CPA Australia Ltd
ABN 64 008 392 452
20/F Tai Yau Building
181 Johnston Road
Wanchai, Hong Kong
T +852 2891 3312
F +852 2832 9167
E hk@cpaaustralia.com.au
cpaaustralia.com.au

21 May 2021

Dear Kelvin,

Re: FRC Overview of the Market for Listed Entity Audits in Hong Kong

CPA Australia appreciated the opportunity to meet with the FRC to discuss your report on the *Overview of the Market for Listed Entity Audits in Hong Kong* (FRC report) and the FRC's new inspection function. We would like to take the opportunity to provide our response to the FRC's report and reflect on our experience of audit inspections in Australia and New Zealand.

We welcome the FRC's analysis of the market for listed entity audits. This will serve to inform your regulatory approach, policy development and audit inspection program by providing an understanding of current competition, concentration and other relevant issues in the Hong Kong audit market.

In addition to the views expressed in our meeting with the FRC on 8th April, we make the following comments and observations:

Market concentration in other jurisdictions

We note that the findings from other jurisdictions may not be strictly comparable to the FRC's findings due to differences in how the FRC has categorised the data in the report compared with other jurisdictions. Nonetheless, there are still useful insights to be gained from examining the findings from other jurisdictions.

Australia

According to a 2019 research report on the *Audit Market Structure and Competition in Australia (2012 – 2018)* commissioned by the Audit and Assurance Standards Board (AUASB), the listed audit market share of the Big Four auditors in Australia declined from 40.7 per cent in 2012 to 37.7 per cent in 2018. The market share of the six largest providers of audit services[1] in Australia was 58.3 per cent in 2018, down from 63.0 per cent in 2012.

Of note, about one-third of the listed companies in Australia are from the mining industry and the Big Four have a lower market share of audit clients from that sector (25.7 per cent in 2018) relative to their market share of audit clients from other industries (43.8 per cent in 2018). This may be due to the large number of small mining companies listed on the Australian Securities Exchange.

When measured using audit fees, the Big Four received 86.5 per cent of total audit fees in Australia in 2018 whilst the six largest audit firms collectively received 91.7 per cent. This represents a slight decline from 87.1 per cent and 92.5 per cent in 2012, respectively.

By market capitalisation of listed companies, the AUASB report found the market is highly segmented with 94 per cent of the largest 200 listed companies in Australia audited by the six largest audit firms in 2018 (92 per cent were audited by the Big Four and 2 per cent were audited by BDO or Grant Thornton). The audit market is moderately concentrated for other large entities but not concentrated for the medium and small listed audits.

Nevertheless, in our submission to the Australian Parliamentary Joint Committee on Corporations and Financial Inquiry Regulation of auditing in Australia we note that: "*concentration is not necessarily a reflection of lack of competition but rather could be a reflection of audit firm's capacity to undertake certain audit engagements*."

[1] Big Four, BDO and Grant Thornton.

Our submission points out that some of our members in Australia "*indicate that mid-tier audit firms do not necessarily have the industry specialisations, scale, geographic spread or resources to tender for or undertake audits of the ASX 200, so may not choose to take on such clients*."

Malaysia
According to a 2019 academic article by the University Utara Malaysia (UUM), on the basis of the number of audits of Malaysian publicly listed companies, the Big Four had a share of 43.0 per cent in 2016, down from 48.2 per cent in 2012.

However, unlike other jurisdictions, the Big Four are not the four largest audit firms in Malaysia. According to the UUM article, the four largest audit firms in the 2012 – 2016 period were: EY, KPMG, Crowe Horwath and Baker Tilly. In this regard, the market share of the Big Four plus Crowe Horwath and Baker Tilly was 61.5 per cent in 2016, down from 65.9 per cent in 2012. The article did not analyse the market share by audit fees, this may have shown a different result.

Singapore
According to a 2020 public report by the Accounting and Corporate Regulatory Authority (ACRA), the Big Four collectively audited about 55 per cent of the companies listed on the Singapore Stock Exchange as of 31 December 2019, down from 58 per cent in 2018.

Audit quality and observations in relation to auditor oversight in Australia and New Zealand

The Australian Securities and Investment Commission (ASIC) and the Financial Markets Authority (FMA) are responsible for auditor oversight in Australia and New Zealand respectively. Both are members of the International Forum of Independent Audit Regulators (IFIAR). IFIAR published a survey of inspection findings arising from its member regulators' individual inspections of audit firms affiliated with the six largest global audit firm networks. See: 2020 Survey of Inspection Findings.

