

Press Release

14 December 2021

FRC completes an investigation relating to an auditor's failure to obtain necessary evidence to conclude that an associate was not impaired

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 in relation to the impairment assessment of the Listed Entity's investment in an associate (**the Investment**). The Investment was included in the Listed Entity's consolidated financial statements for the year ended 31 December 2018 (**2018 Financial Statements**).

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 December 2019, following a complaint received in May 2019.

Impairment assessment of the Investment

Hong Kong Accounting Standard (**HKAS**) 28 *Investments in Associates and Joint Ventures* requires an entity after the application of the equity method to recognise an impairment loss if the recoverable amount is less than the carrying amount of the investment.

In this case, the associate continuously incurred losses in the years 2017 and 2018 and had net liabilities as at 31 December 2018. The Listed Entity considered that the Investment was not impaired with reference to a valuation report.

The audit quality failure of the Auditor

Determining the recoverable amount of the Investment involved significant judgements and estimates in appraising the future financial performance of the associate and the relevant business which are subject to a high level of estimation uncertainty and inherent risk of material misstatement.

The investigation revealed that the Auditor failed to properly exercise professional skepticism, in accordance with applicable standards (see below), and failed to perform adequate procedures to:

- (a) review the outcome of the accounting estimates included in the prior period financial statements to identify circumstances or conditions that increase the susceptibility of

accounting estimates or possible management bias;

- (b) properly evaluate the reasonableness of the significant assumptions adopted in the valuation and the resulting estimation of the recoverable amount of the Investment for the purpose of impairment assessment; and
- (c) properly evaluate the relevance and reliability of the source data used in the valuation for the purpose of impairment assessment.

The engagement quality control reviewer also failed to adequately perform the review required by the relevant standard (see below). In particular, failure to adequately challenge the engagement team's decisions on the impairment assessment of the Investment.

Accordingly, the engagement partner and the engagement quality control reviewer also failed or neglected to observe, maintain or otherwise apply the fundamental principle of professional competence and due care in the Code of Ethics for Professional Accountants.

Relevant technical standards

HKAS 28 *Investments in Associates and Joint Ventures* prescribes the principles and requirements for the recognition, measurement and disclosure in relation to investments in associates and joint ventures.

HKAS 36 *Impairment of Assets* prescribes the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

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 220 *Quality Control for an Audit of Financial Statements* prescribes the performance by an engagement quality control reviewer of an objective evaluation of significant judgements made by the engagement team, and the conclusion reached in formulating the auditor's report.

HKSA 500 *Audit Evidence* prescribes the overarching requirement to design and perform appropriate audit procedures to obtain "sufficient appropriate audit evidence" and sets out what constitutes such evidence.

HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and HKSA 330 *The Auditor's Responses to Assessed Risks* and other relevant HKSAs are to be applied in relation to accounting estimates. It also includes

requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Code of Ethics for Professional Accountants is a guidance on ethics for professional accountants.

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.

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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.

For media enquiries:

Celian Cheung

Associate Director, Corporate Communications

Financial Reporting Council

Tel: (852) 2236 6025

Fax: (852) 2810 6320

Email: celiancheung@frc.org.hk