

Late Changes in Auditor Appointment

Mr. Marek Grabowski

28 March 2023

Introduction and Agenda



Outline of presentation

1. AFRC engagement with INEDs and Audit Committees p.6
2. Late changes in auditor appointment p.10
3. Recent AFRC reports on audit fees and implementation of AFRC Guidelines for effective Audit Committees p.19
4. Your comments and questions p.33

AFRC engagement with INEDs and Audit Committees



- Shaping a competitive environment that nurtures and promotes success of the profession
- Enhancing the quality of financial reporting and auditing
 - To protect the interests of investors and the wider public interest in financial reporting and auditing
 - To maintain Hong Kong's status as a competitive International Financial Centre
- Influencing market behaviours to achieve our mission through:
 - Dialogue, understanding and collaboration
 - Law and governance
 - Thought leadership

- Financial Reporting
 - Capital markets thrive on efficient dissemination of information to investors
 - Financial reporting is designed to provide decision useful information to investors and is pivotal to the efficient functioning of capital markets

- Auditing
 - Is an independent auditor's risk-based evidence gathering process and evidence-based evaluation to obtain assurance about the quality of financial reporting
 - The resulting auditor's opinion enhances investor confidence in financial reporting quality and reduces information risks and the cost of capital

Enhancing engagement with INEDs and Audit Committees

- Audit Committees perform a pivotal governance role:
 - Overseeing financial reporting process and outputs
 - Making recommendations and decisions for the Board to support the Company's duty to maintain an appropriate relationship with its auditor

- The AFRC and audit committees have shared goals:
 - Investor protection and the wider public interest
 - Quality of financial reporting and auditing
 - A market environment in which auditors are free from undue pressure that could compromise audit quality

- Purpose of AFRC in seeking engagement with INEDS and audit committees is dialogue to foster effective understanding and collaboration

- How can we enhance our engagement with you?

- Establishing direct contacts with you?

Late changes in auditor appointment



When is a change in auditor appointment late?

- Normal auditor appointment cycle (e.g. for 31 December financial year)
 - Auditor appointed/ reappointed at AGM (June)
 - Auditor conducts audit both before and after the financial year end (31 December)
 - Auditor completes audit prior to results announcement (31 March)
 - Auditor holds office until next AGM (June)
- A change in auditor appointment can be at the AGM (retirement or termination) or between AGMS (resignation or removal)
- A late change in auditor appointment means a change:
 - (a) close to (within one month before); or
 - (b) after,
the financial year end
- Our current focus is on late resignation by auditors
 - There are virtually no removals, which require approval at an EGM
 - Retirements and terminations occur at the time of the AGM

Late changes in PIE auditor appointment – background

1. AFRC monitored changes in PIE auditors based on public announcements from December 2019
2. AFRC issued a Guideline requiring notification to the AFRC of changes of auditor in February 2021
3. AFRC issued Open letter to PIE auditors in October 2022:
 - A surge in late auditor resignations for December financial year ends from 71 (2020) to 107 (2021)
 - Late changes may indicate issues in the financial statements or difficulties in performing the audit
 - Audit quality may be compromised due to limited time for the incoming auditor to plan and perform their audit to meet the results announcement deadline
 - AFRC expressed growing concerns and set out its expectations of outgoing and incoming auditors
4. AFRC issued further Open letter to PIE auditors and Audit Committees in January 2023:
 - AFRC noted its continuing concerns and new developments since October 2022
 - Set out further AFRC expectations of outgoing and incoming auditors
 - Set out AFRC expectations of Audit Committees

How many late resignations by auditors are there?

