



## 2021 Annual Inspection Report

23 June 2022



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## About the FRC

The Financial Reporting Council is an independent body established on 1 December 2006 under the Financial Reporting Council Ordinance. It is entrusted with the statutory duty to regulate auditors of listed entities through a system of registration and recognition, and through inspection, investigation and disciplinary action.

The mission of the FRC is to uphold the quality of financial reporting of listed entities in Hong Kong, so as to enhance protection for investors and deepen investor confidence in corporate reporting.

To learn more visit <https://www.frc.org.hk> or follow us on LinkedIn.

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## Foreword from the Chief Executive Officer

I am pleased to share with the public our second Annual Inspection Report, which includes the full year results of our inspections of listed entity engagements and systems of quality control completed in 2021. The report includes a description of the common deficiencies in the engagements and firm-wide systems of quality control that we inspected and the actions we expect auditors, directors and audit committees to take to address them. This report also sets out the follow-up actions we have taken in respect of inspections completed in 2020 and our directional observations for audit firms on the implementation of the new and revised quality management and auditing standards.



### *Our findings and their key drivers*

**Our findings are about the quality of an audit and are not about the quality of listed entity financial reporting and should not be taken as being so.**

In 2021, the FRC achieved higher efficiency with a similar level of resources to 2020 by building on the experience gained from our first year of inspections. We completed 50 (up from 37 in 2020) engagement inspections and 17 (2020: 18) inspections of the systems of quality control of listed entity audit firms. In addition, we completed 4 narrow-focus inspections into potential non-compliance with applicable professional standards identified through our whistleblowing channel. The increase in the number of engagement inspections has enabled us to better serve and protect the investing public.

We are glad to see that many firms were responsive and proactive in improving their audits. The results of our inspections show that there has been a year-on-year improvement in overall audit quality as compared to the results of our 2020 inspections. 32% of the engagements we inspected (up from 27% in 2020) were rated as requiring no more than “limited improvements”, which is the standard we expect for listed entity audits.

There is a marked improvement in overall audit quality rating for engagements of the Category A firms and four inspected engagements were rated “Good”, the highest audit quality rating, for the first time. There was a significant reduction in the number of deficiencies identified in inspections of these firms in all but one of the common areas of findings we reported. This indicates that the Category A firms, as a group, are taking robust and effective action to improve their audit quality in response to our inspection findings in 2020. This should provide the investing public and the wider public with increasing confidence in the quality of financial reporting and audits of listed entities.

We found that the lack of adequate exercise of professional skepticism continued to be a common driver of poor audit quality. While there is still room to improve further, there has already been a significant improvement, with 46% of the engagements we inspected in 2021 having deficiencies in this area (down from 81% of the engagements inspected in 2020).

There are also significant reductions in the number of deficiencies identified in relation to the testing of journal entries and other adjustments, Key Audit Matters, the use of auditor's experts and the sufficiency of audit documentation.

In contrast, there has been an increase in the significance of deficiencies in the auditor's evaluation of management's application of the accounting standard for revenue. This is a crucial area of the audit because revenue is a key performance indicator for investors and many revenue recognition models are complex. We also identified an increase in the number of deficiencies in the auditor's evaluation of management's application of the expected credit loss model. This area is particularly challenging amidst the current economic environment and the appropriate exercise of professional scepticism by auditors is essential to achieving a quality audit in this regard. Auditors need to improve their work in these two areas urgently. Audit committees also need to take action to challenge listed entity management as to the appropriateness and implementation of the entity's revenue recognition policies and the assumptions used in the estimation of expected credit losses, and their auditors as to whether their audit work in these areas is adequate.

We also highlight in this report factors contributing to high quality audits and good practices we observed. Firms should consider and implement these, where applicable, to improve their audit quality. These factors include comprehensive audit planning and robust risk assessment, early and substantial involvement of the audit partner throughout the audit, robust challenge of management around key judgements and estimates, obtaining high quality information from the listed entity management and strong oversight exercised by audit committees. The last two factors highlight the significant synergistic benefits that management and audit committees can contribute in delivering high quality financial reporting and audits. Auditors should proactively communicate their expectations to management and report to the Board and audit committee on the financial reporting quality and the quality of information provided when they fall short of the required standards.

An effective system of quality control drives consistent, high quality audits, and deficiencies in these controls directly impact engagement audit quality. For the Category A firms, for the first time we carried out a thematic review on the policies and procedures relating to two elements (human resources and monitoring (including dealing with complaints and allegations)) of the systems of quality control. The focus was in-depth review and comparison of the firm-wide policies and procedures for all the Category A firms. The aim was to identify common areas for improvement and good practices with the Category A firms. Firms in the other categories are strongly encouraged to consider the results and, where applicable, to adopt them to improve their practices.

