct or non-compliance, and the initiation and conduct of investigations and enquiries.
- 3.1.2 Amidst restrictions on travel and lockdowns locally and overseas and the disruption of our operations and that of our regulatees and other regulators caused by the COVID-19 pandemic, the AFRC implemented special arrangements to ensure continuity of the work of the investigation and enquiry functions. These arrangements include including virtual meeting arrangements with other regulators and business partners, handling of submissions electronically and work from home arrangement as far as possible according to operational needs.
- 3.1.3 As mentioned in our last Annual Report, a backlog of cases has developed due to resources issue and the disruptive impact of the COVID-19 pandemic on our operations. In addition to the arrangements adopted to manage the impact of the COVID-19 pandemic as referred to in paragraph 3.1.2 above, during the year, we have also taken some measures to streamline and/or expedite the performance of procedures with an aim to enhance the efficiency and effectiveness of the investigation and enquiry functions, including:
- (i) Taking earlier advantage of our statutory powers under the AFRCO to initiate an investigation or enquiry and require relevant parties to provide information;
  - (ii) Delegation of powers to the department in handling more straightforward cases, e.g. enquiries into less complex financial reporting issues are conducted by the staff of the AFRC instead of a Financial Reporting Review Committee (see paragraph 3.5.1); and

(iii) Prioritizing our resources to handle potential allegations with significant public interest.

3.1.4 During the year, there was a substantial increase (51%, see Table 5 below) in the number of reports about potential misconduct of auditors or potential non-compliance with financial reporting requirements by listed entities received in the year ended 31 March 2022, in particular from whistleblowers and other regulators. This led to a significant increase in the number of investigations initiated during the year (39%, see Table 7 below) as compared to the 18-month period ended 31 March 2021, despite a shorter 12-month reporting period this year. The number of enquiries initiated in the year has also been significantly increased due to our proactive effort in ensuring financial statements preparers are held accountable for financial reporting non-compliances.

3.1.5 Some of the complaints, reports and referrals received and handled during the year were more complex in nature with significant public interest. In particular, a number of investigations initiated during the year involved multiple auditing and financial reporting issues, fraudulent transactions, or complicated and industry-specific accounting matters.

3.1.6 Although the level of reports by informants as well as investigations and enquiries initiated in the year has increased, the level of resources remained at the same level last year. Therefore, the situation of backlog of cases remains a challenge for us even though some measures in streamlining our processes have been taken during the year.

3.1.7 The AFRC is well aware of the importance of timely investigative actions on audits in relation to listed entities and timely information about any inaccurate financial information presented by listed entities. Therefore, we have budgeted to increase our resources in 2022 and will continue to explore measures to streamline our processes and procedures in handling complaints, investigations and enquiries with a view to identifying further ways to simplify or expedite the performance of procedures.

## **3.2 Financial Statements Review Programme**

### **Overview**

3.2.1 Our FSRP is a non-statutory initiative, which is part of our risk-based market monitoring activities, to monitor the quality of financial reporting by PIEs. The AFRC launched the FSRP in 2011 with the objective of proactively reviewing financial statements of PIEs to identify possible misconduct by PIE auditors or non-compliance with accounting requirements by PIEs.

3.2.2 The scope of a review includes considering whether there is non-compliance with financial reporting standards, auditing and assurance standards, and other relevant financial reporting guidelines (such as accounting requirements under the Listing Rules of the SEHK).

3.2.3 A risk-based approach is adopted to identify and select financial statements for review based on various criteria, which are reviewed and set annually and may be updated in response to subsequent changes in the current economic and regulatory environment. For the 2021 cycle, the criteria were updated in view of the impact of the COVID-19 pandemic and the economic environment on businesses. The selection criteria for the 2021 cycle applied to financial statements published in 2021 include:

- a. **Significant changes** – companies undergoing significant changes in business activities, financial position or results. These changes may give rise to increased risk of material misstatements in financial statements based on our experience of previous cycles;
- b. **Market events** – information disclosed by PIEs, short-sellers or media, which indicate potential non-compliance and/or misconduct;
- c. **Prior year adjustments** – financial statements with significant prior period adjustments other than those reflecting a change in accounting policy or resulting from an adoption of newly introduced financial reporting standards, which may indicate possible misstatements in a prior period's financial statements and/or that the audit opinion(s) given in prior period(s) may not have been appropriate;
- d. **Modified auditor's report** – financial statements with a modified auditor's report, which indicate that the financial statements may be materially misstated;
- e. **Resignation of auditors** – resignation of auditors due to unresolved audit issues and successor auditor issued an unmodified audit opinion;
- f. **Retail or tourism related industries** – listed entities in the retail or tourism industries which have been significantly impacted by the COVID-19 pandemic; and
- g. **Impairment and/or a going concern problem** – indications of impairment of non-financial assets and/or going concern problem due to deficiency in applying professional skepticism relating to assessment of impairment and going concern.

3.2.4 In addition, financial statements of PIEs prepared under Chinese Accounting Standards for Business Enterprises were also selected for review.

### Key operations statistics about the FSRP

3.2.5 During the year, the criteria that drove our selections of financial statements for review under our FSRP are set out in Table 2 below.

**Table 2: Financial statements selected for review**

	2021 cycle	2020 cycle
Significant changes	24%	31%
Market events	9%	18%
Prior year adjustments	1%	8%
Modified auditor's report	9%	7%
Resignation of auditors	3%	N/A
Retail or tourism related industries	20%	N/A
Impairment and/or a going concern problem	23%	N/A
Chinese Accounting Standards	11%	20%
Delayed results	N/A	16%

**Table 3: Movements in financial statement reviews**

	April 2021 to March 2022	October 2019 to March 2021
Brought forward	30	39
Financial statements selected for review	75	62
Completed with no follow-up action <sup>7</sup>	(76)	(67)
Initiated investigations or enquiries	(2)	(4)
<b>In progress at the end of the year/period</b>	<b>27</b>	<b>30</b>

3.2.6 Given the importance of this proactive monitoring initiative, we have initiated a revamp of the FSRP to enhance its effectiveness in identifying potential misconduct and non-compliance. The enhanced FSRP aims to create a deterrent for such behavior and incentive for listed entities to prepare high-quality financial reports and their auditors to perform high-quality audits.

<sup>7</sup> Include reviews for which advice letters were issued or were closed without further action.

- 3.2.7 The revamp includes increasing the number of financial statements selected for review; reassessing the selection criteria (based on the probability of misstatement in the financial statements and the impact of the misstatement); introducing rotation and random sampling to the existing risk-based selection approach; and introducing a focused scope for reviews of financial statements selected under certain selection criteria.
- 3.2.8 In view of the resources available, the revamped FSRP is to be adopted gradually over a period of five years. For the 2021 cycle, the number of financial statements selected for review was increased to 75 (i.e. an increase of 21%) and such number will be further increased to 130 (i.e. 5% of the total number of listed entities) for the 2022 cycle.

### **3.3 Allegations of potential misconduct or non-compliance**

#### **Overview**

- 3.3.1 The AFRC encourages complaints from members of the public, reports from whistleblowers and referrals from other regulatory bodies (i.e. informants) which provide information about potential misconduct or non-compliance. When the information received from such informants does not relate to allegations of potential misconduct or non-compliance that fall within the remit of the AFRC, it is not considered pursuable and the AFRC may direct the informant to other relevant regulatory bodies or refer the matter to such bodies directly.
- 3.3.2 Every pursuable allegation of potential misconduct or non-compliance identified from these channels or from our FSRP or Inspection function is evaluated to determine whether to initiate an investigation or an enquiry. Pursuable matters are closed with no follow-up action when, based on our evaluation, when the evidence obtained does not meet the statutory thresholds for initiating an investigation or enquiry or if the allegations would not have a significant public interest impact.

#### **Evidence provided by informants**

- 3.3.3 It is important that an informant provides information that is sufficient for the AFRC to identify and assess the potential allegations. The information should include:
- (i) The name of the PIE auditor, registered responsible person and/or the listed entity that are relevant in the circumstances;
  - (ii) Specific details of the conditions, events or circumstances indicating the potential misconduct or non-compliance including, where relevant, details of the dates and parties involved; and



(iii) Copies of any relevant documents providing evidence in support of the allegations.

