FRC Financial Reporting Council 財務匯報局

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Press Release

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FRC finds that an auditor failed to obtain the necessary evidence to support the measurement and recognition of a gain on extinguishment of a financial liability

The FRC adopted an investigation report finding that the auditor (**the Auditor**) of a listed entity (**Listed Entity**) failed to obtain sufficient appropriate audit evidence to support the measurement and recognition of a gain on extinguishment of a promissory note (**the Promissory Note**) included in the consolidated financial statements of a Listed Entity for the year ended 31 March 2013.

Under the transitional provisions of the amended FRC Ordinance, since the relevant audit was completed before 1 October 2019, the investigation report has been referred to the Hong Kong Institute of Certified Public Accountants to determine if any disciplinary actions are warranted. Names of the relevant parties are being withheld at this time to avoid prejudicing any related disciplinary proceedings.

The investigation was initiated in November 2016, stemming from the FRC's financial statements review programme.

Gain on extinguishment of the Promissory Note

HKAS 8 requires management to develop and apply an accounting policy that provides a faithful representation of the financial position and financial performance of an entity and reflects the economic substance of a transaction, in the absence of a HKFRS that specifically applies to that transaction. HKAS 39 does not specify the accounting treatment for a modification of terms of financial liability between an existing borrower and lender of debt instruments, who is also an owner. HKAS 1 requires transactions with owners in their capacity as owners to be presented as changes in equity.

Under HKAS 39, a modification of the terms of an existing financial liability is substantial if the discounted present value of the cash flows under the new terms discounted using the original effective interest rate is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. A substantial modification would be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. If so, the difference between the carrying amount of the financial liability extinguished and the consideration paid would be recognised in profit or loss.

The Listed Entity issued the Promissory Note to one of its substantial shareholders. During the year ended 31 March 2013, the maturity date of the Promissory Note was extended. Based on qualitative factors, the extension was accounted for as an extinguishment of the original financial liability and a new financial liability was recognised. The resulting gain was recognised in profit or loss, which represented the difference between the carrying amount of the Promissory Note and its fair value as at the date of its extinguishment. The fair value of the Promissory Note on the date of its extinguishment was determined based on a valuation report.

The audit quality failure of the Auditor

The Auditor failed to adequately evaluate the validity of the qualitative factors to support that the change of terms of the Promissory Note was a substantial modification of the terms of an existing financial liability in accordance with the requirements of HKAS 39. The Auditor therefore failed to appropriately assess whether the modification of terms of the Promissory Note was substantial under HKAS 39 and accordingly failed to exercise appropriate professional judgement in doing so.

The Auditor also failed to obtain sufficient appropriate audit evidence to evaluate management's judgement in accounting for the modification of terms of the Promissory Note, including their judgement as to whether the modification was substantial and whether the modification was agreed to by the holder of the Promissory Note in the capacity of a creditor or in its capacity as an owner such that the gain should have been accounted for in equity.

The Auditor used the valuation report as part of the audit evidence and engaged a valuer to review the valuation report during the audit. The Auditor also failed to properly document in the audit working papers any identification of deficiencies in the valuer's work in relation to the fair value measurement of the Promissory Note, their conclusions or any significant professional judgements made on such deficiencies.

Relevant technical standards

HKAS 39 establishes principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

HKAS 1 prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. It also prescribes the disclosure requirements for the judgments that the entity has made which have significant effect on the amounts recognised in the financial statements.

Hong Kong Standard on Auditing **(HKSA)** 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* prescribes the application of a competent understanding of the applicable financial reporting framework in the exercise of professional judgement by an auditor.

HKSA 230 (Clarified) *Audit Documentation* deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.

HKSA 500 (Clarified) *Audit Evidence* explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Our purpose in reporting publicly

The FRC announces the adoption of reports on audit investigations and enquiries into financial reporting of listed entities:

(a) to promote continuous improvement in the quality of auditing and financial reporting by all our regulatees;

(b) to encourage audit committee members to consider the implications of our findings for the financial reporting and audits of their own listed entities; and

(c) to maintain public confidence in the system for independent auditor regulation.

– End –

About the FRC

The FRC is the full-fledged independent listed entity auditor regulator for Hong Kong. We are committed to upholding the quality of financial reporting of listed entities of Hong Kong so as to enhance investor protection and strengthen investor confidence in corporate reporting.

For more information about the statutory functions of the FRC, please visit www.frc.org.hk.

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