We inspected all six elements of the systems of quality control of the eleven Category B and C firms which we selected for our 2021 inspections. These firms were not inspected in 2020 but the common deficiencies identified are largely consistent with those reported in our 2020 Interim and Annual Inspection Reports. The consistency of these findings indicates these firms have yet to respond proactively in response to the observations reported in our previous publications. We urge them to consider the common findings described in this and our previous reports and take necessary actions to strengthen their policies and procedures.

### *The roles of directors and audit committees*

Directors are responsible for the preparation of financial statements, and for the effectiveness of internal controls to ensure those financial statements are prepared in compliance with the applicable financial reporting standards.

Audit committees assist the directors in discharging their responsibilities for overseeing the financial reporting process and have a pivotal role in upholding the quality of financial reporting through their oversight of auditors. They need to take action to ensure that listed entities have adopted accounting policies which comply with the requirements of the applicable accounting standards and that the entities have robust internal governance and adequate resources to prepare high quality financial information. We urge audit committees to consider our key findings and challenge their auditors as to whether and how they have addressed the common deficiencies highlighted in the report. We also urge audit committees to challenge management as to whether they are providing the auditor with information of the quality necessary to enable the auditors to carry out their audits effectively in a timely manner.

### *Our follow up actions*

We will continue to focus on ensuring that firms subject to inspection conduct a robust root cause analysis to identify the underlying causes of the deficiencies from our inspections of systems of quality control and of engagements, and develop a plan to remediate these deficiencies promptly. We will review the proposed remediation plan to address the deficiencies identified from our inspection and agree the timetable for completing the remediation steps with each firm, and assess their effectiveness in the subsequent inspection year.

Where the quality of engagements and systems of quality control inspected fell short, we will consider a range of possible follow up actions, including conducting further inspections on the audit firms, referring the engagements for possible enforcement action and taking any other follow-up action that is considered appropriate.

We will also conduct debriefing and public education sessions with firms and the wider stakeholder audience, such as management, Board and audit committee members, to share our insights on the inspection results and recommendations on strengthening the performance of audits and the quality of financial reporting.

*Further reform*

Under the further reform of the accounting profession, we will take over from the HKICPA the responsibility for conducting inspections of practice units. The future Accounting and Financial Reporting Council will adopt a proportionality approach to regulate the practice units. The assumption of this expanded function will not only enhance regulatory efficiency and ensure consistency with the international practice but also promotes the sustainable development of the accounting profession. We will continue engaging our stakeholders regarding the transitional arrangement.

Last but not least, we welcome constructive engagement by our regulated audit firms and commend their desire to improve the quality of their work.



Marek Grabowski  
Chief Executive Officer

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## Section 1

### Introduction

#### 1.1 Purpose of this report

- 1.1.1 This report sets out the full year results of our inspections of systems of quality control of listed entity auditors and a sample of their audit engagements completed in 2021.
- 1.1.2 We completed 50 (2020: 37) engagement inspections and 17 (2020: 18) inspections of the systems of quality control of listed entity audit firms in our 2021 inspections. Publishing the principal findings enables listed entity auditors to consider the market-wide findings and take action to improve the effectiveness of their systems of quality control and prevent them from occurring in their future audits. We summarise common causes of the identified deficiencies in this report which auditors should avoid. We also highlight in this report factors contributing to high quality audits and good practices we observed. Listed entity auditors should consider and implement these, where applicable, to improve their audit quality.
- 1.1.3 This report also provides an update on our inspections and evaluation of the remediation actions undertaken by auditors regarding inspections completed in 2020. Furthermore, the report provides our directional observations for audit firms on the implementation of the new and revised quality management and auditing standards, and our approach for the preparation of the further reform of the accounting profession.
- 1.1.4 This report also reminds and educates management, Boards, and audit committees about their roles and responsibilities in respect of financial reporting. In addition, it serves as a resource kit for audit committees to enable them to challenge their auditors as to whether and how they have addressed the common deficiencies highlighted in the report. We also include in this report our expectations of listed entity auditors, directors and audit committees in response to our market-wide findings.
- 1.1.5 An overview of our inspection methodology and information on the regulatory follow-up actions that we may take in response to our inspection findings is contained in Annex 1 to this report.