3.3.4 Where the information provided by an informant is not sufficient to meet the statutory thresholds for initiating an investigation or enquiry into potential allegations of misconduct or non-compliance, the AFRC may not be able to pursue the potential allegations.

3.3.5 We accept information sources that are anonymous and the AFRCO (section 52) provides statutory protection for the informants, including confidentiality of their identity if disclosed. However, informants are advised to provide contact details to enable the AFRC to follow up or clarify information received or to obtain further information if considered necessary. Anonymous complaints may severely constrain our ability to pursue the allegations if further information is needed.

### Key operations statistics relating to matters reported by informants

3.3.6 During the year, we handled 130 complaints and referrals, including 29 brought forward from the previous period and 101 pursuable complaints and referrals received in the year. We completed the assessment of 62 reports relating to pursuable allegations, of which 31 were closed with no further action. As at 31 March 2022, 68 reports were still being evaluated.

**Table 4: Movements in reports by informers**

	April 2021 to March 2022	October 2019 to March 2021
Brought forward	29	23
Reports received	114	77
Non-pursuable matters <sup>8</sup>	(13)	(10)
Reports of pursuable allegations received	101 <sup>9</sup>	67
Completed with no follow-up action <sup>10</sup>	(31)	(42)
Initiated investigations or enquiries	(31)	(19)
<b>In progress at the end of the year/period</b>	<b>68</b>	<b>29</b>

8 The subject matters of these reports are outside the remit of the AFRC.

9 Excluded 163 pursuable complaints of a vexatious, abusive or unreasonably persistent nature which were not taken further.

10 Include matters for which advice letters were issued or were closed without further action.

**Table 5: Sources of pursuable matters reported**

	April 2021 to March 2022	October 2019 to March 2021
Members of the public	24	24
Whistleblowers	30	18
Referrals from:		
• Hong Kong Exchanges and Clearing Limited	17	12
• HKICPA	3	4
• SFC	7	5
• Commercial Crime Bureau	–	4
• ICAC	2	–
• Other enforcement agencies	2	–
• Inspection function	16	–
<b>Total</b>	<b>101</b>	<b>67</b>

**Table 6: Category<sup>11</sup> of PIE auditors in pursuable reports**

	April 2021 to March 2022	October 2019 to March 2021
Category A firms	58%	57%
Category B firms	35%	27%
Category C firms	7%	16%

## 3.4 Investigations

### Overview

- 3.4.1 When potential misconduct by PIE auditors is identified through evaluation of matters reported or review of financial statements under the FSRP, the AFRC may initiate an investigation into the possible misconduct under the AFRCO.

<sup>11</sup> PIE auditors are categorised into four types: Category A firms (with >100 PIE clients), Category B firms (with 10 to 100 PIE clients), Category C firms (with less than 10 PIE clients) and Overseas firms (i.e. non-Hong Kong firms).

## Key operations statistics about investigations

- 3.4.2 During the year, the AFRC handled 58 investigations brought forward from the previous period and 32 new investigations that were initiated during the year. Among the new investigations initiated, there are a number of investigations in relation to listed entities and matters with significant public interest where we had publicly announced the initiation of such investigations. We completed eight investigations during the year, seven of which identified auditing irregularities related to audits completed prior to 1 October 2019 (i.e. under the Old Regime). Accordingly, the investigation reports were referred to the HKICPA to consider disciplinary actions. One investigation was closed without further action during the year as the allegations were not substantiated.
- 3.4.3 With effect from 1 October 2022, all disciplinary actions will be carried out by the Department of Discipline of the AFRC.

**Table 7: Movements in investigations**

	April 2021 to March 2022	October 2019 to March 2021
In progress at the beginning of the year/period	58	42
Initiated in the year/period	<u>32</u>	<u>23</u>
Handled during the year/period	90	65
Completed during the year/period <sup>12</sup>	<u>(8)</u>	<u>(7)</u>
<b>In progress at the end of the year/period</b>	<b><u>82</u></b>	<b><u>58</u></b>
Old Regime	55	56
New Regime	<u>27</u>	<u>2</u>
	<b><u>82</u></b>	<b><u>58</u></b>

- 3.4.4 The allegations of potential misconduct in the 32 investigations cases initiated in the year relate to auditing irregularities in the following areas:
- (a) Professional skepticism and professional judgement;
  - (b) Sufficient appropriate audit evidence;

<sup>12</sup> Include investigations which were referred to HKICPA or closed without further action.

- (c) Audit of accounting estimates;
- (d) Using the work of an auditor's expert; and
- (e) Going concern assessment and reporting.

**Table 8: Category of PIE auditors involved in investigations outstanding at the end of the year/period**

	As at 31 March 2022	As at 31 March 2021
Category A firms	38 (46%)	27 (47%)
Category B firms	33 (40%)	20 (34%)
Category C firms	11 (14%)	11 (19%)
	<b>82 (100%)</b>	<b>58 (100%)</b>

**Table 9: Year of initiation of investigations outstanding at the end of the year/period**

	As at 31 March 2022		As at 31 March 2021	
	AWP* located in HK	Mainland#	AWP* located in HK	Mainland#
2021/2022 (12 months)	29	3	N/A	N/A
2019/2021 (18 months)	20	1	22	1
2019 (9 months)	9	1	10	1
2018	7	1	9	3
2017	2	6	2	6
2016	1	1	2	1
2013	1	–	1	–
	<b>69</b>	<b>13</b>	<b>46</b>	<b>12</b>

\* AWP refers to audit working papers

# Further details on the progress of these cases are set out in paragraphs 3.4.7 to 3.4.9

**Table 10: Regulatory outcome of referrals to the HKICPA**

	April 2021 to March 2022	October 2019 to March 2021
Resolution by agreement (RBA)	2	9
Disciplinary sanctions	5	6
Settlement	-	1
	<b>7</b>	<b>16</b>

3.4.5 During the year, the HKICPA took regulatory actions in response to seven investigations which we had completed and referred to them in earlier years as follows:

- (a) For the two cases completed through RBA, the relevant parties were publicly reprimanded, ordered to pay an administrative penalty and required to reimburse the costs of the AFRC and the HKICPA; and
- (b) For the five cases with disciplinary sanctions, there were significant allegations and the relevant parties were publicly reprimanded, ordered to pay an administrative penalty ranging from HK\$100,000 to HK\$500,000 and required to reimburse the costs of the AFRC and the HKICPA.

3.4.6 With effect from 1 October 2022, the disciplinary process for all investigation cases under both the Old Regime and the New Regime will be handled by the Department of Discipline of the AFRC.

### **Cooperation with SEB regarding audit working papers located in the Mainland**

3.4.7 Under the MoU, we made requests for assistance of the SEB in gaining access to audit working papers located in the Mainland for 12 investigation cases in 2019 and 2020 and obtained the first batch of the audit working papers located in the Mainland which involves seven investigations in late November 2020.

3.4.8 We have given priority to these seven cases. During the year, two of these cases have been completed. In this year, we have made three requests for the assistance of the SEB in gaining access to audit working papers for three further investigations.

3.4.9 Building on the experience in obtaining access to audit working papers during the last two years, the AFRC and SEB continue to work closely together to explore ways to enhance the efficiency of the process and to strengthen collaboration.

## 3.5 Enquiries

### Overview

3.5.1 In cases where we believe that there may be non-compliance with accounting requirements by a PIE, we may initiate an enquiry. An enquiry may be conducted either by the investigation and enquiry functions (i.e. AFRC staff) or a Financial Reporting Review Committee (**FRRC**) with delegated power from the AFRC Board. Enquiries which relate to straightforward accounting issues and do not involve application of significant judgment or estimations and complex financial reporting standards would usually be conducted by the AFRC staff. This is one of the measures taken to streamline the process in handling enquiry.

### Key operations statistics about enquiries

3.5.2 During the year, we handled three enquiries brought forward from the previous period and 14 enquiries initiated during the year. One enquiry initiated during the year was completed and a notice was issued by the AFRC to the listed entity for the removal of the relevant non-compliance. There are 16 ongoing enquiries at the end of the year.

