Accounting and Financial Reporting Council
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To Public Interest Entity (**PIE**) Auditors and Members of Audit Committees

Additional issues regarding late changes in auditor appointments

Independent quality audit is pivotal to financial reporting, market confidence, and the effective functioning of capital markets. While auditors have the primary responsibility for audit quality, audit committees also have an undeniable role in overseeing the processes relating to both financial reporting by listed entities and auditing by external auditors. Through such oversight, audit committees can better discharge their fiduciary obligations, uphold and maintain audit quality, and ensure compliance with legal and regulatory requirements.

In our open letter issued on 27 October 2022 (the **last open letter**), the AFRC expressed concerns about the surge in the number of late PIE auditor resignations and reminded both outgoing and incoming auditors of their responsibilities in such situations. We are concerned with the potential compromise on audit quality when the incoming auditor has limited time to plan and conduct a proper audit ahead of the deadlines for announcing audited results. The purpose of this follow-up letter is to reiterate our expectations of both the PIE auditors and audit committees regarding auditor changes.

Since the issuance of the last open letter, between 1 November and 31 December 2022 (the **Period**), there were 56 auditor resignations, representing a 15% decrease from 66 for the same period in 2021. The key reasons underlying these resignations, as disclosed in listed entities' announcements, are summarised as follows:

Key reasons for auditor resignation, as disclosed in listed entities' announcements	**From 1 November to 31 December 2022** (number / percentage of total)	**From 1 November to 31 December 2021** (number / percentage of total)
Disagreement over audit fees	44 / 79%	59 / 89%
Unresolved audit issues	5 / 9%	2 / 3%
"Corporate governance" i.e., voluntary rotation to avoid entrenchment	4 / 7%	- / -

The data shows that compared with one year ago, the number of auditors attributing their resignations to disagreements over audit fees has decreased, with corresponding increases in other reasons, such as unresolved audit issues or corporate governance considerations. We observed an improvement in the quality of disclosures in the listed entities' announcement, with more details about the facts and circumstances leading to an auditor's resignation, rather than just a generic statement typically used when audit fees were the nominal reason.

Notwithstanding the improvements observed above, we remain concerned about certain market developments (such as the use of voluntary rotation under the guise of good corporate governance) in the Period, and their implications on audit quality as well as on the wider issue of market discipline such as opinion shopping. We elaborate our concerns further below.

Our observations and concerns

(i) Auditors were requested to resign by listed entities as a result of issues identified in audits

During the Period, there were five instances where unresolved audit issues were cited as a reason, and all of the five resignations were requested by listed entities. This shows that some listed entities were reluctant to resolve issues and, more worryingly, a possibility of opinion shopping.

Furthermore, when we made enquiries to the incoming auditors of these listed entities about their plans to address the unresolved audit issues as disclosed in the change of auditors' announcement made by the listed entities, one of the incoming auditors was totally unaware of the disclosed unresolved audit issues. This shows that some auditors failed to exercise professional scepticism and due care when accepting audit engagements. This is in direct opposition of the fundamental obligations of an auditor.

(ii) "Corporate governance considerations" is misused as a reason for auditor resignations

A growing number of listed entities attributed auditor resignations to the rotation of firms for corporate governance considerations. In two instances, the audit firms have only been auditors for their respective listed entities for a relatively short period of time (not more than four years), and they were both reappointed at the most recent annual general meetings (**AGM**s). A proper rotation would take place at the time of AGM instead of mid-cycle, providing shareholders with the ability to scrutinise and question the selection and appointment of the incoming auditor. It would also be communicated well in advance of the AGM. In view of the above, we are sceptical of such reasoning and are concerned that listed entities are using this as a generic reason for auditor changes.

(iii) Premature announcements regarding the appointment of an incoming auditor

There were two instances in which a listed entity announced that it had resolved to appoint or has already appointed a particular PIE auditor as the incoming auditor, even though the incoming firm has not yet completed its client and engagement acceptance procedures. Such announcements were premature and could be construed as providing inaccurate and misleading information to the market.

(iv) Using "disagreement over audit fees" as a catch-all explanation for auditor resignations

As the AFRC repeatedly asserted before, disagreement over audit fees should not be used as a catch-all reason for resignations. However, generic statements on disagreement over audit fees remain the predominant reason for the changes in auditor appointments during the Period. We are unconvinced of such reasoning given that audits for the December 2022 year-end financial statements should have already been commenced in the Period, with related audit fees having been agreed in advance. We are concerned that this may suggest deeper underlying issues in the financial statements of the listed entities, and fees may not be the root cause of auditor resignations.