## Section 2

### Overall Audit Quality

#### 2.1 Introduction

2.1.1 The following table shows the number and market capitalisation of Hong Kong listed entity engagements audited by different types and categories of auditors as at 31 December 2020:

**Table 1 Number and market capitalisation of listed entities and location of their auditors**

	Number of firms	Number of listed entities audited	Market capitalisation of listed entities audited
<b>Hong Kong</b>	<b>44</b>	<b>2,628</b>	<b>93.8%</b>
- Category A <sup>1</sup>	6	1,965	91.5%
- Category B <sup>1</sup>	15	582	2.2%
- Category C <sup>1</sup>	23	81	0.1%
<b>Mainland China</b>	<b>10</b>	<b>74</b>	<b>1.0%</b>
<b>Overseas</b>	<b>25</b>	<b>72</b>	<b>5.2%</b>
<b>Total</b>	<b>79</b>	<b>2,774</b>	<b>100.0%</b>

2.1.2 In addition to the six Category A auditors, which are inspected annually, we inspected 8 (2020: 4) Category B and 3 (2020: 8) Category C Hong Kong audit firms in 2021.

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<sup>1</sup> Category A, B, and C firms complete more than 100, between 10 and 100, and at least one but less than 10 listed entity audits annually, respectively. We inspect Category A firms annually and Category B and C firms at least once in a three-year inspection cycle.

- 2.1.3 Mainland audit firms were not selected for inspection in 2021 due to their relatively small share of listed entity audits, which represented approximately 1% of the capitalisation of the Hong Kong stock market. Where the FRC wishes to inspect a Mainland China audit firm which is appointed as the auditor of a Hong Kong listed entity, we will request assistance from the SEB of the MOF.
- 2.1.4 Overseas audit firms audited approximately 5% of the Hong Kong stock market in terms of market capitalisation and 3% in terms of the number of listed entities. We did not select overseas auditors to inspect in 2021 because their share of the Hong Kong audit market was relatively small and many of them are the network firms, i.e. firms share significant professional resources, of the Category A firms which are inspected annually.
- 2.1.5 Our 2021 inspections continued to focus on audit firms and audit working papers in Hong Kong. We are continuing to work closely with the SEB on the collaborative framework for inspecting the audit working papers in Mainland China.

## 2.2 Inspection results and analysis

### Overall inspection results

**Table 2 Engagement inspection results by categories of audit firms**

		Number of engagements under each category of audit quality rating / total number of engagements inspected				Average audit quality rating <sup>2</sup>
Category of audit firm	Good	Limited improvements required	Improvements required	Significant improvements required		
2021	Category A	4 / 31 (13%)	10 / 31 (32%)	14 / 31 (45%)	3 / 31 (10%)	2.5
	Category B	0 / 16 (0%)	2 / 16 (13%)	5 / 16 (31%)	9 / 16 (56%)	3.4
	Category C	0 / 3 (0%)	0 / 3 (0%)	1 / 3 (33%)	2 / 3 (67%)	3.7
	<b>Total</b>	<b>4 / 50 (8%)</b>	<b>12 / 50 (24%)</b>	<b>20 / 50 (40%)</b>	<b>14 / 50 (28%)</b>	<b>2.9</b>
2020	Category A	0 / 22 (0%)	9 / 22 (41%)	9 / 22 (41%)	4 / 22 (18%)	2.8
	Category B	0 / 8 (0%)	0 / 8 (0%)	2 / 8 (25%)	6 / 8 (75%)	3.8
	Category C	0 / 7 (0%)	1 / 7 (14%)	3 / 7 (43%)	3 / 7 (43%)	3.3
	<b>Total</b>	<b>0 / 37 (0%)</b>	<b>10 / 37 (27%)</b>	<b>14 / 37 (38%)</b>	<b>13 / 37 (35%)</b>	<b>3.1</b>

2.2.1 In 2021, we achieved higher efficiency with a similar level of resources to 2020 by building on the experience gained from our first year of inspections. We completed 50 engagement inspections in 2021, increased from 37 engagement inspections completed in 2020. In addition, we completed four narrow-focus inspections into potential non-compliance with applicable professional standards. These four cases were identified through the FRC's whistleblowing channel and internal referrals from the Department of Investigation and Compliance. One of the narrow-focus inspections related to an engagement that was subject to our inspection in 2020 and was reported as an inspection substantially completed in the 2020 Annual Inspection Report. Since this engagement has a negligible effect on the overall average audit quality rating for 2020, comparative data provided in this report has not been adjusted.

<sup>2</sup> A quantitative audit quality rating of "1", "2", "3" and "4" was assigned to engagements rated "Good", "Limited improvements required", "Improvements required" and "Significant improvements required" respectively. Therefore, **the lower the average rating the higher the quality of audit we observed** in the engagements we inspected.