**Table 11: Movements in enquiries**

	April 2021 to March 2022		October 2019 to March 2021	
	FRRC	FRC staff	FRRC	FRC staff
Handled by				
In progress at the beginning of the year/period	2	1	1	–
Initiated in the year/ period	–	14	1	1
Handled during the year/period	2	15	2	1
Completed	–	(1)	–	–
<b>In progress at the end of the year/period</b>	<b>2</b>	<b>14</b>	<b>2</b>	<b>1</b>

3.5.3 The 14 enquiries initiated during the year relate to the following non-compliance with accounting requirements:

- (a) Revenue recognition;
- (b) Impairment of cash generating unit;
- (c) Impairment of financial assets;
- (d) Loans and payables;
- (e) Financial guarantee;
- (f) Investment in associates; and
- (g) Going concern assessment and reporting.

## Section 4

# Findings and observations on financial reporting non-compliance

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### 4.1 Introduction

- 4.1.1 This section highlights our findings and observations regarding areas where non-compliance with financial reporting requirements were identified in investigations and enquiries completed or handled, and during our review of financial statements under the FSRP during the year.
- 4.1.2 To apply principles-based financial reporting standards appropriately, preparers of financial statements and their auditors need to understand the purpose and content of the standards sufficiently for appropriate applications to their circumstances. It is therefore important that preparers have the appropriate expertise to be able to apply the applicable financial reporting standards properly, in particular for complex transactions and those that require the exercise of significant judgement and estimations.

### 4.2 Financial instruments

#### Impairment assessment of financial assets

- 4.2.1 Hong Kong Financial Reporting Standard (**HKFRS**) 9 *Financial Instruments* (**HKFRS 9**) requires an entity to adopt an expected credit loss (**ECL**) model in the impairment assessment of financial assets, which focuses on the risk that the counterparty will default. The ECL model differs from the incurred credit loss model under Hong Kong Accounting Standard (**HKAS**) 39 *Financial Instruments: Recognition and Measurement* (**HKAS 39**), which considers whether a loss event has occurred. ECL model requires the consideration of forward-looking information.



4.2.2 In an enquiry, the following issues were identified:

- (a) The ECL loss allowances of debtors were estimated based on their carrying values net of impairment allowances determined under HKAS 39, instead of the principal amount (or the gross amount) of the respective receivables, i.e. the total value that the listed entity was exposed to when the counterparty defaulted;
- (b) No loss allowance was considered necessary for certain trade and other receivables that were secured. However, the legal titles and the fair values of such collateral did not support this conclusion;
- (c) There were higher credit risks noted for certain trade and other receivables but the listed entity failed to make appropriate adjustments to the default rates of these debtors in estimating the impairment allowances to be recognised;
- (d) There was no evaluation on whether there was a significant increase in the credit risks of other receivables since initial recognition in order to determine whether a lifetime ECL should be applied;
- (e) The same probability of default and the same recovery rate were used to estimate the ECL for all receivables, including counterparties in different operating segments and geographic regions, without any justification as to why they all had common credit risk characteristics and shared the same loss pattern; and
- (f) No forward-looking information about future economic conditions was considered in estimating the probabilities of default and the recovery rates for the debtors.

### **Measurement of consideration payable in an acquisition**

4.2.3 A listed entity acquired the equity interest in a subsidiary for a cash consideration which was payable in several instalments. The transaction was accounted for as an asset acquisition. The balance of the consideration payable was initially measured on an undiscounted basis, i.e. without taking into account the time value of money.

4.2.4 HKAS 39 (the then applicable financial reporting standard) requires an entity to measure a financial liability at fair value upon initial recognition. The failure to measure the consideration payable at fair value at initial recognition also affected the initial measurement of the assets acquired and their subsequent measurements. HKFRS 9 has the same requirement.

### Classification of unlisted investments

4.2.5 A listed entity made prior year adjustments to rectify the accounting non-compliance in relation to the classification of certain investments in unlisted investment funds. These investments were wrongly classified as financial assets at fair value through other comprehensive income (**FVOCI**) and should be classified as financial assets at fair value through profit or loss (**FVTPL**) under HKFRS 9. The investments in unlisted investment funds contained contractual obligations to deliver to the listed entity a pro rata share of the net assets upon their termination or to deliver cash or other financial assets upon redemption or repurchase by the listed entity.

4.2.6 HKFRS 9 states that an entity may make an irrevocable election at the date of initial application of HKFRS 9 to designate an investment in an equity instrument as at FVOCI based on the facts and circumstances at the material time. HKAS 32 *Financial Instruments: Presentation* (**HKAS 32**) states that a financial instrument can only be classified as an equity instrument if the issuer has an unconditional right to avoid delivering cash or another financial instrument or, if it is settled through own equity instruments, it is for an exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments. In view of the requirement under HKAS 32 above, the investments in unlisted investment funds did not meet the definition of equity instruments for designation as FVOCI. Such investments in unlisted investment funds should be designated as FVTPL at the date of initial application of HKFRS 9.

4.2.7 Under HKFRS 9, an entity shall classify financial assets as subsequently measured at (i) amortised cost; (ii) FVOCI; or (iii) FVTPL on the basis of both of the following:

- (a) Entity's business model for managing the financial assets; and
- (b) Contractual cash flow characteristics of the financial assets.

4.2.8 Given that the cash flows of the unlisted investment funds were not “solely payments of principal and interest”, the investments in unlisted investment funds should be classified as financial assets measured at FVTPL.

### 4.3 Impairment of assets and fair value measurement

4.3.1 A listed entity measured its standing timbers at fair value less cost to sell in accordance with HKAS 41 *Agriculture* (**HKAS 41**). For the purpose of impairment assessment, the recoverable amount of the forestry operation rights was determined based on fair value less cost of disposal in accordance with HKAS 36 *Impairment of Assets* (**HKAS 36**).

4.3.2 The enquiry identified the following deficiencies in the measurement of the fair value of the standing timbers:

- (a) The sample areas selected for the physical count of the standing timbers were inadequate, did not represent the actual forest distribution and had not taken into account various ecosystem issues in the plantation areas; and
- (b) There was a lack of basis and evidence to support classifying all the standing timbers into three categories by tree sizes for estimation of their fair values.

4.3.3 In relation to the impairment assessment of the operating rights, it was found that the valuation of the recoverable amount of the operating rights was principally based on a market concession fee. However, there was no evidence that the concession fee had taken into account the adverse physical conditions of the relevant plantation areas. The management also failed to substantiate that the concession fee would remain stable over the project period. Moreover, the valuation of the operating rights failed to take into account the necessary costs to be incurred relating to forestry operations and other facilities to address the adverse physical conditions of the plantation areas.

4.3.4 HKFRS 13 *Fair Value Measurement* (**HKFRS 13**) requires that fair value of an asset to be measured using assumptions that market participants would use when pricing the asset, assuming that the market participants act in their economic interest. The enquiry revealed that the listed entity failed to comply with HKFRS 13 in relation to the impairment assessment of the operating rights and the year-end measurement of the plantation assets.

## 4.4 Going concern assessment and reporting

- 4.4.1 HKAS 1 (Revised) *Presentation of Financial Statements* (**HKAS 1**) requires management to assess the appropriateness of the going concern basis of accounting when preparing their financial statements. An entity is required to adopt the going concern basis of accounting, except in circumstances where the management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.
- 4.4.2 If management is aware, in making the assessment of the going concern basis, of a material uncertainty relating to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern (**the Going Concern Material Uncertainty**), they should disclose the uncertainty.
- 4.4.3 In making the same assessment, HKAS 1 requires management to take into account all available information about the future, which is at least 12 months from the end of the reporting period. This is a minimum period, not a cap.
- 4.4.4 The threshold for the going concern basis of accounting to be considered inappropriate is very high, as there are often realistic alternatives to liquidation or cessation of operations.
- 4.4.5 It is noted that some listed entities disclosed actions or planned actions to mitigate the liquidity issues in the financial statements. However, the listed entity made no explicit disclosures as to whether the Going Concern Material Uncertainty exists before or after the effects of implementing the mitigating plans.
- 4.4.6 It is important that listed entities consider not only the specific disclosure requirements relating to going concern in paragraph 25 of HKAS 1 but also the overarching disclosure requirements in paragraphs 122, 125 to 133 of HKAS 1, as described below.
- 4.4.7 When management concludes that Going Concern Material Uncertainty exists which may cast significant doubt upon an entity's ability to continue as a going concern, disclosures about the existence and the sources of the Going Concern Material Uncertainty are required (paragraphs 25 and 125 to 133 of HKAS 1).
- 4.4.8 The entity should also disclose the significant judgment of the management that the entity remains a going concern, including the nature of the Going Concern Material Uncertainty and the feasibility and effectiveness of the mitigating actions or plans of the management in this respect (paragraph 122 of HKAS 1).

