AFRC Accounting and Financial Reporting Council 會計及財務匯報局

Common valuation-related audit deficiencies

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28 April 2023

Agenda

- Overview of Investigation and Compliance Department of the AFRC
- Valuation-related accounting issues, inherent risk factors and auditing issues
- Common valuation-related audit deficiencies
- Practical scenarios
- Recap and our expectations

Overview of Investigation and Compliance Department of the AFRC

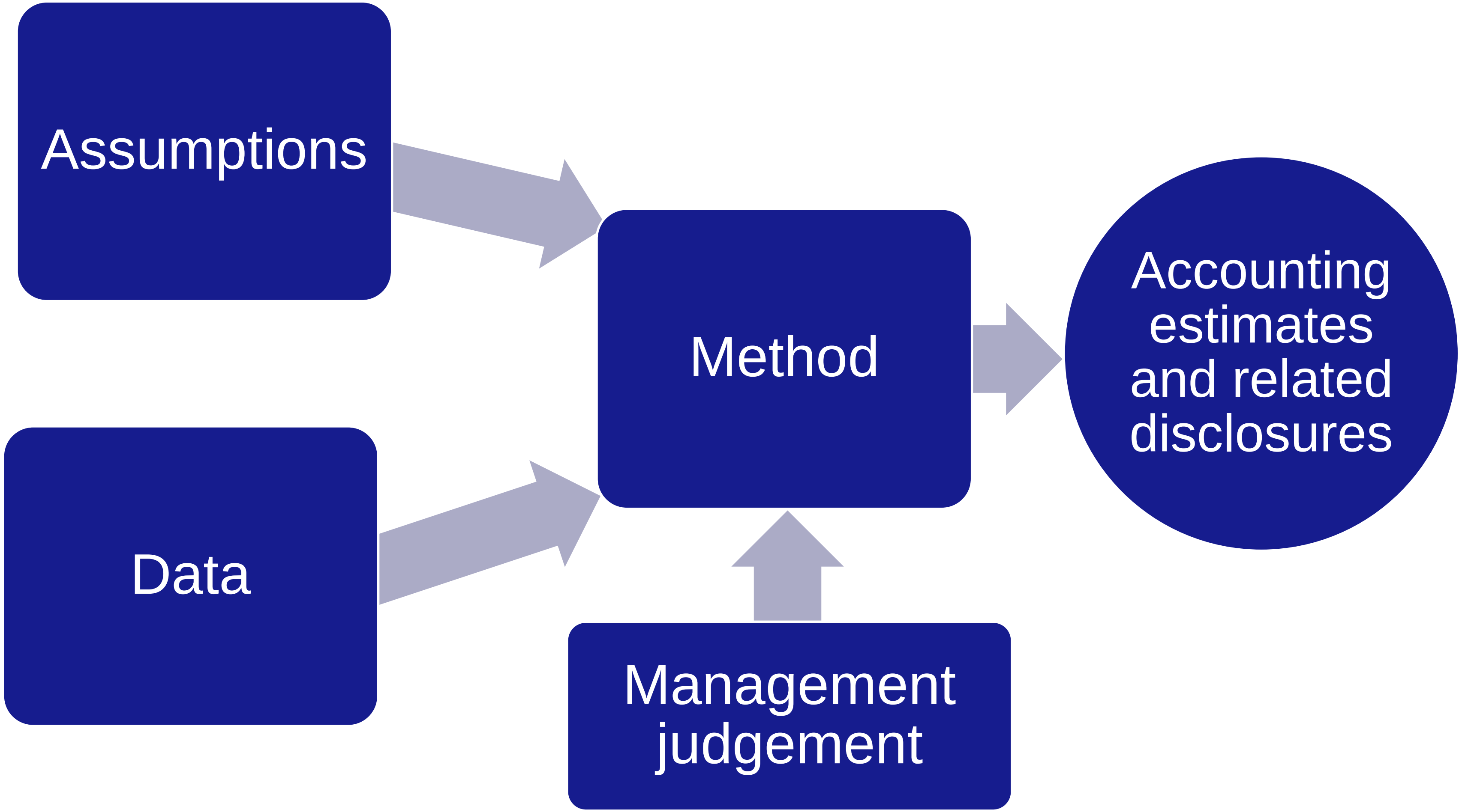
Remits and Powers

- Investigation
  - ❑ Practice irregularity (section 4 of AFRCO)
    - PIE auditors
    - Registered responsible person of PIE auditors (i.e. engagement partner, engagement quality control reviewer, quality control system responsible person)
    - Non-PIE auditors
  - ❑ Professional irregularity (section 3B of AFRCO)
    - CPAs and practice units
- Enquiry
  - ❑ Relevant non-compliance in relation to listed entity (Part 4 of AFRCO)