Our expectations of auditors

With respect to the above issues identified during the Period, we set out our following expectations of auditors in addition to those covered in our last open letter:

(i) For incoming auditors

a. Obtaining a professional clearance letter from the outgoing auditors and making enquiries to company management and audit committees are necessary but not sufficient. Incoming auditors must take all reasonable steps to identify relevant facts and circumstances before making acceptance decisions. In particular when there are unresolved audit issues, incoming auditors must consider performing additional procedures such as reviewing correspondences between the outgoing auditors and the listed entities; and corroborating responses from listed entities through specific enquires with the outgoing auditors or request access to audit working papers. This will allow incoming auditors to obtain a more thorough understanding of the issues.

b. Incoming auditors must maintain professional scepticism when performing client and engagement acceptance procedures, especially when the resignations were triggered by a disagreement over audit fees, corporate governance considerations or when the resignation was requested by the listed entities.

c. Prospective incoming auditors must not allow their identities to be disclosed before the client and engagement acceptance procedures are duly completed. In the event that a premature disclosure is made by the listed entity, the PIE auditor should promptly notify the listed entity and request a public clarification.

(ii) For outgoing auditors

a. Under section 200.36 of Part C of the *Code of Ethics for Professional Accountants*, outgoing auditors have an ethical obligation to respond to the incoming auditors' specific enquiries and, inter alia, should make working papers available relating to matters of continuing accounting significance in respect of unresolved audit issues.

b. Outgoing auditors must detail in their letters of resignation the specific circumstances, including any significant matters or audit issues, resolved or unresolved, that led to their resignations. Specifically for resignations as a result of disagreement over audit fees, the AFRC expects the outgoing auditors to disclose in detail the underlying cause of the disagreement.

Our expectations of audit committees

As mentioned above, audit committees play a critical role in investor protection and are relied upon by boards of directors and shareholders to provide oversight of financial reporting and auditing. They should not seek to avoid addressing unresolved audit issues by changing auditors or requesting auditors to resign. We urge audit committees to follow the Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors (the **Guidelines**) in discharging their responsibilities regarding auditor appointments. Below, we highlight the most pertinent features that will enable audit committees to best discharge their fiduciary obligations:

(i) *Dialogue with the incumbents:* When an incumbent auditor resigns, audit committees should have open and honest discussions with them to understand and form an independent view of the underlying causes of the resignation. This should include the examination of all unresolved audit issues and asking probing questions to management and the incumbents.

(ii) *Resolve outstanding issues:* Audit committees should not assume that resignation is the only way out. If disagreements on unresolved audit issues between management and the incumbent auditor are the main cause of the resignation, audit committees should make their best efforts to resolve the issues by agreeing follow-up actions with management and the incumbent auditors. They should also closely monitor the implementation of such actions.

(iii) *Full disclosure:* In case the incumbent auditor decides to proceed with their resignation, audit committees should review the listed entity's draft announcements. While there are no specific disclosure requirements, audit committees should ensure the circumstances leading to the auditor's resignation and the basis for selecting the incoming auditor are sufficiently disclosed, following section 6 of the Guidelines. Audit committees also have an obligation to ensure that disclosures are factually correct and not misleading when it comes to the appointment of auditors.

(iv) *Selecting an incoming auditor:* When selecting an incoming auditor, audit committees should follow section 2 of the Guidelines and ensure that the incoming auditor possesses the necessary competence and capabilities (including manpower, time and other resources) to perform a high quality audit and resolve outstanding audit issues within the timeframe. While audit fee levels are important, they should not be the only consideration. The consideration of audit quality should outweigh audit fees.

(v) *Communications with incoming auditors:* Audit committees should ensure incoming auditors understand the circumstances relating to the auditor resignation. Incoming auditors should be provided with sufficient information to enable them to conduct thorough client and engagement acceptance procedures, as well as design and perform appropriate audit procedures. Audit committees should facilitate communications between the incoming and outgoing auditors.

Next steps for AFRC

The AFRC will take necessary follow-up actions to ensure that our reminders in the open letters are adequately addressed by PIE auditors when resigning from and taking on late engagements.

Yours faithfully

Mary Leung	Janey Lai
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