

# Director's Duties: Guidelines on Selecting Auditors and Setting Audit Fees

The Hong Kong Independent Non-Executive Director  
Association

28 November 2023

Policy, Registration and Oversight Department, AFRC

Scan code to enter our reports:



Survey report  
on auditor selection

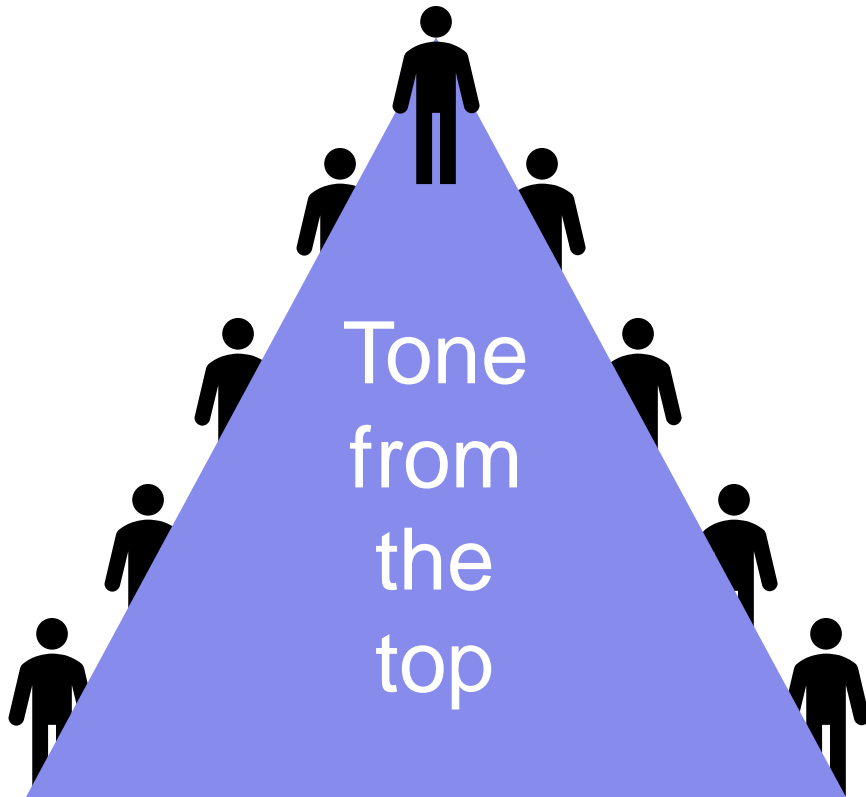


Audit fees report

# 1. Introduction



# Directors take overall responsibility for the financial statements



## Board of Directors / C-Suite Executives

- take overall responsibility for the financial statements
- make decisions on auditor selection and determine audit fees
- rely on financial information to make informed decisions about strategic business activities that are paramount for ensuring the long-term success

## Audit Committee members have been delegated by the board to:

- oversee companies' financial statements
- make recommendations to the Board of Directors on the selection of auditors and evaluation of audit fees

# A high-quality audit is beneficial to all concerned



# AFRC: Hong Kong's independent regulator for the accounting profession



## Mission statement

**To shape a competitive environment that will nurture and promote the success of the profession**

- This pivotal role not only enhances the quality of financial reporting but in turn reinforces our pursuit of promoting the healthy development of the profession, and Hong Kong's position as a competitive international financial centre

## Policy, Registration and Oversight

### Policy and governance

- Conduct research and set policies in relation to the quality of financial reporting and auditing
- Publish guidance on governance and other issues where appropriate

### Registration

- Review new and renewal applications for the issuance of practising certificates to CPAs, and the registration of practice units and PIE auditors.

### Oversight

- Oversee specified functions performed by the HKICPA, including:
  - Registration of certified public accountants (CPAs)
  - Setting continuing professional development requirements
  - Setting standards
  - Providing training

# AFRC guidelines and resources

## Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors (“AC Guidelines”)

- Provides practical guidance to audit committees on:
  - selecting capable and experienced auditors; and
  - evaluating audit fees



Scan code to open the AC Guidelines

## 2023 Survey Report on the Implementation of AC Guidelines (“Survey”)

- Contains the results of AFRC’s survey to auditors and audit committees on the implementation progress of the AC Guidelines
- Provides practical recommendations to audit committees, auditors, management / the Board and investors



Scan code to open the Survey

## Audit Fees Paid by Listed Companies in Hong Kong 2020-2021 (“Audit Fee Report”)

- Analyses the audit fees paid by listed companies and what effects, if any, COVID-19 and the ensuing economic downturn have had on the market



Scan code to open the Audit Fee Report

## Guidance Notes on Change of Auditors (“Guidance Notes”); AFRC Addresses Concerns Surrounding Auditor Changes (the “Paper”)

- Articulates AFRC’s expectations of PIE auditors and audit committees when changing auditors
- Provides concrete examples of how auditors and audit committees should conduct themselves in these circumstances



Scan code to open the Guidance Note

## 2. Selecting auditors



# Let's imagine...

Which one will you choose?

\$20 / pc





\$10 / pc



## Why are apples of the same size and appearance different in price?

The reasons could be...

- The place of origin may differ 
- The production cost / margin may differ
- The quality may vary
  - Rare / Premium vs Rotten 