Valuation-related accounting issues and inherent risk factors

Measurement basis in financial reporting	**Where valuations may be needed**			**Assumptions for valuations may reflect**
Historical cost	Asset impairment/onerous liability assessment			• Perspectives (market participants, entity-specific) • Sources of values (future cash flows, market transactions, cost of acquisition or construction)
Current value	Fair value (except those based on Level 1 inputs)	Value in use	Current cost	

Valuation-related accounting issues and inherent risk factors



Prevalence of valuation-related matters in AFRC's investigations

- 60 investigations into audits of listed entities were initiated in FY2022/23
- The following valuation-related areas were under the scopes of these investigations:

Measurement basis	Area	Timing		
		Initial recognition	Subsequent re-measurement	Both
Historical cost	Impairment assessment of financial assets		10 cases	
	Impairment assessment of non-financial assets (Note)		13 cases	
Current value	Fair value - business combinations	4 cases		
	Fair value - financial guarantee contracts			3 cases
	Fair value measurements		3 cases	

Management bias may be of a higher risk for these cases

Note: Mainly cash-generating units (Mining, High-tech, Healthcare, etc.)

Investigation cases initiated with valuation-related matters: 33

Corresponding enquiry cases into the relevant non-compliances initiated: 9

Our latest approach: Exercise powers under the AFRCO to conduct enquiries to identify the relevant non-compliances and to require the listed entity to rectify them whenever possible, refer to other regulators if necessary.

Valuation-related auditing issues

A typical valuation flow for an audit

1. Management	2. Valuer	3. Management	**4. Auditor**	5. **Auditor's Expert**	**6. Auditor**	**7. Auditor**
Management appoints a Valuer as a Management's Expert to perform a Valuation to be used in making an accounting estimate and related disclosures	Valuer applies valuation methodology and prepares the Valuation based on information from Management and other sources	Management prepares the relevant financial statements line item and related disclosures using the Valuation report	Auditor performs audit procedures to obtain audit evidence in respect of the financial statements line item and disclosures. Auditor may appoint Auditor's Expert to assist them in obtaining the audit evidence	Auditor's Expert reviews the Valuation by obtaining information/ evidence from the Valuer, Auditor and/or Management, or other sources	Auditor determines whether to use the work of the Auditor's Expert. If so, the Auditor determines whether the work of the Auditor's Expert is adequate for the Auditor's purposes	Auditor determines, based on the evidence obtained, whether management's decisions relating to recognition, measurement, and presentation and disclosures of the financial statements line item are in accordance with accounting standards

Audit focus

- **Assessment and responses to risk of material misstatement**
- **Planning and performing the audit with professional judgement and professional skepticism**
- **Obtaining sufficient appropriate audit evidence for:**
  - ❖ **The accounting estimates and related disclosures; and**
  - ❖ **The adequacy of the Auditor's Expert's work for the purpose of the audit**

Valuation-related inherent risk factors

What are the financial reporting characteristics of such measurements that drive risks of material misstatements?

Measurement uncertainties

Changes

Management bias and other fraud risk factors

Complexity in measurement

Subjectivity

Consideration for risk assessment

Specialized skills/knowledge:
- Management's expert
- Auditor's expert

Management's judgment regarding:
- Methods
- Data
- Assumptions

Management's incentive and pressure

Common valuation-related audit deficiencies

Failures in applying professional skepticism and appropriate professional judgement

- Failing to identify and respond to red flags for potential misstatements in valuation, such as:
  - Ambitious projected revenue growth during the forecasted period *(e.g. Practical scenario 2)*
  - Significant goodwill/bargain purchase recognised in business combinations *(e.g. Practical scenario 2)*
  - Recurring declining business performance *(e.g. Practical scenario 1)*
  - Significant cost reduction
  - Unreasonable discount rate
  - Inappropriate determination of cash-generating units

- Failing to evaluate the reliability and relevance of the information used by the management in forming the accounting estimates, and to identify and respond to contradictory audit evidence about various matters, such as:
  - Revenue *(e.g. Practical scenario 1 & 2)*
  - Contractual terms (periods, scope)
  - Disclosures of assumptions

