

## The FRC summarizes its experience from the review of modified auditors' reports

(14 December 2009, Hong Kong) The Financial Reporting Council (the "FRC") started to proactively review modified auditors' reports of financial statements of entities listed in Hong Kong on 16 July 2008, a year after it became fully operational, with a view to identifying possible non-compliances with accounting requirements.

Among the 1,611 auditors' reports issued from 16 July 2008 to 30 September 2009, 146 (9.06%) are modified auditors' reports and had been screened by the FRC. Except for the 84 reports related to emphasis of matter only (i.e. matters that do not affect the auditor's opinion), reviews were performed on the other 62 reports. These 62 reports can be categorized as (1) no issue of non-compliance, (2) possible non-compliance but follow-up action would not bring any benefit, and (3) possible non-compliance identified with follow-up action.

### **No issue of non-compliance**

According to the FRC, certain issues identified in the modified auditors' reports are not issues of non-compliance with accounting requirements. These issues include uncertainty if the listed entities can continue as a going concern and other business uncertainties.

### **Possible non-compliance but follow-up action would not bring any benefit**

The FRC had reviewed cases in which auditors were unable to obtain sufficient information and evidence to support an unqualified opinion, or there were no proper books and records for subsidiaries. These cases may involve non-compliances. However, in the absence of information, and/or proper books and records, there were insufficient grounds on which the FRC may consider taking action. It does, however, reflect on the quality of the management of the listed entities concerned. In addition, it reflects on the effectiveness of the audit committees which are to supervise the process of the issue of financial reports and internal controls. The FRC had reported to the relevant regulatory body on some of these cases.

On the other hand, the FRC will take into account the benefits to investors in deciding on the follow-up action to be taken. Under normal circumstances, no further action will be taken by the FRC if (1) the modification relates to events in previous years and has no impact on the future, (2) the shares of the listed entities have been suspended from trading for some time, and (3) the listed entities are under liquidation or provisional liquidation.

### **Possible non-compliance identified with follow-up action**

There are four cases in which the FRC have identified non-compliance with accounting requirements and have taken follow-up action. Coincidentally, all these cases are related to the impairment of assets. Among these four cases, two enquiries were initiated. Of which one was completed and the other is in progress.

For the other two cases, since either the non-compliance is unlikely to cause a material misstatement in the financial statements concerned or the auditor has sufficiently reported on the case, the FRC considered that formal enquiries were unnecessary and has advised the listed entities of the findings of their review and suggested improvement for the future.

Mr. M.T. Shum, the Chief Executive Officer of the FRC, said "Although certain issues identified in the modified auditors' reports, e.g. going concern and business uncertainty, are not issues of non-compliance with accounting requirements, investors are reminded to take note of the difficulty of the listed entities continuing as a going concern and the significance of the business uncertainty identified by the auditors in making their investment decision in relation to these entities."

"The primary responsibility for reliable financial reporting rests with the accountants and directors of listed entities. As key providers of financial information, management should ensure that sufficient information and evidence is provided to auditors and that proper books and records are kept for the listed entities and its subsidiaries and associates. Auditors should notify the audit committee should there be any information or evidence missing for the audit. The higher the quality maintained by the accounting and auditing profession, the stronger our markets." Mr. Shum added.

"For the enquiry completed, it is understood that in preparing its latest financial statements, the listed entity in question performed the value-in-use calculations for measuring the recoverable amounts of the property, plant and equipment taking into account all the findings in the FRC's enquiry report. We are pleased to know that our review of modified auditors' reports does help to uphold the quality of financial reporting of listed entities in Hong Kong." Mr. Shum concluded.