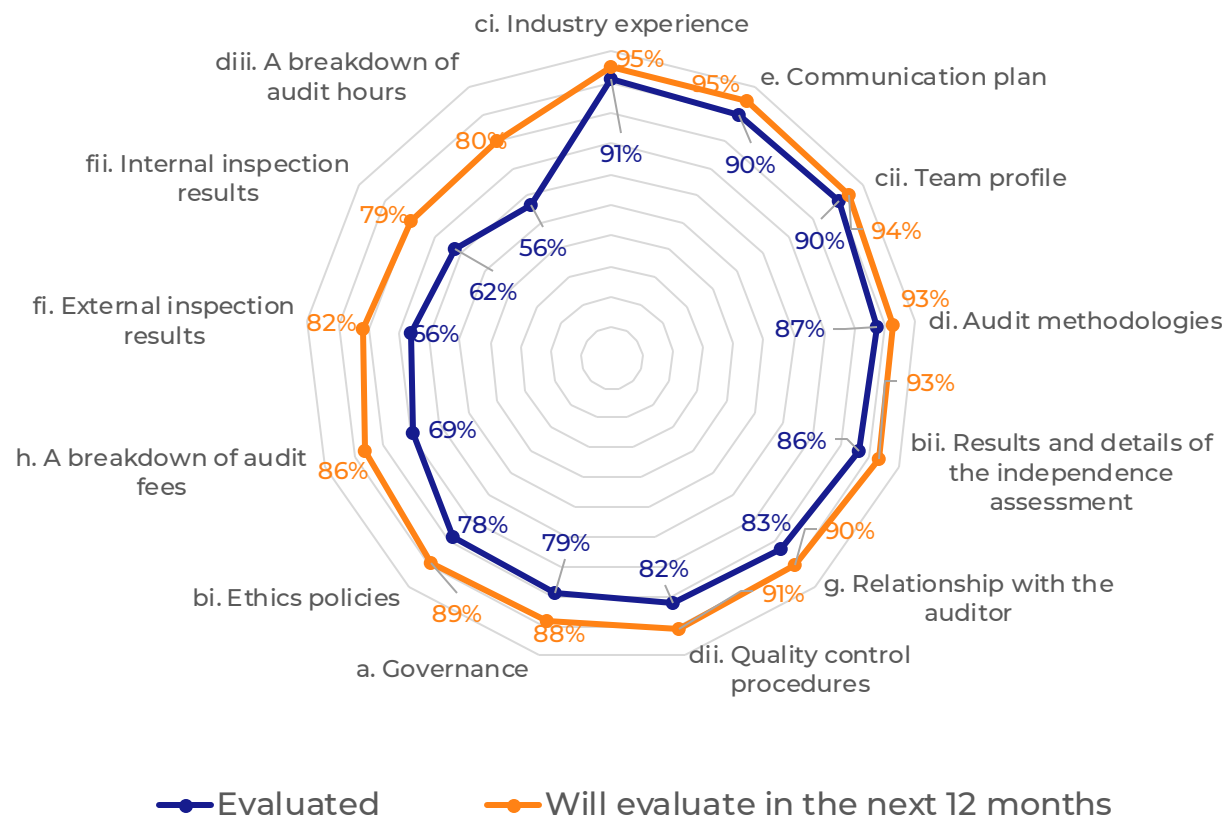


## Features of a quality auditor to be taken into consideration during the selection process

- Good governance and strong leadership
- Rigorous Compliance with relevant ethical requirements
- Proficiency in industry knowledge and technical competence
- Effective engagement performance
- Effective communication and interaction with audit committee
- Satisfactory inspection outcomes and disciplinary records



## Finding 1: What factors have been / will be evaluated by audit committees in the past and next 12 months



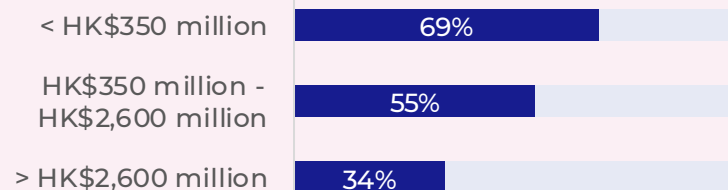
- We asked listed company respondents to select from a list of 13 items those they evaluate when selecting auditors.
- There is an **increase in audit committees' intention** for all the items to be evaluated in the next 12 months.
- By comparing the survey results relating to the information required by audit committees against that supplied by auditors, we noted the **response of auditors is consistent with that of audit committees.**

## Finding 2: Which factors do listed companies consider most when selecting auditors



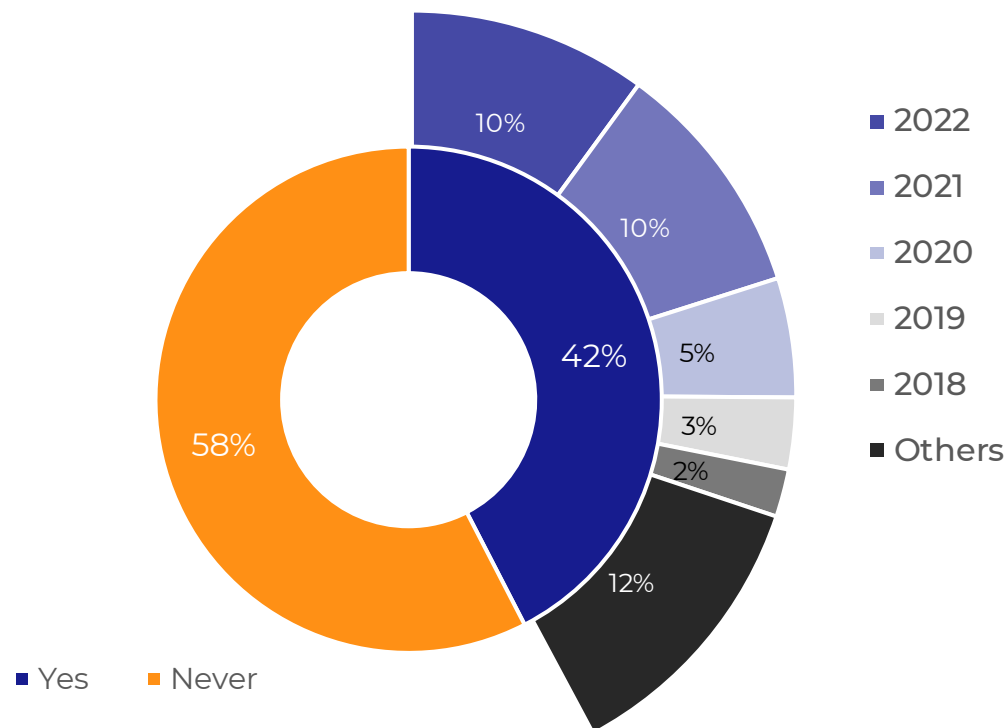
- The results show a mixed picture. “**Industry experience and team's profiles**” and “**Engagement performance**” were selected as the two most important factors in selecting an auditor. We concur they are important factors to consider.
- However, despite AFRC's continuous effort in promoting audit quality when evaluating an auditor's capabilities, listed companies still rank proposed audit fees as one of the top three factors.
- There appears to be **some inconsistencies** in the factors audit committees evaluate.

