

AFRC Addresses Concerns Surrounding Auditor Changes

28 September 2023

Introduction

In line with its mission to oversee the financial reporting and auditing of listed companies and to protect public interest, the Accounting and Financial Reporting Council (**AFRC**) has closely monitored the issue of late auditor resignations¹, and has expressed its concern over the trend on multiple occasions, including via two open letters issued in October 2022 and January 2023.

Late auditor resignations impose tight time constraints on incoming auditors who replace the outgoing auditors. Listed companies may use the change of auditors as a means to obtain a more favourable audit opinion. In this regard, late auditor resignations are red flags for investors, asset managers and regulators. As highlighted in the AFRC's [2022 Annual Inspection Report](#)², poorly planned audit engagements are at a higher risk of audit deficiencies and low audit quality.

The purpose of this publication is to provide an update on the progress that has been made following the AFRC's regulatory actions. It also highlights its ongoing initiatives aimed at addressing the issues.

¹ Late auditor resignations refer to auditors resigning from one month before the end of the financial reporting period of a public interest entity (**PIE**).

² AFRC, 2022 Annual Inspection Report, July 2023, https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/2022_AFRC%20Inspection%20Report_eng.pdf

Progress update

Subsequent to the open letters and other regulatory actions taken by the AFRC, significant improvements have been observed, as shown in the following table:

Reasons for late auditor resignations, as disclosed in listed companies' announcements	From 1 Dec 2021 to 31 May 2022 (number)	From 1 Dec 2022 to 31 May 2023 (number)	Year-on-year change (number/percentage)
Disagreement over audit fees	64	39	-25 / -39%
Unresolved audit issues	27	14	-13 / -48%
Corporate governance	–	2	+2 / N/A
Other	7	4	-3 / -43%
Total	98	59	-39 / -40%

Key improvements include:

- In the six months ending 31 May, there was a decrease of 40% in the number of late auditor resignations among listed companies with 31 December year-ends, from 98 in 2022 to 59 in 2023.
- There has been a noticeable improvement in the quality of disclosures from listed companies reporting auditor changes. For resignations relating to unresolved audit issues, over 90% provided comprehensive details about the facts and circumstances leading to the resignation. Even more encouragingly, three listed companies provided additional disclosures on how the incoming auditors planned to resolve the issues, as well as the views of audit committees on such plans. These transparency enhancements are conducive to better understanding of critical audit issues by market participants.

- Following the AFRC's earlier criticism in the follow-up open letter in January 2023, no listed companies used "corporate governance" as a reason for late auditor resignation.
- Furthermore, some Category A audit firms (i.e., those with more than 100 PIE engagements) have proactively reported their forthcoming resignations to the AFRC.

Remaining issues

Despite the improvements highlighted above, two issues remain, and further effort to address them is needed to ensure that public trust in the quality of financial reporting and audit of listed companies in Hong Kong is maintained.

1. Insufficient planning and resources

The [Audit Focus \(2023\)](#)³ recently published by the AFRC underscores the importance of audit planning. Incoming auditors often underestimate the importance of effective audit planning and fail to allocate sufficient time and resources to plan an audit. This may lead to:

- incomplete identification of relevant audit risks;
- inadequate design of audit procedures to address the risks; and
- inability to devote resources and expertise to address potential audit issues.

These shortcomings may ultimately result in unsupported or even inaccurate audit opinions. Therefore, the AFRC urges PIE auditors to start their audit planning as soon as practicable, and no later than three months before the end of the financial reporting period.

³ AFRC, Audit Focus Effective Planning: The Key to High-Quality Audits, July 2023, https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/2023_Audit_Focus_Effective_Audit_Planning.pdf

2. Unwillingness to resolve audit issues

The more detailed information about auditor changes provided in recent disclosures has reinforced our earlier concerns regarding the possibility of opinion shopping on the part of listed companies. In reviewing the announcements from listed companies, we have noted a number of instances where (i) unresolved audit issues were cited as a reason for late changes of auditors; and (ii) incumbent auditors were requested to resign by listed companies.