FY End (31 December)	No. of late resignations	
	(1 December of FY to 31 August to next FY)	(1 December of FY to 15 March of next FY)
2020	71	56
2021	107	75
2022	[N/A]	51

FY = Financial Year

Late auditor resignations (related to listed entities with a 31 December year end)

Reasons for auditor resignations

	Auditor resigned between 1/12/2021-15/3/2022		Auditor resigned between 1/12/2022-15/3/2023	
Audit fee	64	85%	39	76%
Unresolved Audit Issues	6	8%	6	12%
Auditor rotation due to corporate governance considerations	-	N/A	2	4%
Others	5	7%	4	8%
Total	75		51	

Late auditor resignations (related to listed entities with a 31 December year end)

Change in auditor categories:

	Auditor resigned between 1/12/2021-15/3/2022	Auditor resigned between 1/12/2022-15/3/2023	Change
Downward shift	49	22	(27)
Same category	14	22	8
Upward shift	2	2	-
No subsequent appointment	5	2	(3)
Transition between recognised and registered PIE auditors	5	3	(2)
TOTAL	75	51	(24)

Remarks:

- A higher proportion of the appointments were taken up by incoming auditors who are of comparable size and scale as the outgoing auditors
- No downward shift associated with large-cap entities.

Downward shift vs. size of the listed entities:

	Auditor resigned between 1/12/2021-15/3/2022			Auditor resigned between 1/12/2022-15/3/2023		
	Mid-cap	Small-cap	Total	Mid-cap	Small-cap	Total
Category A to B	3	25	28	-	15	15
Category A to C	1	10	11	1	2	3
Category B to C	-	10	10	-	4	4
TOTAL	4	45	49	1	21	22

Market capitalisation

small-cap companies: less than HK\$2 billion

mid-cap companies: from HK\$2 billion to HK\$10 billion

large-cap companies: more than HK\$10 billion

Observation	Concerns
<p>Reasons for late resignation may be generic and not the root cause</p> <ul style="list-style-type: none">▪ e.g. audit fee disagreement, professional risks, internal resources, corporate governance considerations, auditor requested to resign	<ul style="list-style-type: none">▪ Company announcement may omit relevant disclosures▪ Company may be reluctant to address audit issues or maybe opinion shopping▪ Outgoing auditor may be seeking to avoid responsibility to complete audit and report on financial statements▪ Incoming auditor may not be fully informed about audit risk
<p>Incoming auditor's experience and resources and time to complete the audit (often with unmodified opinion) seem disproportionate to the scale and complexity of the audit.</p>	<p>Audit quality may be compromised</p>
<p>Premature announcements by listed companies of the appointment of an incoming audit (prior to completion of acceptance procedures)</p>	<p>Could provide inaccurate or misleading information to the market</p>

Outgoing auditors

1. Comply fully with Section 300 of Chapter C of the Code of Ethics for Professional Accountants
2. Make every reasonable effort to discharge duty to complete the audit by reporting to shareholders on the financial statements
 - Do not seek to avoid fulfilling this duty by resigning
 - If considering resigning, discuss related contentious issues with audit committee and seek its assistance to address them and complete the audit
3. Communication with Audit Committee and Board in resignation letter
 - Set out all circumstances[#] leading to the resignation in precise terms (root cause) not a general statement
 - AFRC also reminds outgoing auditors of their duty to respond to an incoming auditor's specific enquiries and give access to working papers available on unresolved issues
4. Company's announcement on change of auditor
 - Notify Audit Committee and Board of any material difference in the disclosure of circumstances in the announcement and in their resignations letter
 - If Company response to such a material difference is inadequate, consider notifying the relevant regulator

[#] *Circumstances are all occurrences that affect the relationship between the Company and the auditor
Occurrences include but are not limited to "disagreements" and "unresolved issues"*

Incoming auditors

- Request copy of outgoing auditor's resignation letter and related correspondence directly from Company
- Request professional clearance from the auditor
- Take all reasonable steps to identify relevant facts and circumstances before accepting appointment and obtain a thorough understanding of any unresolved audit issues
- Evaluate the audit implications of the circumstances in the resignation letter
- Maintain professional scepticism, particularly when the circumstances disclosed are generic
- Don't allow Company to disclose your appointment before completing your acceptance procedures. Request Company to clarify its announcement if you become aware of premature disclosure