### Sensitivity to audit fees (based on listed companies' market cap)

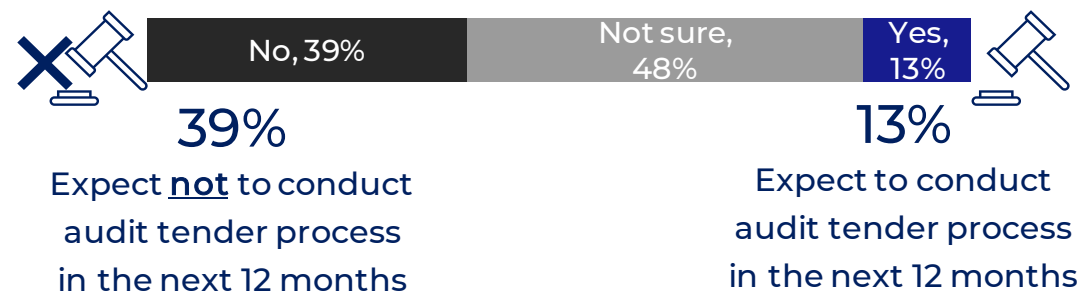


# Findings 3 and 4: How common is it for audit committees to conduct an audit tender when selecting auditors

Have audit committees conducted an audit tender when selecting auditors?

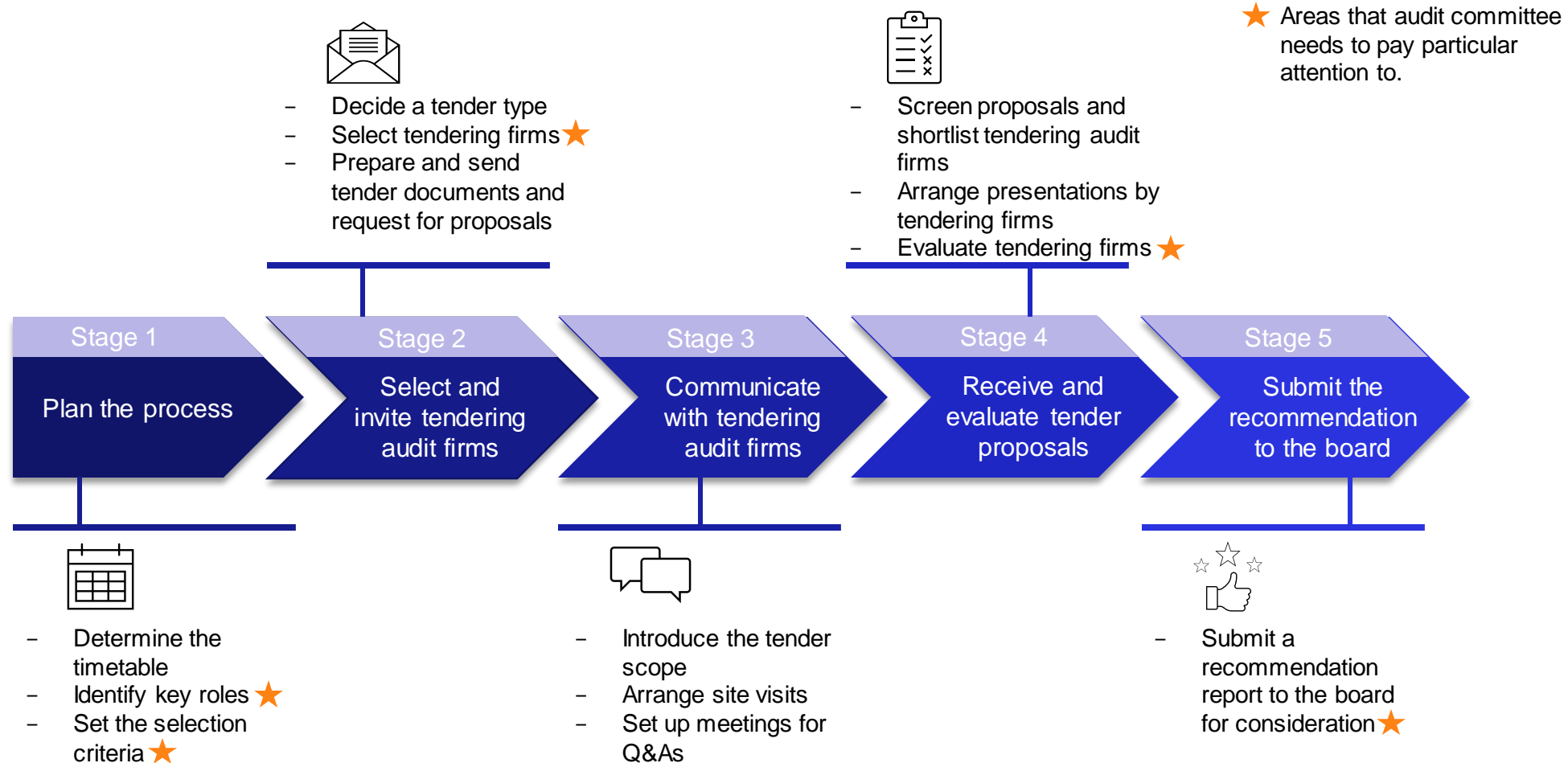


Do they intend to conduct an audit tender in the next 12 months?