- 2.2.2 In 2021, we selected four to seven engagements for inspection for each Category A firm, two engagements for each Category B firm and one for each Category C firm. The number of firms to be inspected under each category in each year of the three-year inspection cycle depends on the size and complexity of the audit firms, the risk profiles of the listed entity audits completed by the firms, and the available resources of the FRC. Category A firms are inspected annually, and Category B and C firms are inspected at least once in a three-year inspection cycle.
- 2.2.3 Table 2 sets out the number of engagements inspected disaggregated by the audit quality rating. There has been a year-on-year improvement in overall audit quality as compared to the results of our 2020 inspections. 32%, or 16 out of the 50 engagements inspected were rated as requiring no more than “limited improvements”, which is the standard we expect for listed entity audits (2020: 27%, or 10 out of the 37 engagements).
- 2.2.4 Category A firms had a better average audit quality rating for their engagement inspections in 2021 compared to 2020. Four (2020: nil) of their inspected engagements were rated “Good”. We noted that all the Category A firms have invested considerable time and effort in addressing the inspection findings we identified in the 2020 inspections. Actions taken by these firms include:
- a. reinforcing the importance of quality audits by setting high priority for audit quality improvement by the firm’s leadership;
  - b. issuing timely reminders or alerts on matters that auditors may need to consider when auditing key risk areas;
  - c. developing or enhancing audit working paper templates and mandating their uses;
  - d. enhancing the effectiveness of the EQC review. This is achieved by requiring engagement team to document in detail areas that have been subject to challenges raised by the EQCR, the engagement team’s responses and proposed resolutions, and the agreed action steps;
  - e. conducting post-mortem debrief meetings with an aim to evaluating what went well and what went wrong in the current year’s audit, and to develop an improvement plan for next year’s audit;
  - f. conducting sharing sessions on lessons learnt from both the external and internal inspections and providing guidance or practical tips to avoid common pitfalls in future audits; and
  - g. experience sharing from engagement teams who deliver good quality audits.

This suggests that the Category A firms, which collectively audit approximately 70% of the Hong Kong listed entities by number and over 90% of the market capitalisation of the Hong Kong stock market, are taking robust and effective actions to enhance their audit quality. This should provide the investing public and the wider public with increasing confidence in the quality of financial reporting and the audits of listed entities.

2.2.5 Category B firms also had better average audit quality rating for engagements subject to the 2021 inspection. Two (2020: nil) of their engagements were rated as requiring no more than “limited improvements”. The average audit quality rating for engagements of the Category C firms were not better than 2020. However, this should not be taken as indicating that the audit quality was worse than that in 2021 for this category given the small number of engagements inspected for these firms in 2021.

2.2.6 Table 3 sets out the number of engagements inspected for each Category A firm disaggregated by the audit quality rating.

*Inspection results by individual Category A auditors*

**Table 3** Engagement inspection results by individual Category A auditors<sup>3</sup>

		Number of engagements under each category of audit quality rating / total number of engagements inspected				Average audit quality rating <sup>4</sup>
Name of the audit firm	Good	Limited improvements required	Improvements required	Significant improvements required		
2021	<b>BDO</b>	0 / 4 (0%)	1 / 4 (25%)	1 / 4 (25%)	2 / 4 (50%)	3.3
	<b>Deloitte</b>	1 / 5 (20%)	1 / 5 (20%)	3 / 5 (60%)	0 / 5 (0%)	2.4
	<b>EY</b>	1 / 6 (17%)	1 / 6 (17%)	4 / 6 (67%)	0 / 6 (0%)	2.5
	<b>HLB</b>	0 / 4 (0%)	0 / 4 (0%)	3 / 4 (75%)	1 / 4 (25%)	3.3
	<b>KPMG</b>	1 / 5 (20%)	3 / 5 (60%)	1 / 5 (20%)	0 / 5 (0%)	2.0
	<b>PwC</b>	1 / 7 (14%)	4 / 7 (57%)	2 / 7 (29%)	0 / 7 (0%)	2.1
	<b>Total</b>	<b>4 / 31 (13%)</b>	<b>10 / 31 (32%)</b>	<b>14 / 31 (45%)</b>	<b>3 / 31 (10%)</b>	<b>2.5</b>

<sup>3</sup> The firms were: BDO Limited (**BDO**), Deloitte Touche Tohmatsu (**Deloitte**), Ernst & Young (**EY**), HLB Hodgson Impey Cheng Limited (**HLB**), KPMG and PricewaterhouseCoopers (**PwC**)

<sup>4</sup> A quantitative audit quality rating of “1”, “2”, “3” and “4” was assigned to engagements rated “Good”, “Limited improvements required”, “Improvements required” and “Significant improvements required” respectively. Therefore, **the lower the average rating the higher the quality of audit we observed** in the engagements we inspected.