- Failing to identify and respond to limitations in valuation reports (e.g. Caveat)

Common valuation-related audit deficiencies

Failures to obtain sufficient appropriate audit evidence on:

- **Competency, capabilities and objectivity of the management's expert**
- **Work of the management's expert**
- **Adequacy of the work of the management's experts as audit evidence**

In particular, the Auditor failed to:

- Consider other valuation approach / publicly-available market information that indicate over-estimation of valuation
- Obtain sufficient appropriate audit evidence for reasonableness of key parameters and assumptions:

  Business-related
  - Projected revenue *(e.g. Practical scenario 1 & 2)*, considering future market demand and growth rates
  - Projected expenses *(e.g. Practical scenario 2)*
  - Impact of changes of interest rates and inflation rates
  - Terminal growth rates *(e.g. Practical scenario 1)*
  - Non-operating items *(e.g. Practical scenario 2)*

  Discount rate-related
  - Discount rates, weighted average cost of capital
  - Effective interest rate

  Market approach-related
  - Comparability of market transactions

  Expected credit loss-related
  - Rebuttal of the 90 days-past due default presumption
  - Grouping of financial assets by credit quality
  - Rates of default and loss given default, adjusted by current condition and forward-looking information
- Evaluate the findings of all the management experts involved (not just the Valuer, consider the findings of other technical experts)

Common valuation-related audit deficiencies

Failures to challenge management's processes

Management bias

- Failed to evaluate the reason(s) for over-estimation in performance in the prior period and consider their impact

Disclosures

- Failed to assess whether:
  - Disclosures are consistent with the Valuation, and
  - All the disclosure requirements are met (HKAS/IAS 1, HKAS/IAS 36, HKFRS/IFRS 13)

Failures to evaluate the reasonableness of the accounting estimates and disclosures in the context of the applicable financial reporting framework *(e.g. Practical scenario 2)*

- Failed to assess impairment for each cash-generating unit level (smallest identifiable group & generate cash inflows that are largely independent)

- Failed to evaluate the compliance of the calculation of recoverable amounts with the FVLCD and VIU definitions in HKAS/IAS 36

Common valuation-related audit deficiencies

Failures to determine whether the work of the Auditor's Expert is adequate for the Auditor's purposes

- Evaluate the competence, capabilities and objectivity of the Auditor's Expert (for both internal and external experts)
- Agree with the Auditor's Expert on the scope of work
- Evaluate whether the Auditor's Expert was reporting in accordance with the agreed scope:
  - If the work of the Auditor's Expert is not adequate:
    - Agree with the Auditor's Expert on the nature and extent of the **further work to be performed**, or
    - **Perform additional audit procedures** appropriate to the circumstances as required under HKSA 620
- Follow up the comments raised by the Auditor's Expert

Practical scenario 1

Background

- ❑ Company A had an investment in an associate which was an online game developer.

Impairment indicators

- ❑ Delay in development/marketing plan
- ❑ Public information revealed that the associate faced financial problems and operating issues (e.g. missing payroll, staff layoffs, departure of key personnel, and suspension of server)
- ❑ Termination of a major game distributor’s agreement.

For impairment assessment, Company A engaged an independent valuer to assess the value of its investment in the associate at year end.

Practical scenario 1 (cont'd)

Recoverable amount of the investment in the associate was based on cash flow projections with:

Contracted license fee income under a <u>terminated</u> distributor agreement:

i. Initial one-off fee of $10 million upon commercial release of the mobile game in the PRC,
ii. Year 1 fee of $20 million,
iii. Year 2 fee of $30 million,
iv. Year 3 fee of $40 million,
v. Year 4&5 fees of $60 million p.a., **and**

The following considerations:

a. Replacement of the distributor is feasible
b. Expansion of the mobile game into other markets
c. Terminal value with a continuous growth rate of 3% p.a.