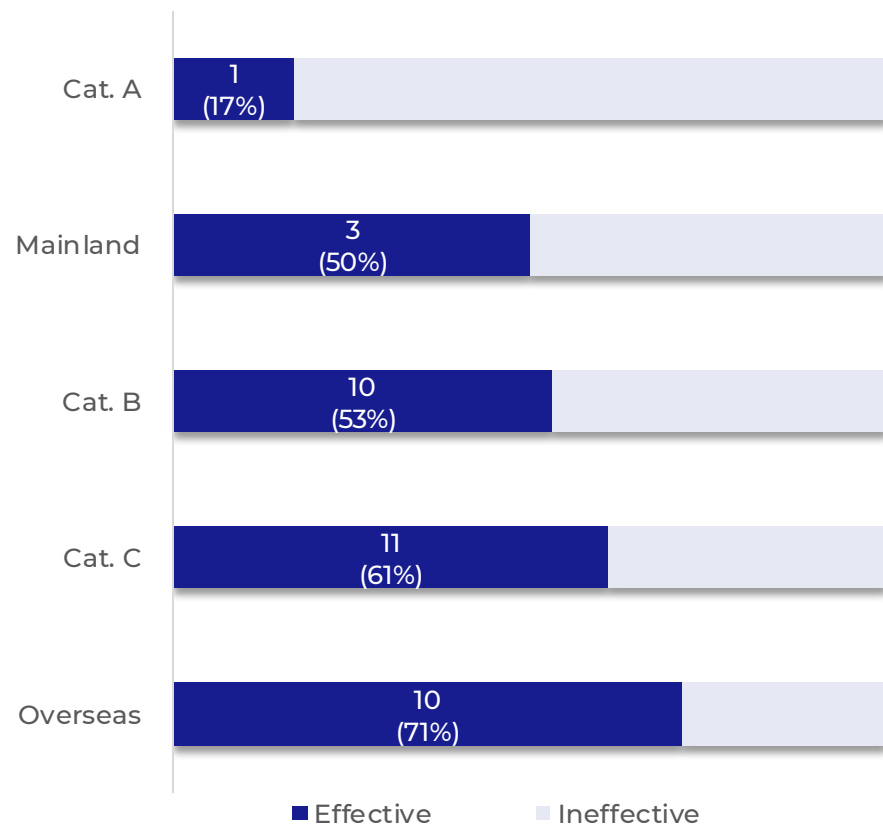


# How to run an effective audit tender when selecting auditors

## A 5-stage approach for audit tender process



## Finding 5: The effectiveness of audit committees implementing the AC Guidelines viewed by PIE auditors



- We asked PIE auditors to rate the overall effectiveness of the implementation of the AC Guidelines by the audit committees.
- Only **one Cat. A auditor (17%)** believes that the audit committees they work with have implemented the AC Guidelines effectively.
- This is far lower than Overseas auditors, where **10 (or 71%)** thought implementation was effective.

Cat. A – Local PIE auditors which audit more than 100 Hong Kong listed companies

Cat. B – Local PIE auditors which audit 10 to 100 Hong Kong listed companies

Cat. C – Local PIE auditors which audit 1 to 9 Hong Kong listed companies

Mainland – Mainland PIE auditors recognized by AFRC

Overseas – Overseas PIE auditors recognized by AFRC

### **3. Red flags in late auditor changes**



# AFRC's concerns on late auditor changes

## Observations

- A growing trend of listed companies **changing their auditors shortly before the deadline** for releasing their annual results.

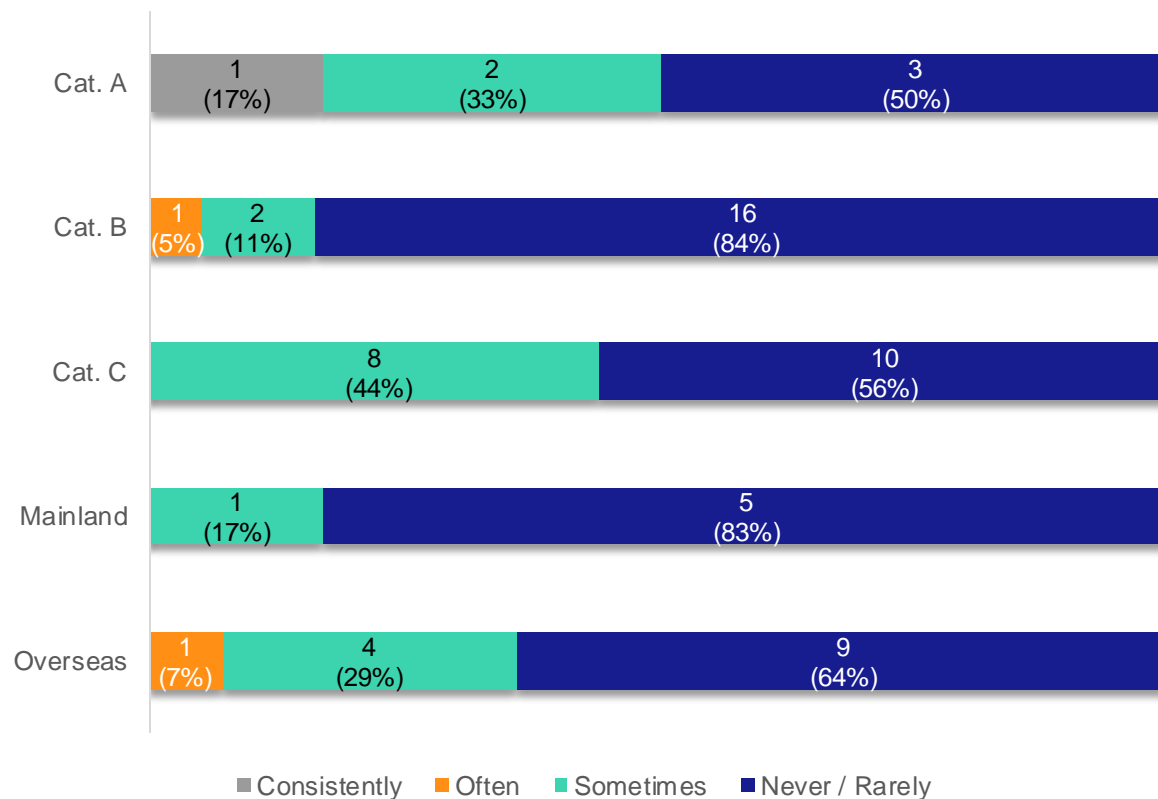
	2020	2021
<b>Listed companies that changed auditors</b>		
- Number	249	285
- As a % of all listed companies	11.0%	12.2%
<b>Late changes in auditors</b>		
- Number	71	107
- As a % of total changes	28.5%	37.5%

## Concerns

- Audit quality may be compromised given the incoming auditor has limited time to plan and conduct a proper audit.
- Announcements made by certain listed companies on the reasons for changing auditors are generic and may not adequately reflect the underlying cause
- Some incoming auditors accepted engagements with significant operations in other jurisdictions, even when they had limited experience and resources in those jurisdictions.
- There are also instances where auditors have been requested to resign as a result of audit issues, which could be an indication of possible opinion shopping.