1. Take action to ensure the Company does not seek to avoid addressing unresolved audit issues by changing auditors or requesting auditors to resign
2. Have open and honest discussions with the auditor, if they seek to resign, to understand and form an independent view of the underlying root cause
3. Make best efforts to resolve any disagreements or unresolved issues between management and the auditor
4. Ensure that the announcement of a change in auditor sufficiently includes the circumstances leading to the resignation and the basis for selecting the incoming auditor (following section 6 of the AFRC guidelines) and is factually correct and not misleading
5. Follow section 2 of the AFRC Guidelines when selecting an incoming auditor
6. Ensure incoming auditors fully understand the circumstances relating to the resignation and that they receive the information needed to conduct thorough acceptance procedures and design audit procedures
7. Facilitate communications between incoming and outgoing auditors

Recent AFRC reports on audit fees and implementation of AFRC Guidelines for effective Audit Committees

Audit Fee report

- This report updates our analysis of the audit fees paid by listed companies in Hong Kong in the period between 2010 and 2019 published in March 2021 for audit fees paid in 2020 and 2021

Key findings

Average (“mean”) and median audit fees

- Both average and median audit fees were stagnant in 2020 as compared with 2019, but recovered some ground in 2021
 - From 2010 to 2021, the average and median audit fees stagnated with a CAGR of 0.8% and 1.9%, respectively
 - Both measures contain important information about the market. While average fee is a more comprehensive representation of the market as a whole, the median fee is more representative of the fees paid by a typical listed company.
- The continuing large gap between average and median audit fees reflects that the market is skewed towards a high number of engagements with lower fees
 - The number of engagements with audit fees above HK\$5 million constitute 20% of the market, but their fees represent 70.2% and 71.3% of audit fees in 2020 and 2021 respectively
 - The median may be a more relevant measure in considering a typical listed company, given the skewness in distribution towards lower fee engagements

Nominal and CPI-adjusted audit fees

- Audit fees have not kept pace with inflation, whether based on average or median fees
 - When adjusted for inflation, average and median audit fees show a decline of 20% and 10% respectively since 2010
 - The CAGR for CPI-adjusted average and median audit fees since 2010 are -2.0% and -0.9% respectively
- 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 could be adversely affected as a result

CAGR is the compound annual growth rate



Key findings (continued)

Growth in average audit fees, total asset book values and revenues

- Growth of audit fees significantly lags behind the growth experienced by listed companies and the level of complexity in the underlying business
 - Total asset book values and revenues 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 revenues by 67%, but average audit fees only by 9%

Key findings (continued)

Number of listed companies that changed auditors and 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
 - Out of the 249 and 285 listed companies changed auditors in 2020 and 2021, 201 (80.7%) and 198 (69.5%) experienced a fee reduction subsequent to the change
- Among the 534 listed companies that changed auditors in 2020 and 2021, audit fees were the most cited reason (346 times or 64.8%)

Report on Implementation of Guidelines for Effective Audit Committees

- Separate sets of survey questions were posed for audit committees and PIE auditors
- The survey for audit committees attracted 165 responses - a response rate of 6%
- The survey for PIE auditors attracted 63 responses – a response rate of 100% for local registered PIE auditors and of 82% for all PIE auditors

- Key questions covered by the surveys:
 - Overall implementation of the Guidelines
 - How auditors are evaluated and appointed
 - Pressures faced by PIE auditors