Practical scenario 1 (cont'd)

Our investigation found that in assessing the reasonableness of the recoverable amount, the Auditor failed to:

- Obtain sufficient appropriate audit evidence for:
  - The commercial release of the new mobile game in the PRC,
  - Feasibility and effectiveness of (i) the market expansion plan and (ii) the distributor replacement,
  - Terminal growth rate of 3% p.a. in the relevant industry

Practical scenario 2

Background

- ❑ Company B acquired 55% equity interest of the Subsidiary, for cash consideration of $200 million.
- ❑ The Subsidiary's main assets include a building with fair value of $80 million.
- ❑ Goodwill of $160 million was recognised.
- ❑ Planned to spend $100 million capital expenditure to develop the building as a special logistic centre in 1 year, and to conduct the special logistic business for 15 years.
- ❑ For annual impairment assessment of the Goodwill, Company B engaged an independent valuer to assess the recoverable amount of the Subsidiary as a cash-generating unit at the year end.
- ❑ Forecasted revenues in the first four years of operations - $160 million, $248 million, $350 million, and $350 million.

Red flags

- ❑ Significant goodwill → Should be more sceptical in assessing the recoverable amount of the Subsidiary
- ❑ Significant projected revenue growth → May not be supportable

Practical scenario 2 (cont'd)

Recoverable amount of the Subsidiary was estimated based on …

- Estimation method =
  (Value of the Special Logistic Business + Value of Building) x (1 – Marketability discount)

- Value of the Special Logistic Business was determined based on the discounted cash flows of the business, supported by
  - non-legal binding agreements of intent;
  - cost structure of two benchmarked listed companies

- Value of Building was the estimated proceeds in an immediate sale

- The recoverable amount was compared to the carrying amount of the Subsidiary's net assets for the impairment assessment

Practical scenario 2 (cont’d)

Our investigation found that the Auditor failed to:

- Obtain sufficient appropriate audit evidence for the value of the Special Logistic Business (enforceability and period for the agreements of intent? comparability of the benchmarked companies)
- Justify the Building as a non-operating asset of the Subsidiary and including the Building’s fair value in the recoverable amount of the Subsidiary
- Identify that, according to paragraph C4 of HKAS/IAS 36, the amount of goodwill for the impairment assessment of the Subsidiary should also include the goodwill attributable to the non-controlling interest (45% in this case)

Recap and our expectations - Auditors

- Valuation-related audit deficiency is commonly found in our investigations.

- Common root causes for auditors' attention:
  - Resources-related
    - Lack of required technical knowledge and experience of the engagement team
  - Management-related
    - Over-reliance on management's representations and lack of sufficient challenges over management's estimates, including method, data and assumptions
    - Insufficient documentation of the nature and details of supporting evidence and basis of conclusions
    - Ineffective project management by assigning complex or highly judgmental areas to junior team members
    - Insufficient involvement and inadequate supervision and review by engagement manager and partner
  - Training-related
    - Insufficient firm training or guidance in relation to audits of key risk areas

- Auditors should comply with the requirements in the auditing standards in relation to:
  - Planning (to allow sufficient time to conduct the risk assessment procedures, and interact with management, audit committee, management's expert and auditor's expert regarding the accounting estimates and related disclosures!)
  - Risk assessment
  - Responses to the assessed risks of material misstatements
  - Obtaining sufficient appropriate audit evidence in relation to accounting estimates and related disclosures (including the adequacy of the work of the Auditor's Expert, if any)
  - Professional judgement and professional skepticism
  - EQCR review under HKSA 220 (if involves listed entity and significant risk area)

Our expectations - Directors

- Fulfill their fiduciary duty in financial reporting:
  - Assume a primary role in understanding and approving key areas of judgement and estimation applied in financial statements to ensure compliance with the applicable financial reporting standards
  - Sufficiently challenge management as to the relevance and appropriateness of information and assumptions used to determine significant accounting judgment and estimates
  - Ensure that the entity has adequate resources and competent staff for financial reporting

- Ensure that management provide the auditor with information requested in connection with the audit on a timely basis, and be open and receptive to challenges raised by the auditor.

Reference materials from the AFRC

AFRC's press release publications:
https://www.afrc.org.hk/en-hk/news-centre/press-releases/

Inspection reports:
https://www.afrc.org.hk/en-hk/publications/periodic-reports/inspection-reports/

- Audit focus: 2022 financial year-end audits reminders
- 2022 Interim Inspection Report
- 2021 Annual Inspection Report
- An External Auditor's Guide to Performing Root Cause Analysis

Investigation and Compliance reports:
https://www.afrc.org.hk/en-hk/publications/periodic-reports/investigation-and-compliance-reports/

Policy and Governance reports:
https://www.afrc.org.hk/en-hk/publications/periodic-reports/policy-and-governance-reports/

- 2023 Survey Report to follow up on the implementation of the Effective Audit Committees Guidelines
- Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors (2021)

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Thank you