## Finding 6: Frequency with which audit teams experienced fee pressure that may compromise audit quality



- Almost half of the Cat. A and C auditors experienced some fee pressure on a periodic basis. By contrast, only three Cat. B auditors (16%) indicated they often or sometimes experienced fee pressure.
- Possible reasons include:
  - The shift in market share from Cat. A to Cat. B auditors.
  - The quality of engagements typically undertaken by Cat. C auditors.

Cat. A – Local PIE auditors which audit more than 100 Hong Kong listed companies

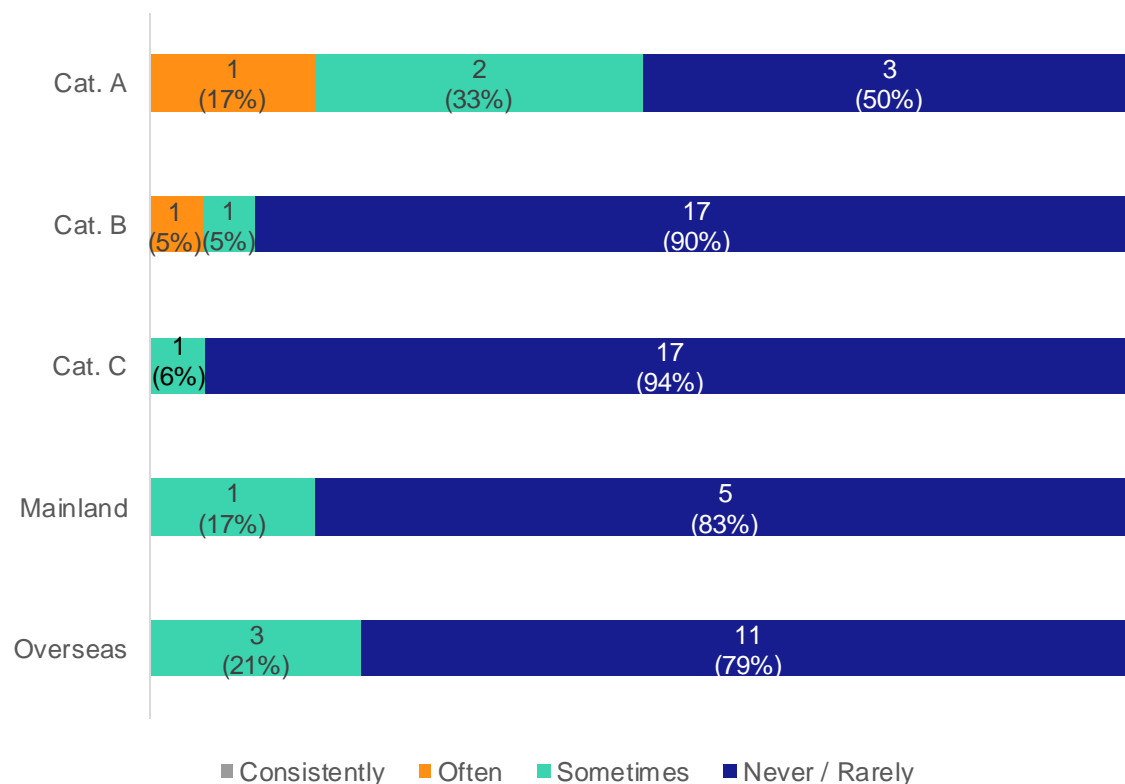
Cat. B – Local PIE auditors which audit 10 to 100 Hong Kong listed companies

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## Finding 7: Frequency with which PIE auditors experienced pressure to issue a clean audit opinion



- Auditors across all categories experienced a certain amount of pressure to issue a clean audit opinion
- The twin pressures to reduce fees and to issue a clean opinion may be linked to the spate of late auditor resignations we have been observing in the market



## When encountering disagreements

- **Hold separate meetings** with the auditor and management to understand the nature and details of the issues
- **Form an independent view** of the issues and make best efforts to seek resolution with them



## When the auditor resigns

- **Ensure that the letter of resignation and the listed company's announcement** have disclosed the precise circumstances leading to the resignation
- **Refrain from using a generic statement** as a catch-all explanation for the resignation



## When selecting a new auditor

- Ensure the new auditor **possesses the necessary competence and resources**
- Assist the new auditor in **understanding any unresolved issues**
- Evaluate the **reasonableness of the audit timetable and audit fees** proposed by management

# AFRC's initiatives and progress made on late auditor changes

- Issued two open letters in October 2022 and January 2023, respectively, to PIE auditors and audit committees
  - ✓ To express AFRC's concerns on the matters
  - ✓ To reiterate AFRC's expectations on auditor changes
- Monitored auditor changes on proactively and on an ongoing basis
- Followed up with PIE auditors and initiated investigations where appropriate to bring accountability to those who failed to comply with professional standards
- Initiate enquiries into the financial statements of listed companies if there is an indication of non-compliance with accounting standards, and refer any identified misconduct of listed companies to the relevant regulators

Following the open letters and actions taken by AFRC, some improvements have been observed:

Reasons for changes	From 1 Dec to 31 May of the following year		Change / Change %
	2021/22	2022/23	
Disagreement over audit fees	64	39	-25 / -39%
Unresolved audit issues	27	14	-13 / -48%
Corporate governance, i.e., auditor rotation	-	2	+2 / N/A
Other	7	4	-3 / -43%
<b>Total</b>	<b>98</b>	<b>59</b>	<b>-39 / -40%</b>