4.4.9 The table below summarises the requirements under HKAS 1.

Scenario	Basis of preparation	Disclosure/requirement
No significant doubts about going concern	Going concern	No specific disclosure requirement
Significant doubts about going concern and management concluded that no material uncertainties exist after consideration of planned mitigating actions	Going concern	Disclosure of management's judgement in concluding that no material uncertainties exist under paragraph 122 of HKAS 1.
Significant doubts about going concern and management concluded that material uncertainties exist after consideration of mitigating actions	Going concern	Disclosure of: (a) material uncertainties under paragraph 25 of HKAS 1.  (b) management's judgement that the going concern basis of preparation is appropriate under paragraph 122 of HKAS 1.
Entity is no longer a going concern	Alternate basis (not going concern)	Disclosure under paragraph 25 of HKAS 1 of: (a) the fact that the financial statements are not prepared on a going concern basis;  (b) the basis of preparation of the financial statements; and  (c) the reason why the entity is not regarded as a going concern.

## 4.5 Non-compliance with disclosure requirements

4.5.1 Disclosure notes in a complete set of financial statements provide information necessary for readers of financial statements to understand the entity's financial performance and position, cash flow condition and any risks or uncertainties surrounding the operations of an entity, and to assist them in making informed decisions.

4.5.2 During our investigations and review of financial statements under the FSRP, we noted that there were instances of non-compliance in disclosure requirements. Non-compliance with disclosure requirements identified are summarised below. Some of these were also identified in our last Annual Investigation and Compliance Report.

### **HKFRS 15 Revenue from Contracts with Customers**

4.5.3 We identified that disclosures relating to the timing of satisfaction of performance obligations and the related judgements were inadequate. For example, an entity recognised over 90% of the balances of the contract liabilities as revenue, without disclosing information about the timing when the performance obligation is considered as completed.

4.5.4 We observed that disclosures in relation to performance obligations that are satisfied over time were inadequate. For example, an entity did not disclose the methods used to recognise revenue from its services over time and explain why the methods provide a faithful depiction of the transfer of services.

### **HKFRS 16 Leases**

We identified the following omission of disclosures applicable to lessees:

4.5.5 Total cash outflows relating to the leasing activities, including, for example, lease payments not included in the measurement of lease liabilities and variable lease payments. Such disclosures should include cash outflows within:

- operating cashflow (e.g. expenses related to leases of low-value assets and short-term leases);
- investing cashflow (e.g. payments for right-of-use assets or additions of leasehold properties); and

- financing cashflow (e.g. payments of lease liabilities);
- (b) Additional information about variable lease payments, including the lessee's reasons for using the variable lease payments and the prevalence of those payments, the relative magnitude of variable lease payments, future cash outflows to which the lessees are potentially exposed, and other operational and financial effects of those options; and
- (c) Additional information about extension options or termination options in leases, including the lessee's reasons for using the options and the prevalence of those options, the relative magnitude of optional lease payments, future cash outflows to which the lessees are potentially exposed, and other operational and financial effects of those options.

### **HKFRS 13 *Fair value Measurement***

4.5.6 We observed that certain disclosures in relation to fair value measurements were omitted by listed entities, such as:

- (a) Description of the valuation techniques and the key inputs used in Level 3 fair value measurements;
- (b) Quantitative information about the significant unobservable inputs used in Level 3 fair value measurements;
- (c) Reconciliation of the opening balance to the closing balance for recurring fair value measurements categorised within Level 3 of the fair value hierarchy;
- (d) Description of the valuation processes and policies used by the listed entities for Level 3 fair value measurement; and
- (e) Sensitivity analysis on changes in the unobservable inputs, e.g. discount rates used in determining the fair value.

### **HKFRS 7 *Financial Instruments: Disclosure***

4.5.7 The disclosure on how an entity has responded to risks arising from financial instruments is another area where we have identified disclosure deficiencies. For example, adequate disclosures were not made about the basis of inputs and assumptions and the estimation techniques used to measure the expected credit losses to support the conclusion that no loss allowance should be recognised.

### **HKFRS 3 *Business Combinations***

4.5.8 In one case where the listed entity acquired the entire issued share capital of another entity subsequent to the reporting period, the listed entity did not disclose the information about the acquisition, including:

- (a) the acquisition date;
- (b) a qualitative description of the factors that make up the goodwill recognised;
- (c) the acquisition-date fair value of the consideration transferred; and
- (d) the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed;

or describe which disclosures could not be made and the reasons why they cannot be made.



## Section 5

# Findings and observations on auditing irregularities

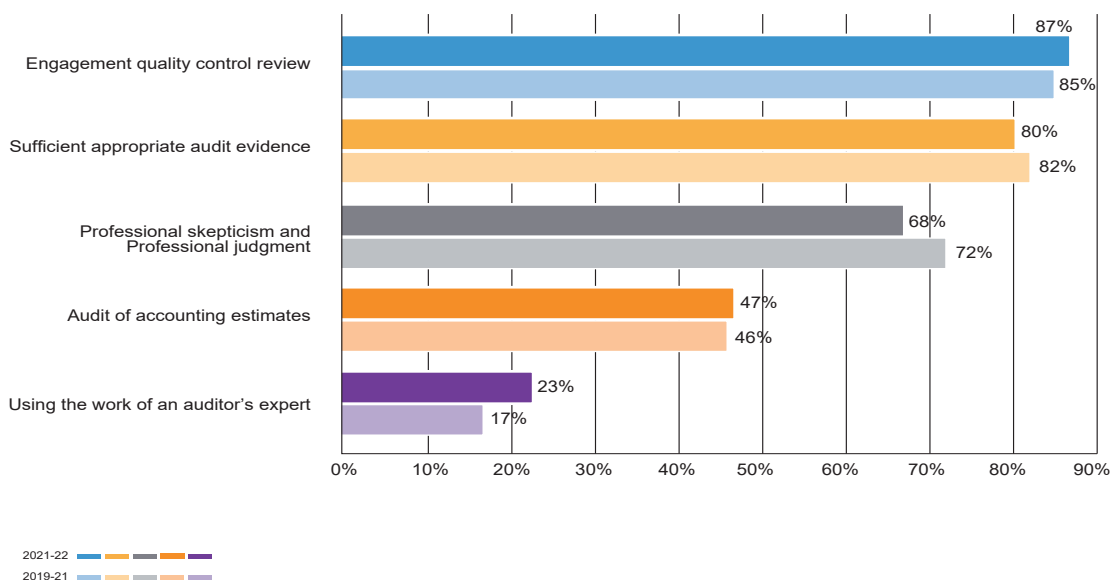
### 5.1 Introduction

5.1.1 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 (HKSA 200)* sets out the overall objectives of the auditor which are to:

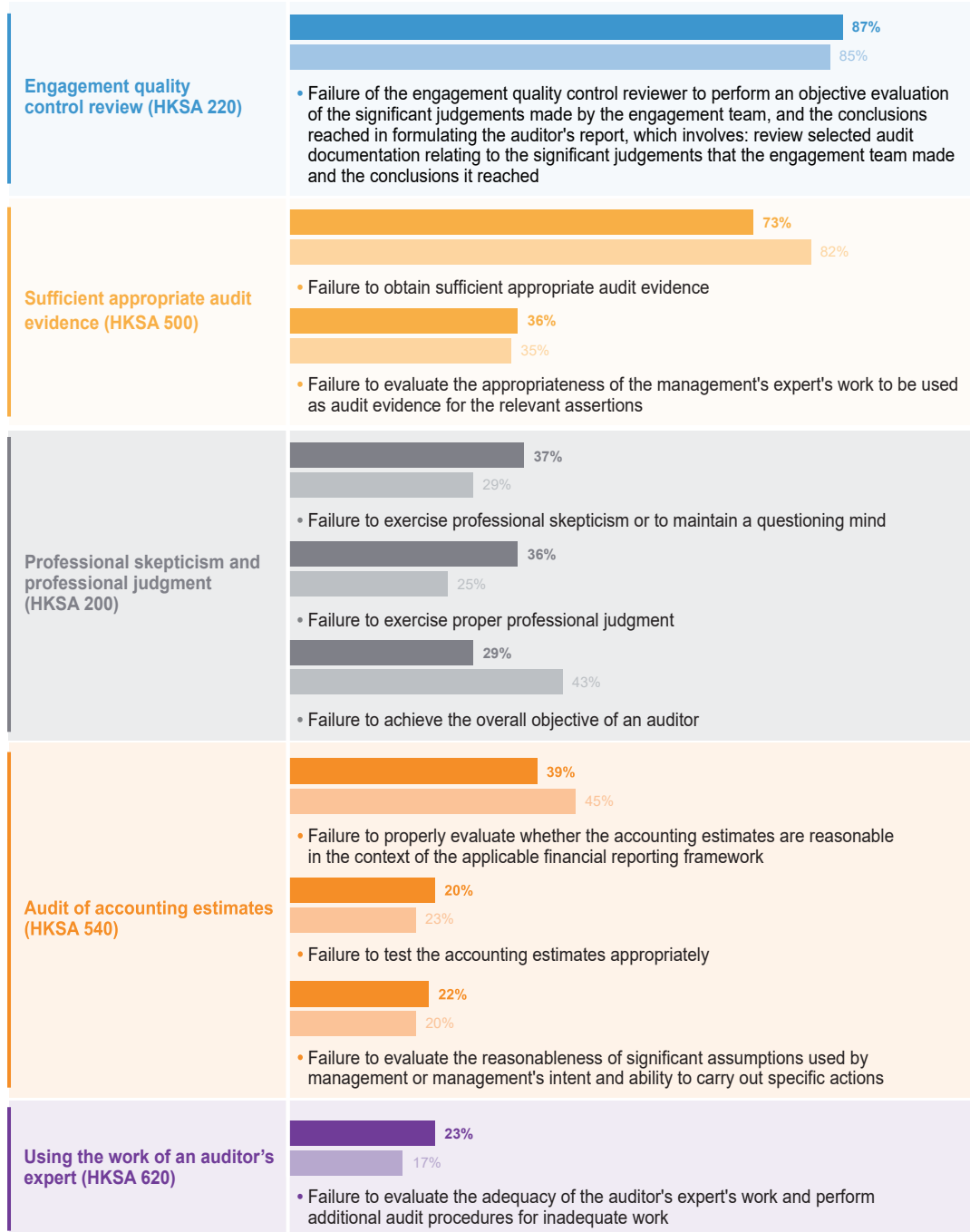
- (a) obtain reasonable assurance to enable the auditor to express an opinion about whether the financial statements are prepared materially in accordance with an applicable financial reporting framework; and
- (b) report on the financial statements, and communicate the auditor's findings.

5.1.2 The chart and table below show the most common areas where auditing irregularities or practice irregularities were identified in the seven completed investigations and 82 ongoing investigations handled during the year.

**Chart 1: Key areas of auditing irregularities**



**Chart 2: Detailed nature of auditing irregularities**



2021-22 ■ ■ ■ ■ ■  
 2019-21 ■ ■ ■ ■ ■

- 5.1.3 The key common areas where potential auditing irregularities were identified remain the same as those for 2019-21 (i.e. 18-month period ended 31 March 2021).
- 5.1.4 During the year, there has also been an increased number of investigations which relate to auditing irregularities about audit reporting and going concern assessment and reporting.
- 5.1.5 The requirements of the relevant auditing standards and examples of allegations found or being investigated during the year are set out in sections 5.2 to 5.8 below.

## 5.2 Engagement quality control review

- 5.2.1 Engagement quality control review is a quality control procedure required for audits of listed entities' financial statements or other audit engagements the audit firm has determined that such control review is required, in accordance with HKSA 220 *Quality Control for an Audit of Financial Statements*.
- 5.2.2 The purpose of an engagement quality control review in an audit is to serve as an objective evaluation, on or before the date of the auditor's report, of the work performed and decisions made by the engagement team in formulating the auditor's report. The reviewer, not being a member of the engagement team, must have sufficient and appropriate experience and authority to perform such evaluation, which include:
- (a) Discussion of significant matters;
  - (b) Review of the financial statements, the auditor's report, and the relevant audit documentation relating to significant judgments; and
  - (c) Evaluation of the conclusions and the appropriateness of the auditor's report.
- 5.2.3 In our investigations, we found that engagement quality control reviewers did not adequately review the audit working papers, critically challenge the nature and extent of audit procedures performed and evidence obtained during the audits and objectively evaluate the conclusion reached by the engagement teams.

5.2.4 Examples of deficiencies in engagement quality control review include:

- (a) The reviewer failed to objectively evaluate and question the engagement team's decision on the relevant events that would require the exercise of significant judgment on necessary adjustments to the calculations of the earnings per share of the listed entity.
- (b) The reviewer did not sufficiently challenge the decision of the engagement team in respect of impairment assessment of certain listed investments and identify the relevant non-compliance.

5.2.5 Auditors should be aware of the new and revised quality management standards, namely, Hong Kong Standard on Quality Management 2 *Engagement Quality Reviews (HKSQM 2)* and Hong Kong Standard on Auditing 220 (Revised) *Quality Management for an Audit of Financial Statements*, and the equivalent international standards issued by the International Auditing and Assurance Standards Board which will be effective from 15 December 2022.

5.2.6 HKSQM 2 specifies requirements for (i) the appointment and eligibility of an engagement quality reviewer; (ii) the performance of an engagement quality review, includes evaluating the exercise of professional skepticism, when applicable to the engagement, by the engagement team in relation to those significant judgments; and (iii) documentation of an engagement quality review.

5.2.7 Auditors are strongly encouraged to assess the implication of HKSQM 2 to their engagement quality control review procedures and operation and develop a plan of implementation at the organisational level and engagement level.

### 5.3 Sufficient appropriate audit evidence

5.3.1 HKSA 500 *Audit Evidence* requires an auditor to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. Evidence must be relevant to the audit assertions that the auditor is testing. The quality of the audit evidence obtained by the auditor depends on its relevance and reliability (i.e. appropriateness) in addition to its sufficiency.

- 5.3.2 When forming an opinion on the financial statements, the auditor is required to conclude as to whether reasonable assurance has been obtained about whether the financial statements are free from material misstatement, whether due to fraud or error. Such a conclusion should take into account whether sufficient appropriate audit evidence, whether such evidence corroborates or contradicts management's assertions in the financial statements, has been obtained. Failure to obtain sufficient appropriate audit evidence would result in failing to obtain reasonable assurance and therefore failing to meet the overall objectives of an auditor and may result in the auditor giving an inappropriate audit opinion on the financial statements.
- 5.3.3 More assurance is ordinarily obtained by obtaining consistent audit evidence from different sources or of different natures than from considering items of audit evidence individually. Information from sources independent of the entity generally provide more reliable evidence than that obtained internally or from the entity.
- 5.3.4 The following are instances where the auditors failed to obtain sufficient appropriate audit evidence:
- (a) The auditor relied on discussion with management and the audit committee in relation to the recognition of an impairment loss of receivables of a former subsidiary. The auditor failed to perform audit procedures to identify that the impairment of the relevant receivables had already been fully provided for at the time when the subsidiary was disposed of in the prior year;
  - (b) In an investigation relating to impairment assessment of a listed entity's interest in an associate, the auditor accepted the valuation provided by management but failed to (i) review the outcome of the management's assessment included in prior year financial statements to evaluate the effectiveness of management's estimation process; and (ii) question management on whether the key estimates, assumptions and other inputs relating to the expected future business of the associate were reasonable and supportable; and
  - (c) In another investigation, we found that the auditor accepted a recent transaction provided by management as evidence for the fair value measurement of a land use right acquired in a business combination. The auditor failed to question the relevance and reliability of the evidence provided given that the land was authorised for different use and might not reflect the market condition at the acquisition date.

In addition, the auditor also failed to obtain sufficient supporting evidence for the forecast revenue and the necessary details of the forecast expenses in the cash flow forecast prepared by the entity for the purpose of the impairment assessment of goodwill.

## 5.4 Professional skepticism and professional judgment

5.4.1 Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. It is part of the skill set of an auditor and is essential (together with professional judgment) to maintain audit quality. The following situations indicated that the auditor failed to exercise professional skepticism during the audit:

- (a) The auditor failed to critically evaluate the reliability of the cash flow forecasts used in the impairment assessment of the interest in an associate, including the method adopted and the assumptions applied despite the fact that the actual result of the associate was less than the prior year forecast.
- (b) For the purpose of impairment assessment, the valuation made reference to similar companies to justify that the profit margins of a cash-generating unit were reasonable. However, our investigation revealed that the auditor did not question the comparability of these referenced companies, given that the nature, scale and locations of the businesses were not comparable to the cash-generating unit being assessed for impairment.