		Number of engagements under each category of audit quality rating / total number of engagements inspected				Average audit quality rating <sup>5</sup>
	Name of the audit firm	Good	Limited improvements required	Improvements required	Significant improvements required	
2020	BDO	0 / 3 (0%)	0 / 3 (0%)	2 / 3 (67%)	1 / 3 (33%)	3.3
	Deloitte	0 / 3 (0%)	1 / 3 (33%)	1 / 3 (33%)	1 / 3 (33%)	3.0
	EY	0 / 4 (0%)	2 / 4 (50%)	1 / 4 (25%)	1 / 4 (25%)	2.8
	HLB	0 / 3 (0%)	1 / 3 (33%)	1 / 3 (33%)	1 / 3 (33%)	3.0
	KPMG	0 / 4 (0%)	3 / 4 (75%)	1 / 4 (25%)	0 / 4 (0%)	2.3
	PwC	0 / 5 (0%)	2 / 5 (40%)	3 / 5 (60%)	0 / 5 (0%)	2.6
	<b>Total</b>	<b>0 / 22 (0%)</b>	<b>9 / 22 (41%)</b>	<b>9 / 22 (41%)</b>	<b>4 / 22 (18%)</b>	<b>2.8</b>

- 2.2.7 **Care should be exercised in interpreting the above audit quality ratings. Given the relatively small number of engagements inspected for each firm in each year, the ratings shown above are not necessarily indicative of the audit quality across their whole portfolio. Please also note that the lower the average audit quality rating the higher the quality of the audits.**
- 2.2.8 Publishing an individual firm’s audit quality ratings provides transparency about the quality of a firm’s listed entity audit engagements. It also provides a powerful incentive to firms to improve the quality of their listed entity audits, which would enhance confidence in the quality of financial reporting by listed entities.
- 2.2.9 Four Category A firms had year-on-year improvements in the average audit quality rating. Two of them (KPMG and PwC) had over 70% of their engagements subject to our 2021 inspections rated as requiring no more than “limited improvements”, which is encouraging.

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<sup>5</sup> A quantitative audit quality rating of “1”, “2”, “3” and “4” was assigned to engagements rated “Good”, “Limited improvements required”, “Improvements required” and “Significant improvements required” respectively. Therefore, **the lower the average rating the higher the quality of audit we observed** in the engagements we inspected.

*Analysis of inspection results*

- 2.2.10 Engagements classified as “Improvements required” or “Significant improvements required” do not meet the standard we expect for listed entity audits. These engagements either had one or more significant findings in the application of professional standards in an area(s) relating to significant audit risk, KAM, or material account balance or transaction, or had a number of findings individually not significant but collectively led to a greater impact on overall audit quality.
- 2.2.11 The lack of adequate exercise of professional skepticism continued to be a common driver of poor audit quality, with 46% (2020: 81%), or 23 of the 50 (2020: 30 of the 37) engagements inspected having one or more deficiencies related to professional skepticism and 74% (2020: 70%) of these deficiencies had a greater impact on the audit quality rating. This represents a substantial improvement from 2020. Significant improvement in this area was observed at the Category A and B firms compared to the results from our 2020 inspections. We look forward to seeing further progress made by the auditors in this area.
- 2.2.12 Revenue recognition was an area with increasing inspection focus in our 2021 engagement inspections. Out of the 50 engagements we inspected in 2021, we reviewed auditor’s work in this area for 43 engagements. There is a significant increase in the significance of deficiencies identified in the auditor’s evaluation of management’s application of the accounting standard for revenue. Our inspection results show that 47% (2020: 46%), or 20 of the 43 (2020: 12 of the 26) engagements inspected had deficiencies in this work and 70% (2020: 33%) of these deficiencies had a greater impact on overall audit quality rating.
- 2.2.13 We also identified an increase in the number of deficiencies with respect to auditor’s evaluation of management’s application of the ECL model under HKFRS 9 *Financial Instruments* for measuring impairment of financial instruments. In our 2021 inspections, we identified deficiencies in 71% (2020: 55%), or 12 of the 17 (2020: 11 of the 20) engagements we inspected where auditor’s work in this area was an area of inspection focus. 67% (2020: 82%) of these deficiencies were determined to have a greater impact on overall audit quality rating.
- 2.2.14 Auditors need to improve their work in these two areas urgently. Audit committees also need to take action to challenge listed entity management as to the appropriateness of the entity’s revenue recognition policies and the assumptions used by management in estimating the ECL. They should also challenge their auditors as to the adequacy of their audit work in these areas.
- 2.2.15 The COVID-19 pandemic and the resulting economic fallout caused significant hardship for some entities which adversely affected their abilities to repay bank and other borrowings. In response, some lenders agreed to change the borrowing terms or provide waivers or modifications to the loan agreements. In this context, we inspected two engagements where auditor’s evaluation of debt

modification was an area of inspection focus. Audit work of both engagements were found to contain significant deficiencies in this area.