## 4. Setting audit fees



# How to set and assess audit fees

## Why are audit fees important?

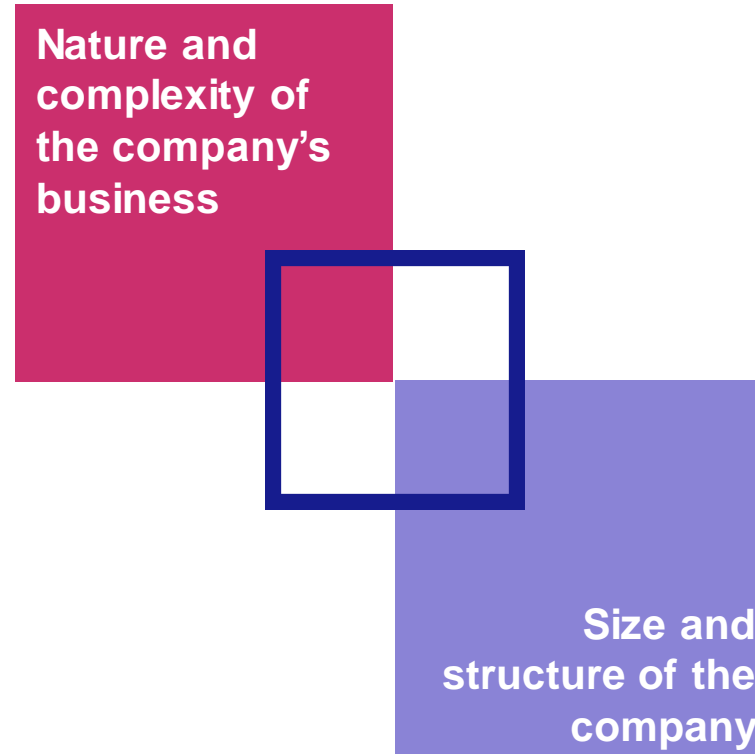
“There is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance; this will usually be reflected in the audit fee” according to “*Audit Quality Framework, IAASB [2014]*”.

## What is an adequate audit fee?

It should be at a level that:

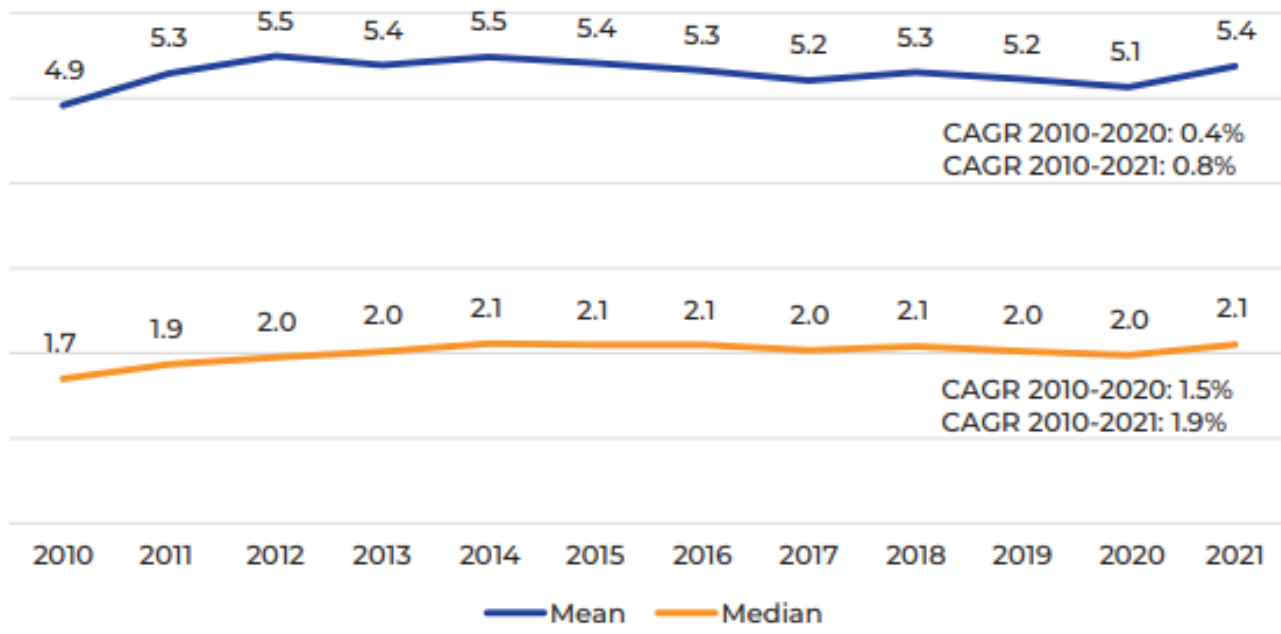
- enables sufficient audit resources to be allocated to perform audit procedures; and
- is comparable to the previous year if there is no significant change in the audit scope.

## Key factors for consideration



# Finding I: Average (“mean”) and median audit fees

Mean and median audit fees (HK\$m)

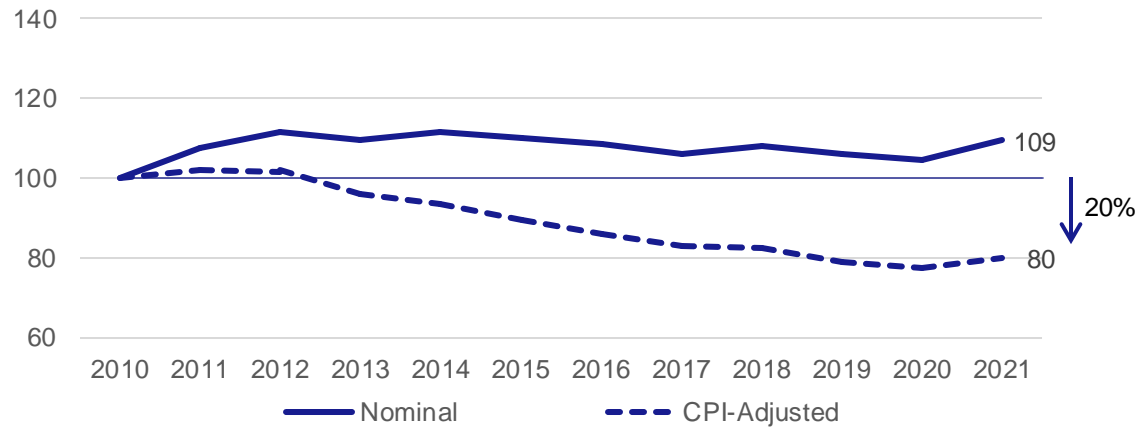


- Both average and median audit fees were stagnant in 2020 as compared with 2019, but recovered some ground in 2021.
- The large gap between average and median audit fees shows that the market is skewed towards a small number of engagements with higher fees.