5.4.2 HKSA 200 requires auditors to exercise professional judgment in planning and performing an audit of financial statements. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report. Instances where the auditors failed to exercise appropriate professional judgment include:

- (a) The auditor failed to have a proper assessment of the modification of terms of the promissory note issued by a listed entity to determine whether it was substantial and to have an understanding about the

substance and rationale of the modification. The assessment would impact the accounting for the modifications, i.e. if the modification is substantial, it would be accounted for as an extinguishment of the original financial liability and a recognition of a new financial liability.

- (b) The auditor did not apply all the relevant technical considerations to evaluate the impact of the open offer and bonus issue on the earnings per share calculations during the audit.
- (c) The auditor did not properly apply professional judgment when determining the materiality of the relevant financial statements as a whole for their audit, which should include consideration of whether the resulting materiality level would reflect the principles set out in HKSA 320 *Materiality in Planning and Performing an Audit*, i.e. taking into account the information needs and expectations of users of the financial statements.
- (d) The auditor calculated three potential levels of materiality using different benchmarks and percentages applied to the benchmarks. The auditor chose revenue with a percentage applied as the basis for determining the materiality for the financial statements as a whole. In the investigation, it was found that the auditor failed to justify why the chosen benchmark and the percentage applied were appropriate in the circumstances.

## 5.5 Audit of accounting estimates

5.5.1 Accounting estimates involve significant judgments, assumptions and estimates. It is an area where audit deficiencies are often found, including accounting estimates in relation to (i) fair value measurement of financial instruments and biological assets; (ii) acquisition-date fair value measurement of purchase considerations and assets acquired; and (iii) impairment assessments of assets.

5.5.2 HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* requires auditors to perform audit procedures and obtain sufficient appropriate audit evidence to evaluate the reasonableness of the accounting estimates. The determination of accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management. This can give rise to inherent uncertainty and considerable complexity in measurement, thereby increasing the risk of material misstatement.

5.5.3 Observations on deficiencies in auditing accounting estimates include:

- (a) The auditor failed to properly evaluate the reasonableness of the assumptions used in the impairment assessment of goodwill. Given that the relevant business was loss making, the auditor did not question whether the assumption of a 25% annual growth rate over the 10-year forecast period (representing a cumulative growth of 645%) was reasonable and supportable, nor whether the use of United States annual GDP growth rate to determine the long term growth rate for a business in Mainland China was relevant.
- (b) The auditor failed to adequately evaluate the reasonableness of the credit rating and effective interest rate used in the valuation of the convertible bonds issued by a listed entity. These estimates were determined by the valuer with reference to the listed entity's historical financial performance, without considering the deterioration of the liquidity of the listed entity.

## 5.6 Using the work of an auditor's expert

5.6.1 In auditing accounting estimates, auditors may engage experts in a field other than accounting or auditing, to assist them in obtaining sufficient appropriate audit evidence. We observed that auditors often failed to adequately evaluate the work of an expert in accordance with HKSA 620 *Using the Work of an Auditor's Expert* (**HKSA 620**) when using their work as audit evidence.

5.6.2 In addition to assessing the competence and objectivity of the auditor's expert, HKSA 620 requires evaluation of the adequacy of the expert's work for the auditor's purpose. Auditors are required to consider:

- (a) the source data, assumptions and methods used by the expert in their work and their consistency with prior periods; and
- (b) whether the results of the expert's work are consistent with the auditor's overall knowledge of the business and the results of other audit procedures performed. Such discussion should be properly documented in the audit file.



5.6.3 Our observations include:

- (a) Failure to identify the deficiencies in the expert's work with regards to review of the valuation of financial liabilities provided by the listed entity. For example, the expert used nominal spread of other corporate bonds to benchmark the credit spread used in the valuation, which were not comparable, and thus not appropriate to support the reasonableness of the inputs used in the valuation.
- (b) Failure of the auditor to evaluate the competence, capabilities, objectivity, the field of expertise and the adequacy of the work of the auditor's expert.

## 5.7 Going concern assessment and reporting

5.7.1 Going concern assessment is an evidence-based judgment that management have to make in the preparation of the financial statements. Auditors are required to opine on the appropriateness of the going concern basis of preparation and the relevant disclosures which provide information for users of the financial statements about the financial performance and position of the entity.

5.7.2 HKSA 570 (Revised) *Going Concern* requires an auditor to obtain sufficient appropriate audit evidence to conclude and to report on:

- (a) the appropriateness of management's use of going concern basis of accounting in preparing financial statements; and
- (b) whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (i.e. Going Concern Material Uncertainty).

5.7.3 If, based on the audit evidence obtained, the auditor concludes that management's use of the going concern basis of accounting is appropriate and adequate disclosure of the Going Concern Material Uncertainty is made in the financial statements, the auditor should express an unmodified opinion and include a separate section in the auditor's report under the heading "Material Uncertainty Related to Going Concern". This section should (a) draw attention to the note in the financial statements that discloses the matter; and (b) state that the Going Concern Material Uncertainty exists and that the auditor's opinion is not modified in respect of this matter.

- 5.7.4 If the disclosure of the Going Concern Material Uncertainty in the financial statements is not adequate, the auditor should express a qualified opinion or an adverse opinion, as appropriate.
- 5.7.5 Only in extremely rare circumstances involving multiple uncertainties that are significant to the financial statements as a whole (which might include the Going Concern Material Uncertainty), the auditor may consider it appropriate to express a disclaimer of opinion on the relevant financial statements.
- 5.7.6 In a number of investigations, it was noted that the auditor might have failed to obtain sufficient appropriate audit evidence to conclude that there was no Going Concern Material Uncertainty even though the listed entity disclosed in the financial statements that there were events and conditions that might cast significant doubt on the group's ability to continue as a going concern. The investigation also revealed that the auditor failed to obtain adequate support for the assumptions and estimates underlying the cash flow projection used for the going concern assessment.

## 5.8 Audit reporting

- 5.8.1 A proper audit reporting reflects the quality of an entity in conducting its business which is important information for financial statements users in the context of business decision making. Auditors must have sufficient expertise, performed adequate audit work and obtained sufficient evidence to give an appropriate audit opinion.
- 5.8.2 HKSA 700 *Forming an Opinion and Reporting on Financial Statements* prescribes the need for an auditor in forming their audit opinion, to evaluate whether sufficient appropriate audit evidence has been obtained and whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- 5.8.3 HKSA 705 *Modifications to the Opinion in the Independent Auditor's Report* states that the audit opinion is modified when (i) the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (ii) the auditor is unable to obtain sufficient appropriate audit evidence to conclude whether the financial statements as a whole are free from material misstatement.

5.8.4 The decision regarding the appropriate type of modified opinion depends upon:

- (a) the nature of the matter giving rise to the modification, i.e. whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) the auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

5.8.5 The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affect the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

5.8.6 In an investigation, we found that the auditor expressed an adverse opinion on a set of consolidated financial statements. However, under the basis for adverse opinion section of the auditor's report, the auditor stated that they were:

- (a) "*unable to obtain*" sufficient appropriate audit evidence on the recoverability of certain financial instruments;
- (b) "*unable to determine*" whether any necessary adjustments should be made;
- (c) "*unable to assess*" the effects of the material uncertainty that may cast significant doubt on the Group's ability to continue as a going concern; and

- (d) “unable to obtain” sufficient appropriate audit evidence to ascertain the intention of certain parties in providing the necessary financial support to the Group.

These indicate that there were limitations of scope which would not lead to an adverse opinion being given. In addition, the auditor also failed to state whether the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the adverse opinion as required by the auditing standard.

5.8.7 An “adverse opinion” is a type of modified auditor’s opinion on a set of financial statements where the auditor has obtained sufficient appropriate audit evidence and concluded that the misstatements, individually or in the aggregate, are both material and pervasive. However, the above descriptions in the basis for adverse opinion do not support the auditor’s conclusion that the relevant financial statements do not give a true and fair view as sufficient appropriate audit evidence had not yet been obtained.