- 2.2.16 We welcome the current year improvements in the testing of journal entries and other adjustments, the auditor's responses to KAMs, the use of auditor's experts and the sufficiency of audit documentation. Table 4 shows that 40%, 12%, 12% and 30% of the engagements we inspected in 2021 had deficiencies relating to the testing of journal entries and other adjustments, KAMs, the use of auditor's experts and audit documentation which reduced from 57%, 32%, 46% and 68% in the 2020 inspections. Except for findings related to the testing of journal entries and other adjustments by Category B and C firms and KAMs by Category C firms, there were significant reductions in the number of deficiencies identified in these areas in all sizes of the audit firms inspected.
- 2.2.17 An effective system of quality control drives consistent, high quality audits, and deficiencies in these controls directly impact the audit quality rating of an engagement. The common areas for improvement from our inspections of the eleven Category B and C firms are largely consistent with those reported in our 2020 Interim and Annual Inspection Reports. These areas related to internal monitoring, independence and promotion of a culture of quality within the firm. We also identified new common deficiencies in areas relating to handling of complaints and allegations, training, and integrity, accessibility or retrievability of engagement documentation. We urge these firms, especially those which have yet to be inspected by us, to read this report and carefully to consider the common findings described in this and our previous reports and take all necessary actions.

## 2.3 Our responses

- 2.3.1 We take robust action in relation to those inspected engagements rated "Improvements required" and "Significant improvements required". Engagements rated "Significant improvements required" will be considered for enforcement action through conducting an investigation or imposing a disciplinary sanction due to the significance of the deficiencies in applying relevant professional standards that led to such a rating. Engagements rated "Improvements required" may be considered for enforcement action, depending on the nature and significance of the findings identified. Where our inspections identified potential material misstatements in the financial statements and/or indications of fraud committed by a listed entity, we will also share the relevant information with the SFC for its consideration of appropriate follow-up action.
- 2.3.2 Firms we inspected are required to conduct a robust RCA to identify the underlying causes of audit deficiencies and establish appropriate corrective actions to prevent them from recurrence. RCA is potentially a powerful tool for audit quality improvement. However, as noted in our 2021 Interim Inspection Report, the RCA and remediation process were not sufficiently well understood by many of the firms we inspected. On 17 June 2022, we published a guide to

all listed entity auditors to performing RCA. This guide is intended to assist audit firms in performing a robust RCA and formulating a plan of action to prevent matters that affect audit quality from recurring in their future audits.

- 2.3.3 We will review the proposed remediation plan and agreed the timetable to complete the remediation steps with each firm, and assess whether the proposed measures or corrective actions can address the inspection findings. We may also inspect and evaluate the additional work performed and evidence obtained by the auditors to address the significant findings identified for both the systems of quality control and engagements.
- 2.3.4 To provide firms with greater transparency about our findings and expectations, all Hong Kong listed entity auditors will be invited to debriefing sessions. We will share our insights on the inspection results, including both deficiencies and good practices observed, and our expectations for the coming inspection period. We will also conduct public education sessions to share with the wider stakeholder audience, such as company directors and audit committee members, audit quality matters, best practices and our recommendations for management and audit committees on strengthening the performance of audits and the quality of financial reporting.
- 2.3.5 We will also discuss the inspection results with the Department of Oversight, Policy and Governance to facilitate its oversight over the performance of the Hong Kong Institute of Certified Public Accountants in relation to the provision of sufficient training and/or appropriate guidance to the audit profession concerning the market-wide deficiencies.
- 2.3.6 We will continue to review the appropriateness of the risk factors for our engagement selections, and to identify engagements for inspection that present a greater risk to audit quality and investor confidence.

## **2.4 Our expectations**

### *Actions by auditors*

- 2.4.1 We require firms that have been inspected to conduct RCA to identify the underlying causes of the deficiencies from our inspections of the systems of quality control and selected engagements and develop plans to remediate these deficiencies. Auditors are also required to evaluate significant findings on engagement inspections and perform further work to support their conclusions where needed.
- 2.4.2 We also recommend firms perform an analysis on engagements rated “Good” or “Limited improvements required” to identify good practices that could have a positive impact on other audits.

2.4.3 Auditors (including those not subject to our inspections this year) should consider the common deficiencies described in this report and take action to prevent them from recurrence in their future audits. This report also highlights factors contributing to high quality audits and good practices observed. Firms should consider and implement these, where applicable, to improve their audit quality.

*Actions by directors*

2.4.4 Directors are responsible for the preparation of the financial statements that give a true and fair view in accordance with applicable financial reporting standards. They should ensure that adequate and appropriate financial reporting systems and processes are in place and are sufficiently and appropriately managed by competent accounting personnel.