Both ASIC and the FMA publish reports on the outcomes of their auditor oversight programs, along with guides targeted at both directors and auditors aimed at improving audit quality:

- ASIC:
  - ASIC Audit inspection report: 1 July 2019 to 30 June 2020 and six largest international networks' individual firm inspection reports
  - ASIC Audit quality measures, indicators and other information: 2019–20
  - ASIC INFO 222: Improving and maintaining audit quality
  - ASIC INFO 223: Audit quality – the role of others
  - ASIC INFO 196: Audit quality – the role of directors and audit committees
- FMA:
  - Audit Quality Monitoring Report for 30 June 2020
  - Audit Quality - A Director's Guide
  - FMA's Investor's guide to auditing

We note that ASIC's audit inspections are risk based so the findings cannot be extrapolated across all audits. In addition, they are reported on key audit area rather than by audit file, so findings are not directly comparable to the IFIAR survey report. In contrast the FMA, whilst primary risk based, have begun to include a random sample of audit files in their monitoring reviews, and the FMA reports on audit files.

CPA Australia work very closely with ASIC and FMA to understand and communicate the outcomes of their audit oversight programs, and guidance material published, so that auditors and their firms they can learn from those findings to maintain and improve audit quality. We assist the regulators promote this work through our weekly member newsletters. Another popular communication channel is podcasts. Recent examples of joint podcasts between CPA Australia and the regulators include:

- ASIC Report on Audit Quality Measures (7th February 2021)
- ASIC Audit Inspection Report: How to improve audit quality (15th January 2021)
- New Zealand Audit Quality Monitoring Report: A discussion (18th December 2020)
- ASIC speaks on improving and maintaining audit quality and the role of others

Overall, we have found that the more collaborative, constructive and transparent the regulators are in their approach to auditor oversight, the more receptive auditors and firms are to the findings and acting on them. Since 2019 ASIC have reported on the largest six international network firms' audit inspection findings individually. Every six months ASIC holds forums for auditors and audit committees covering both financial report surveillance and audit inspections.
In addition to supporting the regulators, CPA Australia undertakes projects aimed directly at improving audit quality. For example, CPA Australia and CA ANZ have jointly developed the following guides, with the Australian Public Policy Committee (APPC – comprising the six largest international networks):

- Improving audit quality using an individual recognition and accountability framework
- Improving audit quality using root cause analysis

CPA Australia provides commentary around how audit can be more effective, including an INTHEBLACK (ITB) article on the recommendations of the Inquiry into the Regulation of Auditing in Australia , an ITB article on the Monitoring Group reforms of international audit-related standard-setting, a submission to the IAASB on fraud and going concern in an audit of the financial statements, and further articles to raise awareness of audit quality challenges to be addressed, such as:

- Audit in Australia: A way forward
- Why is it proving so hard to lift audit quality?

Audit fees and non-audit service fees

In Australia, similar to the findings in the FRC report, a 2019 research report on *The Provision of Non-Audit Services by Audit Firms in Australia (2012-2018)* commissioned by the AUASB found that Big Four clients purchase a higher proportion of non-audit services from their audit firm relative to audit fees than clients of other firms (an average of 34.4 per cent in the period 2012 - 2018 relative to 29.9 per cent for large non-Big Four, 20.9 per cent for medium non-Big Four and 17.0 per cent for small non-Big Four firms). The level on non-assurance services has been raised by the Parliamentary inquiry into the Regulation of Auditing in Australia with their recommendations focus on more explicit prohibitions and greater transparency in disclosures.

In the UK, concerns regarding the extent of non-audit services provided by firms to their audit clients has been addressed in the Government's proposals for reform, including operational separation of audit and non-audit services with audit firms, which are discussed further below.

Observations in relation to current proposals for reform in Australia and the United Kingdom

In recent years, governments in both the UK and Australia have sought ways to address concerns with audit quality, competition and conflicts of interest. Whilst the UK has experienced several recent corporate collapses which precipitated a series of inquiries culminating in the UK Government's White Paper *Restoring trust in audit and corporate governance: proposals on reforms*, Australia's Parliamentary inquiry into the issues arose due to poor ASIC audit inspection findings coupled with public concerns about perceived conflicts of interest. The recommendations arising from both inquiries are worthy of wider consideration as they reflect an understanding of the importance of the whole reporting ecosystem working effectively with all participants playing their part to provide confidence in the information reported and in turn in capital markets.