5.8.8 In another two investigations, the listed entities failed to recognise the decline in fair value of equity investments as impairment loss in accordance with the applicable financial reporting standard, which were material to the financial statements. The investigations found that the auditors failed to identify the non-compliance with accounting requirements by considering all relevant audit evidence and exercising proper professional judgment to evaluate the entities’ application of the relevant financial reporting framework in order to form their audit opinions, which led to an inappropriate opinion being given.

## Section 6

# Looking ahead

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### 6.1 Introduction

6.1.1 This section highlights key aspects of our plans to further strengthen our investigation and enquiry functions in the coming year.

### 6.2 Enhance processes and procedures

6.2.1 Following the plan as set out in our first Annual Investigation and Compliance Report to enhance our processes and procedures, we made several changes to streamline our processes and to prioritise the use of our resources in handling potential allegations about improper conduct and behavior of our regulatees which caused greater potential harm to public interest (paragraph 3.1.3 above).

6.2.2 There was a substantial increase in the caseload of the investigation and enquiry functions, including some high profile cases, during the year due to various factors as described in section 3.1 above. Despite the actions taken, the situation of the backlog remains. Building on the efforts taken in the year, we will continue to explore ways to streamline our processes and procedures in handling complaints, investigations and enquiries with a view to further simplify or expedite the performance of procedures. These efforts aim to enable us to enhance our ability to address the backlog of cases while maintaining our ability to respond with agility to new significant public interest cases.

6.2.3 In addition, we are developing plans and workflows to enhance the collaboration and coordination among the investigation, the inspection and the disciplinary functions to ensure that issues are handled in the most effective and efficient manner.

## 6.3 Strengthen cooperation with other regulators

### Hong Kong

- 6.3.1 The AFRC continued the collaboration with other regulators and law enforcement agencies. The number of referrals from these organisations for the year ended 31 March 2022 increased by 24% as compared to the 18-month period ended 31 March 2021. Such referrals include alleged misconducts of high public interest and notoriety. This is solid proof of the trust of other regulatory and enforcement bodies in the AFRC in dealing with non-compliance with financial reporting and misconducts in relation to listed entity auditors.
- 6.3.2 We aim at working more closely with these regulators to foster a coordinated regulatory effort on matters in which we have a common interest in ensuring the quality of financial reporting and audits.

### Mainland China

- 6.3.3 During the year, we completed two investigations where the relevant audit working papers were located in the Mainland and were obtained with the assistance of the SEB. We will continue to give priority to the other five cases for which we have obtained audit working papers from the Mainland in the coming year.
- 6.3.4 In September 2022, we obtained the relevant audit working papers located in the Mainland in relation to 5 other investigations with the assistance of the SEB.
- 6.3.5 We will continue to work with the SEB to enhance the efficiency of the process in obtaining access to audit working papers located in the Mainland. Furthermore, we also plan to further strengthen the cross-boundary cooperation and collaboration in relation to the investigation function with the SEB and other Mainland authorities.

## 6.4 Preparation for the Further Reform

- 6.4.1 The passage of the Amendment Ordinance 2021 expanded the remit of the AFRC, including the transfer of the investigatory power over “professional persons” (as defined in the Amendment Ordinance 2021) to the AFRC. This expands the existing regulatory powers of the AFRC over PIE auditors and their registered responsible persons. Details of the expanded remit of the investigation and enquiry functions are set out in the policy statements on the AFRC’s website.
- 6.4.2 In view of the expanded remit and the anticipated increase in workload, the investigation and enquiry function has significantly expanded its team of professional staff, who are richly experienced in handling complaints and investigations relating to CPAs and CPA practices.
- 6.4.3 We have also updated our operational processes and procedures for the expanded work scope and have been liaising with the HKICPA for a smooth and seamless transition of the new responsibility. All of these will enable us to discharge our new responsibilities effectively and efficiently.

# Appendix 1

## Summary of remit and powers

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### 1 Remit and powers – investigations

#### Remit

- 1.1 Under sections 23 and 23A of the AFRCO, the AFRC may direct an investigation to be carried out where the AFRC:
- a. has **reason to inquire into** whether there has been misconduct on the part of a PIE auditor or registered responsible person;
  - b. has **reasonable cause to believe** that a non-PIE auditor has committed a practice irregularity;
  - c. has **reasonable cause to believe** that a PIE auditor or registered responsible person may have contravened a provision of the AFRCO; or
  - d. has **reasonable cause to believe** that a PIE auditor has carried out a PIE engagement completed on or after 1 October 2019 in a way which is not in the interest of the investing public or in the public interest.
- 1.2 Under sections 37A and 37B of the AFRCO, “**misconduct**” by a PIE auditor or a registered responsible person includes:
- a. a “practice irregularity” (see 1.3 below);
  - b. contravention of a provision of the AFRCO;
  - c. contravention of a condition imposed in relation to the registration or recognition of the PIE auditor;
  - d. contravention of a requirement imposed on a PIE auditor or registered responsible person under a provision of the AFRCO; and



- e. conduct in relation to a PIE engagement which, in the opinion of the AFRC, is or is likely to be prejudicial to the interest of the investing public or the public interest.
- 1.3 Under section 4 of the AFRCO, a “**practice irregularity**” is committed in relation to a PIE engagement and examples include:
- a. failing or neglecting to observe, maintain or otherwise apply a professional standard (such as an auditing standard);
  - b. negligence in the conduct of profession;
  - c. professional misconduct;
  - d. act or omission which would reasonably be regarded as bringing or likely to bring discredit on the auditor, the Hong Kong Institute of Certified Public Accountants (i.e. the HKICPA) or the accountancy profession;
  - e. falsifying a document; and
  - f. making a statement in respect of a document which is material, knowing the statement to be false or not believing it to be true.
- 1.4 Under Schedule 1A of the AFRCO, a PIE engagement is the preparation of:
- a. an auditor’s report on a PIE’s annual financial statements required by the Companies Ordinance (Cap 622), the relevant rules of The SEHK or the relevant code issued by the SFC of Hong Kong (i.e. the annual report);
  - b. a specified report required to be included in a listing document for the listing of a corporation’s shares or stocks or for the listing of a collective investment scheme (i.e. listing prospectus); or
  - c. an accountant’s report required under the listing rules to be included in a circular to be issued by a PIE for a reverse takeover or a very substantial acquisition completed on or after 1 October 2019.

## **Powers**

- 1.5 An investigation may be carried out by an Audit Investigation Board (i.e. the AIB) or an employee of the AFRC (an investigator). Under section 22 of the AFRCO, the Chief Executive Officer of the AFRC is an ex officio member and chairperson of the AIB.

- 1.6 In determining whether there is sufficient evidence of misconduct or a practice irregularity by exercising power under section 25 of the AFRCO, the AIB or an investigator has the power to require any person who is relevant to the matter under investigation or any person who the investigator has reasonable cause to believe is in possession of a relevant record or document or the relevant information to:
- a. produce any record or document relevant to the investigation;
  - b. provide an explanation or further particulars in relation to a record or document produced;
  - c. provide an answer in writing to a question to be raised by the investigator relevant to the investigation;
  - d. attend before the investigator to answer questions relevant to the investigation; or
  - e. provide any other assistance in connection with the investigation which a person so required is reasonably able to give.

It is important for any person issued with a requirement under section 25 to comply with it. Failure to do so without reasonable excuse amounts to an offence under section 31 of the AFRCO and is punishable upon conviction by a fine and/or imprisonment.

### Transitional arrangements

- 1.7 Sections 92 and 93 of the AFRCO set out that investigations on audits of PIE engagements completed before 1 October 2019 should be conducted as if the 2019 Amendment Ordinance had not been enacted (Old Regime). That is, the Financial Reporting Council Ordinance (Cap 588) in effect immediately before 1 October 2019 (Pre-amended FRCO) continues to apply to such investigations.
- 1.8 Key differences between the Old Regime and the New Regime for conducting investigations are as follows:

	Old Regime	New Regime
<b>Regulated person</b>		Includes the quality control system responsible person of a PIE auditor

	Old Regime	New Regime
<b>Subject matter for investigation</b>	Relevant irregularities	Misconduct, apart from relevant irregularities (now called practice irregularities), also includes: <ul style="list-style-type: none"> <li>• contravention of a provision of the AFRCO;</li> <li>• contravention of a condition imposed in relation to the registration or recognition of the PIE auditor;</li> <li>• contravention of a requirement imposed under a provision of the AFRCO; and</li> <li>• conduct which is or is likely to be prejudicial to the interest of the investing public or the public interest.</li> </ul>
<b>Basis to initiate an investigation</b>	There are “circumstances suggesting” (under section 23(1) of the Pre-amended FRCO) or “reasonable cause to believe” (under section 23(3) of the Pre-amended FRCO) that a relevant irregularity has occurred.	There is “reason to inquire” or “reasonable cause to believe” that a misconduct has been committed (under section 23 of the AFRCO).
<b>Follow-up actions</b>	Investigation findings will be referred to the HKICPA for consideration of appropriate follow-up actions.	Investigation findings will be referred to the AFRC’s department of discipline for consideration of sanctions.