2.4.5 Directors also play an important role in supporting and promoting audit quality. We expect directors to create a culture which focuses on financial reporting quality and to exercise sufficient oversight over the management to provide auditors with all information and explanations that may be relevant to the audits in a timely manner. With respect to our engagement inspection findings in section 3, we also expect directors to take the following actions because quality of an audit engagement is directly impacted by the quality of the financial reporting system of the audit client:

- a. critically review the adequacy of resources and competence of the accounting personnel overseeing the financial reporting systems and processes;
- b. obtain an understanding of the key assumptions used by the management in making judgements and accounting estimates that are material to the financial statements and challenge management where the judgements or estimates did not reflect their knowledge and understanding of the entity's business, industry and/or the economic environment at that time;
- c. critically review any judgement made by the management about the adoption of the going concern basis in the preparation of the financial statements and ensure appropriate disclosures are made in the financial statements;
- d. take all reasonable steps to ensure management maintains sufficient documentation to support the accounting treatment adopted and the judgements and accounting estimates used in preparing the financial statements;
- e. take all reasonable steps to ensure that journal entries are appropriately prepared, reviewed, supported and posted with a clear description; and
- f. be open and receptive to challenges made by the auditors.

*Actions by audit committees*

- 2.4.6 Audit committees assist the directors in discharging their responsibilities for overseeing the financial reporting process and play a pivotal role in the quality of financial reporting through their oversight of auditors.
- 2.4.7 Audit committees need to take action to ensure that listed entities have adopted accounting policies which comply with the requirements of the applicable accounting standards and that the entities have robust internal governance and adequate resources to prepare high quality financial information. We urge audit committees to consider our key findings and challenge their auditors as to whether and how they have addressed the common deficiencies highlighted in the report.
- 2.4.8 We strongly encourage audit committees to inquire of their auditors whether audits of their companies have been selected for our inspection. Where an inspection has been performed, the audit committee should obtain an understanding from the auditor of the inspection findings. For instance, whether or not the findings are significant and how they are addressed. The audit committee should also request a copy of the engagement inspection report from the auditor.

## Section 3

### Results from our inspections of engagements

#### 3.1 Introduction

3.1.1 Our inspection focuses on the quality of audit engagements completed by auditors for listed entities and assesses whether the applicable professional standards, laws and regulations have been complied with.

3.1.2 We adopt a risk-based approach to select engagements for inspections. In response to the changing economic conditions, continued effects of the COVID-19 pandemic and leveraging on the experience we gained from our 2020 inspections, we gave higher weighting to engagements which exhibited higher risks to audits in 2021. These include engagements:

- involving listed entities in industries that were adversely impacted by the COVID-19 pandemic;
- that had a change in auditor near or after the end of the reporting period; and
- with greater public interest, such as audits of listed entities with larger market capitalisation and capital market transaction engagements e.g. initial public offerings.

3.1.3 We set out below our most common findings across the engagements we inspected in 2021, the common drivers of these findings and factors contributing to high quality audits.

3.1.4 The tables on the following pages show the number of engagements we inspected in 2021 that had one or more findings in key areas, disaggregated by their significance (Table 4) and by category of audit firm (Table 5). Comparative information, as shown in our 2020 Annual Inspection Report, was included to illustrate the trend of these findings.

3.1.5 An engagement-related finding represents a deficiency in applying applicable professional standards that may be significant on its own or significant only when considered in combination with other deficiencies. The significance of an individual deficiency to the quality of an audit varies widely. In the table below, findings reported as having a greater impact on the audit quality rating are individually significant on their own. Other findings are those that impact the audit quality rating only in combination with other deficiencies.

- 3.1.6 We do not inspect the entire audit file and our areas of inspection focus vary from one engagement to another. Therefore, our selected areas of inspection focus for the 2021 inspections are not necessarily consistent with those for the 2020 inspections.
- 3.1.7 We only inspected auditor's work on the evaluation of the entity's application of accounting standards for revenue, expected credit loss, and the modification of debt instruments, use of an auditor's expert and audit of opening balances for certain selected engagements in 2021. Therefore, the total number of relevant engagements inspected is less than 50 for these areas.
- 3.1.8 In interpreting the data in the following tables, **it is important to recognise that the findings do not necessarily indicate that the financial statements are materially misstated but rather that the quality of the audit has been affected by deficiencies in important aspects of the auditor's work.** As a matter of policy, where we consider it reasonably possible that the financial statements may be materially misstated, we refer the case internally for consideration of enforcement action. We may also share the relevant information with the SFC for its consideration of appropriate follow-up action.