Improving audit planning, raising transparency, and resolving outstanding audit issues are matters of high priority for the profession and listed companies and constitute undisputable responsibilities of auditors, audit committees, boards of directors and senior management of listed companies. In conjunction with ongoing regulatory collaboration between the AFRC and other regulatory authorities, all relevant parties are urged to take necessary actions to uphold the quality of financial reporting and audit.

AFRC's ongoing initiatives

The AFRC is proactively taking the following actions:

1. **Pre-emptive interviews:** The AFRC has carried out pre-emptive interviews with incoming auditors to determine whether their resources and expertise are aligned with the complexity of the audit or the unresolved audit issues raised by outgoing auditors, for example, when an incoming auditor accepts an engagement with significant operations in industries and jurisdictions in which it has limited experience and resources.
2. **Specific scope inspections:** The AFRC may conduct specific scope inspections of incoming auditors when doubts arise regarding their ability to perform quality audits for PIE engagements. Such inspections would focus on areas where the competence and capability of the incoming auditors are in doubt.

3. **Initiation of investigations and enquiries:** The AFRC may initiate investigations into the audits or enquiries into the financial statements of listed companies involving late auditor resignations, when there is an indication of non-compliance with auditing and accounting standards.
4. **Regulatory collaboration:** The AFRC continues to strengthen its collaboration with other regulators and enforcement agencies in Hong Kong and the Mainland to combat market misconduct and ensure the financial market operates in an orderly manner. As a result of AFRC's recent initiatives, the Hong Kong Exchanges and Clearing Limited has also commented on the issue in its bulletins by making references to the AFRC's [Guidelines for Effective Audit Committees \(2021\)](#)⁴ and open letters.

AFRC's enforcement priority

After considering the nature and extent of the unresolved audit issues, the availability of incoming auditors' resources, and the tight reporting deadlines, the AFRC has reasonable causes to believe that some audit engagements may not have been carried out in the best interest of the public. Those who perform sub-standard audits should expect regulatory scrutiny through the AFRC's enforcement and disciplinary sanctions.

The AFRC has conducted a specific scope inspection on a registered PIE auditor to assess the audit quality of its late assignments. As a direct outcome, the AFRC has initiated five investigations on this auditor, and is also looking into its client acceptance procedures. The purpose of our action is to bring to account those who failed to comply with auditing standards. The AFRC will refer any misconduct of listed companies to relevant regulators.

⁴ AFRC, Guidelines for Effective Audit Committees—Selection, Appointment and Reappointment of Auditors , December 2021, <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/guidelines-for-effective-audit-committees/>

The AFRC monitors all sanctions, disciplinary or regulatory actions against PIE auditors and their responsible persons, and will evaluate the severity of the actions and the need for imposing conditions and revoking the PIE auditor registrations. The conditions may include firm-wide training programmes, independent monitoring reviews and restrictions of practice.

Given the importance of audit quality on market confidence, the AFRC urges PIE auditors taking on late engagements to maintain heightened awareness of the AFRC's expectations of them. Following the repeated reminders, the AFRC will not hesitate to take robust enforcement actions and impose heavier sanctions for audit irregularities in engagements that result from late auditor resignations.

Looking ahead

Our initiatives have successfully brought to public attention the potential quality issues in financial reporting and audit resulting from late auditor resignations. We are confident that the issue can be addressed following the AFRC's intervention through ongoing collaboration with relevant parties.

We will continue to monitor market developments and identify any further potential misconduct arising from auditor changes. We urge PIE auditors and audit committees of listed companies to follow our recommendations published in the [Guidance Notes on Change of Auditors](#)⁵ in September 2023. In it, the AFRC articulates its expectations of PIE auditors and audit committees in the event of change of auditors and provides concrete examples on how auditors and audit committees should conduct themselves in these circumstances.

⁵ AFRC, Guidance Notes on Change of Auditors, September 2023, <https://www.afrc.org.hk/en-hk/policy-and-governance-publications/guidance-notes-on-change-of-auditors/>