## 2 Remit and powers – enquiries

### Remit

- 2.1 The AFRC has the power to initiate an enquiry if it appears that there is or may be a question as to whether or not there is a relevant non-compliance in relation to a relevant financial report published by a PIE.

- 2.2 For a PIE (other than a listed collective investment scheme), relevant financial report generally refers to its financial statements, which comprise of its annual and interim financial statements as required under the Companies Ordinance or the Listing Rules. It also includes accountants' reports required for a listing document, for example, a prospectus.
- 2.3 In relation to a listed collective investment scheme, a relevant financial report generally refers to the financial statements of the scheme published for the purposes of the relevant SFC Codes or guidelines or Listing Rules. It also includes accountants' reports required for a listing document.
- 2.4 The enquiry may be conducted by the staff of the AFRC under the delegated powers from the AFRC Board under section 40(1)(a). Alternatively, the AFRC may appoint a Financial Reporting Review Committee (i.e. the FRRC) to conduct the enquiry under section 40(1)(b) of the AFRCO.
- 2.5 An FRRC consists of a Panel Convenor as Chairman and at least four other members of the Financial Reporting Review Panel (FRRP). Members of the FRRP are appointed by the Financial Secretary under the delegated authority from the Chief Executive of the HKSAR, in consultation with the AFRC, because of their experience in accounting, auditing, finance, banking, law, administration or management, or because of their professional or occupational experience.

## **Powers**

- 2.6 Once an enquiry is initiated, the AFRC or the FRRC may, in writing, require certain persons such as auditors, listed entities and their officers or employees to produce records or documents and to give information or explanation under section 43(1) of the AFRCO.
- 2.7 Where the AFRC finds that there is a relevant non-compliance, based on a report on the findings of the AFRC or the FRRC in an enquiry, the AFRC may give a notice to the listed entity concerned to remove the non-compliance in the manner and within a period as specified in the notice.
- 2.8 In the event that a listed entity does not rectify the relevant non-compliance (which relates to a breach of an accounting requirement as provided in the Companies Ordinance (Cap 622)) within a specified period, the AFRC may apply to the Court of First Instance for a declaration that there is a relevant non-compliance and an order requiring the director of the listed entity to cause the relevant non-compliance to be rectified under section 50(2) of the AFRCO.

The AFRC may take any other action as it considers appropriate including referral to the appropriate regulatory body for follow-up action.

## Appendix 2

# Outline of our process

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### 1 Introduction

- 1.1 The AFRC may initiate an investigation or an enquiry based on reactive or proactive sources of intelligence (see paragraph 2.2.1).

### 2 Initial assessment

- 2.1 In response to intelligence acquired from reactive sources, initial assessment will be conducted to determine whether there are pursuable potential allegations of misconduct or non-compliance, i.e. whether there are potential allegations that are within the remit of the AFRC. When the potential allegations fall outside the remit of the AFRC, the intelligence is not pursuable and will not be taken further, but may be referred to another appropriate authority if within their remit.

### 3 Further assessment of allegations

- 3.1 For intelligence acquired from proactive sources and intelligence acquired from reactive sources for which there are pursuable allegations, an assessment is conducted of the intelligence acquired and all publicly available information which may include the relevant financial statements. In addition, the AFRC may seek to acquire further information proactively from other sources.
- 3.2 For example, if considered necessary, the AFRC may request information from the listed entity, the auditor or any other relevant party. The purpose of the assessment is to identify potential allegations of potential misconduct or non-compliance and whether the evidence acquired meets the statutory thresholds for initiating an enquiry or investigation.
- 3.3 When the evidence acquired meets the statutory thresholds, the AFRC will initiate an investigation or an enquiry. Otherwise, the AFRC will not pursue the case further. However, the AFRC may issue a letter of advice to the PIE and/or its auditor to highlight certain issues identified based on the evidence obtained and to suggest improvements for the preparation of future financial statements or the performance of future audits.

## **4 Investigation/Enquiry**

- 4.1 The AFRC exercises the powers under the Accounting and Financial Reporting Council Ordinance Cap 588 (AFRCO) to conduct an investigation or an enquiry. This includes powers to obtain records, documents, explanations or any other information from relevant parties through issuing requirements. Applications for an extension to comply with a requirement will only be granted if made on reasonable grounds.
- 4.2 A report on an investigation or an enquiry is prepared to set out the potential allegations under investigation or enquiry and our analysis and findings. Persons named in the report are provided with a reasonable opportunity of being heard before the report is adopted by the AFRC.
- 4.3 The AFRC may close the case if the potential allegations of misconduct or non-compliance with accounting requirements is not substantiated by the evidence obtained, or refer the matter to another appropriate regulatory body or law enforcement agency if applicable.

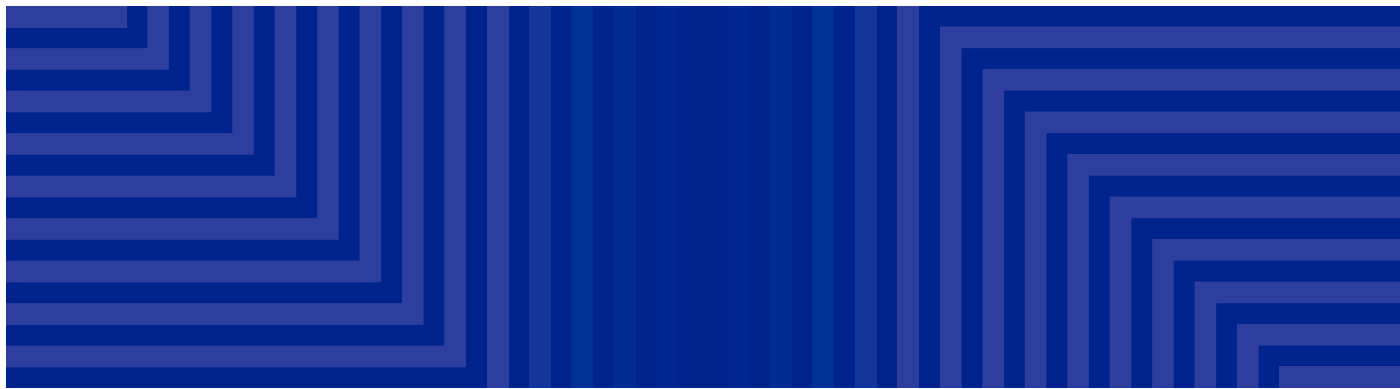
## **5 Removal of non-compliance**

- 5.1 When an enquiry concludes that there is a non-compliance, the AFRC may give a notice to the PIE concerned to remove the non-compliance in the manner and within a period as specified in the notice.
- 5.2 If the PIE does not remove the relevant non-compliance within the specified period, the AFRC may apply to the Court of First Instance for an order requiring directors of the PIE to cause the relevant non-compliance to be removed.

## **6 Disciplinary**

- 6.1 For investigation cases involving audits of PIE engagements completed before 1 October 2019 (Old Regime), the investigation findings will be referred to the Hong Kong Institute of Certified Public Accountants (HKICPA) for consideration of appropriate follow-up actions. From 1 October 2022, the investigation findings in relation to such engagements will be referred to the AFRC's Department of Discipline.
- 6.2 For investigation cases involving audits of PIE engagements completed on or after 1 October 2019 (New Regime), the investigation findings will be referred to the AFRC's Department of Discipline. Where there is sufficient evidence of misconduct, the Department of Discipline will consider whether the AFRC should impose disciplinary sanctions on the relevant PIE auditor and/or registered responsible person.

## Contacts



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