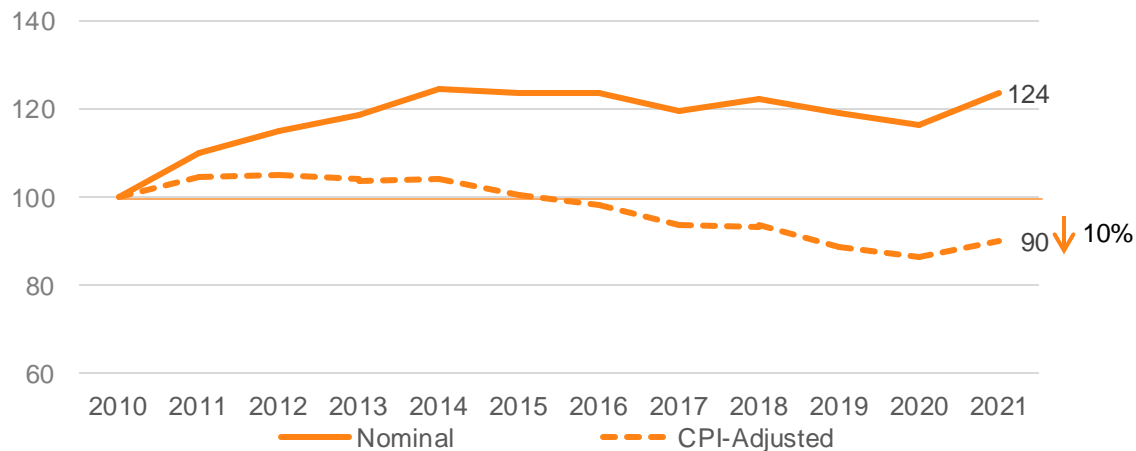
## Finding II: Nominal and CPI-adjusted audit fees

### Mean audit fees



- Audit fees have not kept pace with inflation, regardless of whether we are looking at mean fees or median fees.
- The absence in real growth in audit fees may signal margin erosion
  - If situation persists, it may adversely affect the ability for firms to upskill their workforce or invest in new technology. **Audit quality will be adversely affected** as a result.

### Median audit fees



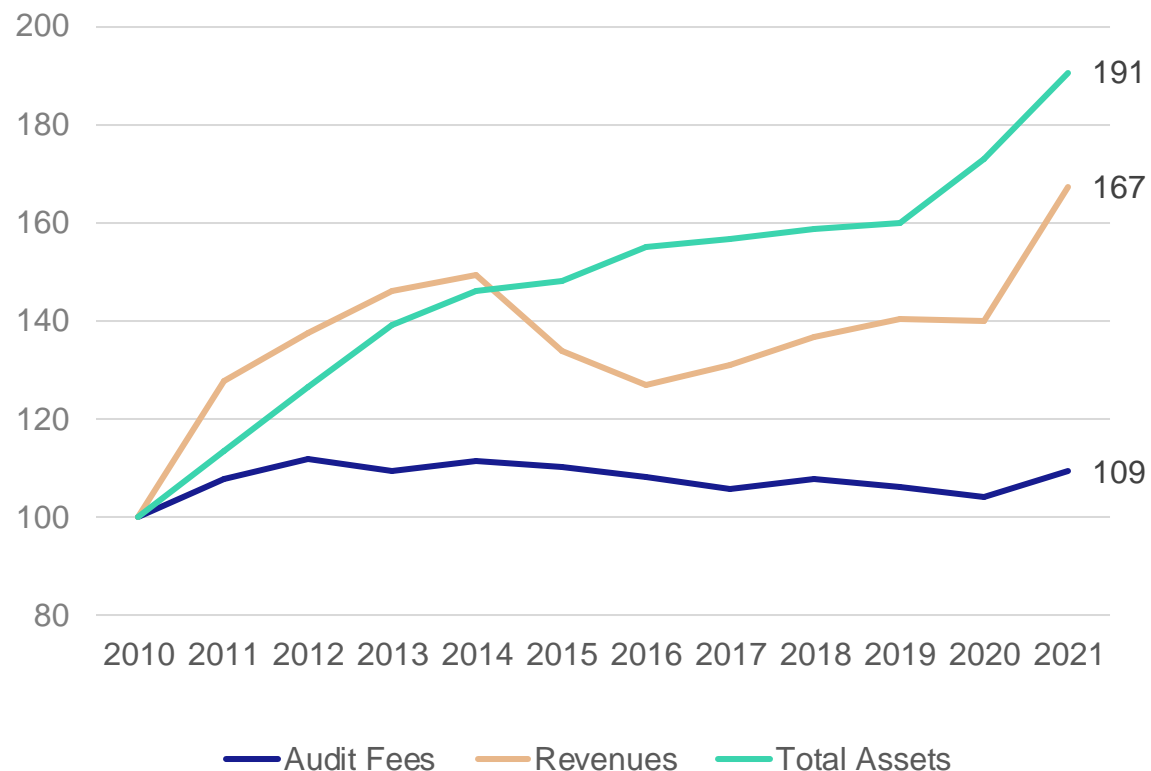
Note: Both nominal and CP-adjusted audit fees are shown here as indices, with their 2010 values rebased to 100.