The UK proposed reforms include:

- new reporting and attestation requirements for directors covering internal controls, dividend and capital maintenance decisions, and resilience planning
- the creation of a new, stand-alone audit profession
- measures to increase competition, by providing new opportunities for challenger audit firms
- reducing the potential for conflicts of interest, with new requirements for audit firms to separate their audit and non-audit practices; and
- measures to improve shareholder engagement including an advisory shareholder vote on the audit and assurance policy and opportunity to propose to the audit committee areas of emphasis to be considered within the auditor's annual audit plan.

The Australian parliamentary report's recommendations, to which the Australian Government has not yet responded, are not as far-reaching but have merit. They encompass:

- greater transparency in reporting of ASIC inspection findings
- increased disclosure of fees for non-assurance services provided by the auditor
- disclosure of audit tenure
- mandatory audit tendering
- review of fraud and going concern reporting requirements
- internal controls reporting
- digital financial reporting.

CPA Australia will be responding to the UK proposals and continue to work with standard-setters and regulators to address the Australian parliamentary inquiry's recommendations.

We commend the FRC for issuing the *Interim Inspection Report* in December last year, and we look forward to the first FRC annual inspection report and to working with the FRC to share your insights with our members.

Observations from our Hong Kong members

Our discussions with senior members have raised some matters relevant to the Hong Kong audit market which may be of interest to the FRC.

Audit fees

Some members note that the Hong Kong Stock Exchange (HKEX) will occasionally challenge the fees charged by the sponsor as well as the payment terms on the basis of whether the sponsor has performed sufficient due diligence. The members suggest that the FRC could also consider a similar approach when the audit fees charged by the PIE auditor are deemed to be too low.

Market concentration

Some members note that non-Category A or B audit firms may not have the resources, skill set and access to sufficient support across the technical accounting, taxation, valuation and IT domains to take on the audit of larger listed companies or to take on more audits. The members suggest that the FRC will need to seek a balance between lower market concentration and audit quality.

Members also stated that the penalty of up to HK$10 million for misconduct may deter smaller PIE auditors from taking on the audit of larger listed companies.

Geographical segmentation

Some members note that some of the non-Hong Kong incorporated listed entities are audited by non-Hong Kong PIE auditors registered with the FRC and that the quality of non-Hong Kong PIE auditors may vary.

We understand that in Singapore, PIE auditors for companies listed in the Singapore Stock Exchange must come from a local Singapore CPA firm regulated by the Accounting and Corporate Regulatory Authority. Whilst there are a variety of reasons why the HKEX allows listed companies from Mainland China and overseas to be audited by PIE auditors from Mainland China and other jurisdictions, some members are of the view that the FRC could consider requiring non-Hong Kong entities listed on the HKEX to be jointly audited by non-Hong Kong PIE auditors and Hong Kong PIE auditor. Under this requirement, the Hong Kong PIE auditor should be held accountable and be subject to penalties for any audit defects.

Switching of auditors

Some members believe that a possible reason for a listed entity to switch auditors is their unwillingness to accept the higher audit standard imposed by their past auditor. This switching may result in a deterioration of audit quality and the FRC should consider allocating sufficient resources to identify these cases.

Non-audit services
Some members are of the view that carrying out non-audit services may potentially weaken the independence of the PIE auditor. The members suggest that the FRC should consider the possibility of non-audit services, other than those which are required or beneficial to be conducted by the auditor, impairing the independence of the PIE auditor.

Effective audit
Some members have observed that the digital technologies are fundamentally changing the business models of many PIE's. In response to these changes, our members believe the audit approach needs to address the technologies relied on by the client. The FRC may need to focus on whether the auditor, regardless of whether they are Category A, B or C, has sufficient knowledge and resources invested in technology to conduct an effective audit for clients which are highly digitised.

If you require further information on the views expressed in our response to the FRC report, please contact Ms Claire Grayston FCPA, Policy Adviser Audit and Assurance at claire.grayston@cpaaustralia.com.au or Mr Jonathan Ng, Policy Adviser at jonathan.ng@cpaaustralia.com.au.

Yours sincerely,

Deborah Leung FCPA (Aust.)
Executive General Manger, International

Claire Grayston FCPA (Aust.)
Policy Adviser, Audit and Assurance