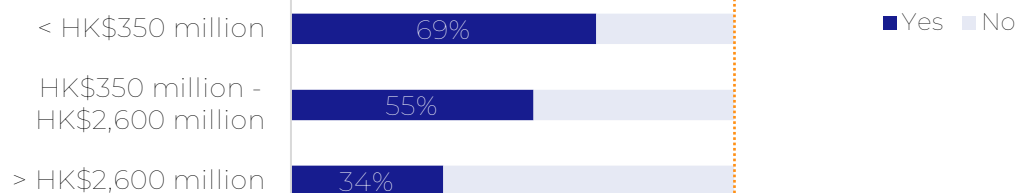
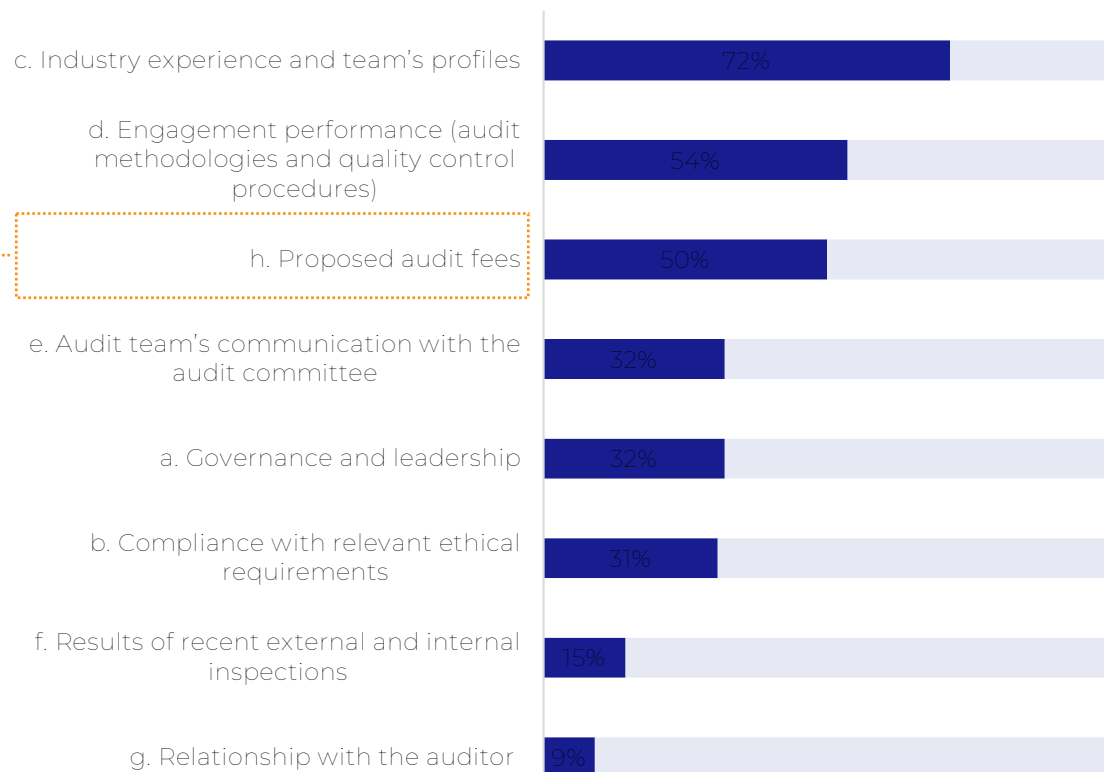
Key findings

Effectiveness of implementation of the Guidelines

- We asked PIE auditors to rate the overall effectiveness of the implementation of the Guidelines by audit committees
- Only one Category A PIE auditor (17%) believes that the audit committees they work with have implemented the Guidelines effectively
 - This is far lower than Overseas auditors, where 10 (or 71%) thought implementation was effective
- However, 97% of listed company respondents agree that they play a key role in enhancing and maintaining audit quality
 - This suggests audit committees may need more time to digest and implement the Guidelines effectively

Key findings (continued)

Factors considered by listed companies when selecting an auditor



- 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
- 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 in selecting an auditor
- Differences were not apparent based on the size of the listed company (as measured by market cap), save for proposed audit fees
- There appears to be some inconsistencies in the factors audit committees evaluate:
 - “Results of recent external and internal inspection” is only ranked second last, however, it is a more direct measure of the audit firm’s capability as compared to “Engagement performance”
 - This shows that audit committees may not understand what is the most objective information to consider

Your comments and questions





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

Thank you

This presentation contains information compiled by the AFRC which is not intended to be exhaustive. The information has been prepared in general terms for reference only, without considering specific circumstances pertaining to any individual or individual case. It does not constitute advice from the AFRC and cannot be relied upon to cover specific situations. You should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. The AFRC does not accept any liability (whether in tort or contract or otherwise) for any loss or damage arising from any inaccuracy or omission or from any decision, action or non-action based on or in reliance upon information contained in this presentation.