## Finding III: Average audit fees, revenues and total assets

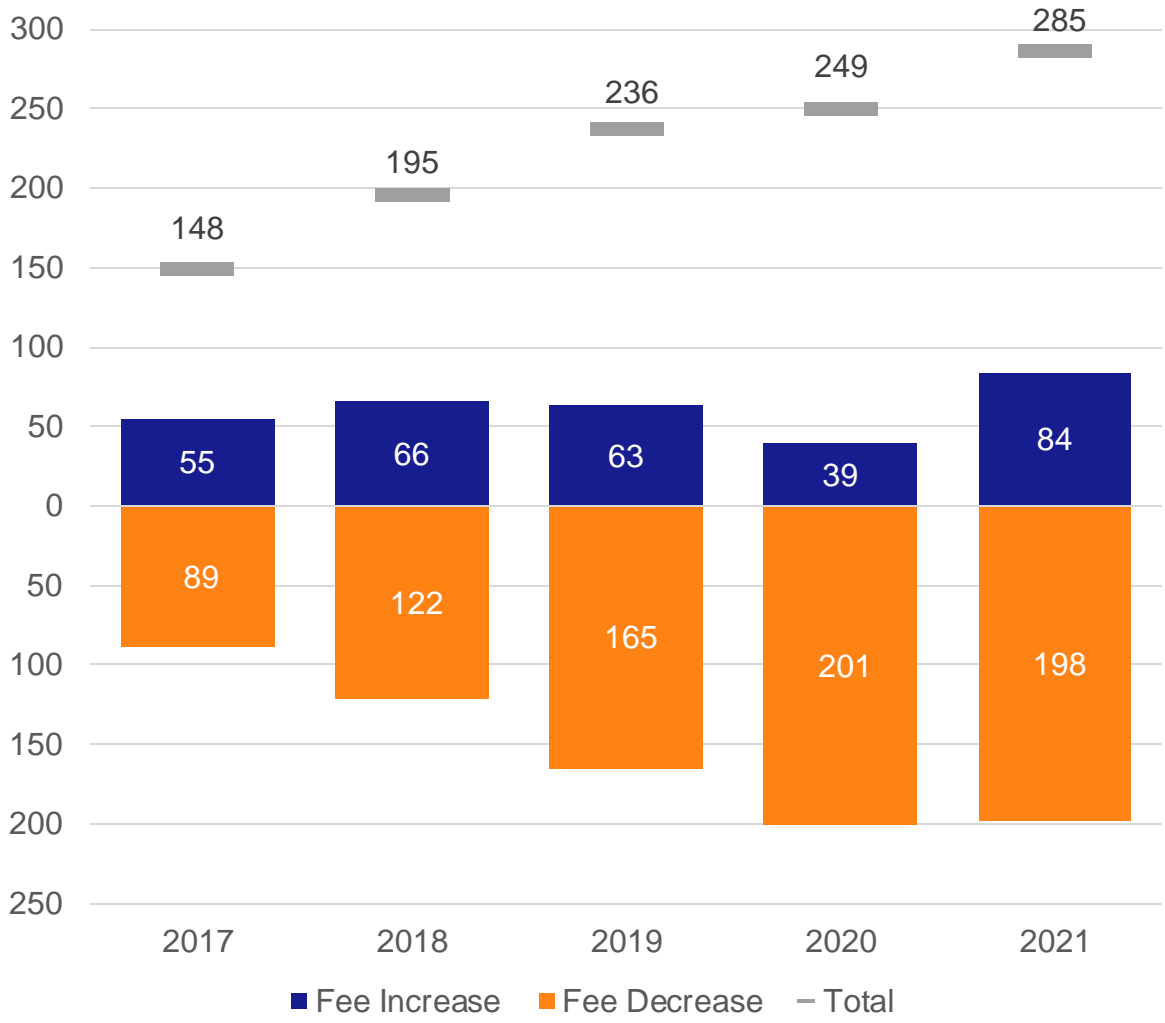
### Index of audit fees, revenues and total assets



- Growth of audit fees significantly lags behind the growth experienced by listed companies and the level of complexity in the underlying business.
  - Revenue and total assets were used as indicators of company size and proxies for audit complexity.
  - Between 2010 and 2021, the average total assets of listed companies in Hong Kong increased by 91% and average revenue by 67%, but average audit fees only by 9%.

Note: Audit fees, revenue and total assets are computed as average values to ensure they are comparable across years. Each series is depicted as indices, with their 2010 values rebased to 100.

# Finding IV: Number of listed companies that changed auditors and subsequent fee movements



- The number of listed companies that changed auditors has been on the rise since 2011, and it has increased rapidly in the last five years.
- More than half of the listed companies who changed auditors experienced a fee reduction.
- Among the 534 listed companies that changed auditors in 2020 and 2021, audit fees were the most cited reason (346 times or 64.8%).

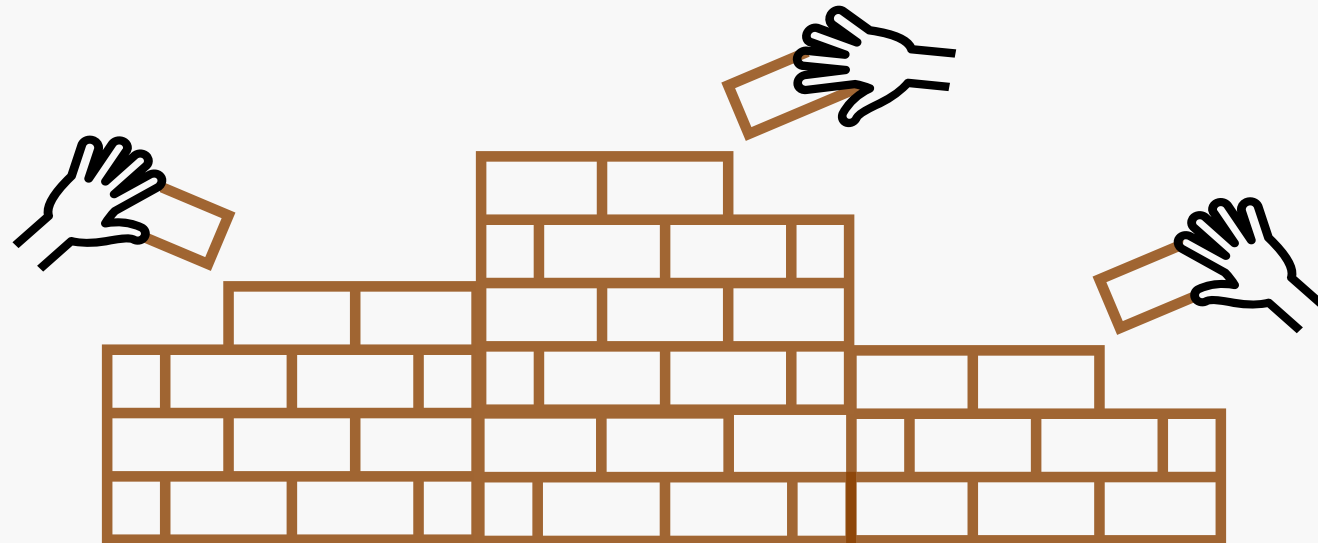
Note: The total population includes the listed companies that did not experience any fee changes following a switch in auditor.



## 5. Key messages to stakeholders



# The pursuit of advancing financial reporting and audit quality requires your compliance





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

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