**Table 4 Significance of findings on audit quality rating**

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected					
	2021			2020		
	Total	Findings which have a greater impact on audit quality rating	Other findings	Total	Findings which have a greater impact on audit quality rating	Other findings
<b>Lack of adequate exercise of professional skepticism</b>	<b>23 / 50</b> <b>46%</b>	17 / 23 74%	6 / 23 26%	<b>30 / 37</b> <b>81%</b>	21 / 30 70%	9 / 30 30%
<b>Deficiencies in evaluating the application of accounting standards</b>						
Revenue recognition	<b>20 / 43</b> <b>47%</b>	14 / 20 70%	6 / 20 30%	<b>12 / 26</b> <b>46%</b>	4 / 12 33%	8 / 12 67%
Expected credit loss	<b>12 / 17</b> <b>71%</b>	8 / 12 67%	4 / 12 33%	<b>11 / 20</b> <b>55%</b>	9 / 11 82%	2 / 11 18%
Modification of debt instruments	<b>2 / 2</b> <b>100%</b>	2 / 2 100%	-	-	-	-
<b>Deficiencies in testing journal entries and other adjustments</b>	<b>20 / 50</b> <b>40%</b>	7 / 20 35%	13 / 20 65%	<b>21 / 37</b> <b>57%</b>	4 / 21 19%	17 / 21 81%
<b>Deficiencies relating to Key Audit Matters</b>	<b>6 / 50</b> <b>12%</b>	4 / 6 67%	2 / 6 33%	<b>12 / 37</b> <b>32%</b>	9 / 12 75%	3 / 12 25%
<b>Deficiencies in using the work of an auditor's expert</b>	<b>3 / 25</b> <b>12%</b>	1 / 3 33%	2 / 3 67%	<b>11 / 24</b> <b>46%</b>	3 / 11 27%	8 / 11 73%
<b>Inadequate documentation</b>	<b>15 / 50</b> <b>30%</b>	0 / 15 0%	15 / 15 100%	<b>25 / 37</b> <b>68%</b>	0 / 25 0%	25 / 25 100%
<b>Deficiencies in the audit of opening balances</b>	<b>4 / 19</b> <b>21%</b>	2 / 4 50%	2 / 4 50%	<b>3 / 10</b> <b>30%</b>	0 / 3 0%	3 / 3 100%

**Table 5 Findings disaggregated by category of audit firm**

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected				2020 Total
	Total	Category A	Category B	Category C	
	<b>2021</b>				
<b>Lack of adequate exercise of professional skepticism</b>					
- Going concern	<b>23 / 50</b> <b>46%</b>	13 / 31 42% (73%) <sup>6</sup>	7 / 16 44% (100%)	3 / 3 100% (86%)	<b>30 / 37</b> <b>81%</b>
- Asset impairment					
- Business rationale					
- Fraud					
<b>Deficiencies in evaluating the application of accounting standards</b>					
Revenue recognition					
- Performance obligations	<b>20 / 43</b> <b>47%</b>	10 / 28 36% (56%)	7 / 12 58% (0%)	3 / 3 100% (50%)	<b>12 / 26</b> <b>46%</b>
- Determination and allocation of transaction price					
- Construction contracts					
Expected credit loss					
- Credit quality assessment	<b>12 / 17</b> <b>71%</b>	4 / 8 50% (50%)	5 / 6 83% (80%)	3 / 3 100% (40%)	<b>11 / 20</b> <b>55%</b>
- Recoverability assessment					
Modification of debt instruments	<b>2 / 2</b> <b>100%</b>	-	2 / 2 100% (N/A)	-	-
<b>Deficiencies in testing journal entries and other adjustments</b>	<b>20 / 50</b> <b>40%</b>	4 / 31 13% (50%)	14 / 16 88% (75%)	2 / 3 67% (57%)	<b>21 / 37</b> <b>57%</b>
<b>Deficiencies relating to Key Audit Matters</b>	<b>6 / 50</b> <b>12%</b>	1 / 31 3% (23%)	3 / 16 19% (50%)	2 / 3 67% (43%)	<b>12 / 37</b> <b>32%</b>
<b>Deficiencies in using the work of an auditor's expert</b>	<b>3 / 25</b> <b>12%</b>	3 / 18 17% (41%)	0 / 7 0% (100%)	0 / 0 N/A (40%)	<b>11 / 24</b> <b>46%</b>
<b>Inadequate documentation</b>	<b>15 / 50</b> <b>30%</b>	7 / 31 23% (55%)	7 / 16 44% (75%)	1 / 3 33% (100%)	<b>25 / 37</b> <b>68%</b>
<b>Deficiencies in the audit of opening balances</b>	<b>4 / 19</b> <b>21%</b>	1 / 8 13% (17%)	3 / 11 27% (50%)	0 / 0 N/A (50%)	<b>3 / 10</b> <b>30%</b>

<sup>6</sup> The percentage in the bracket denotes the comparative figure as shown in our 2020 Annual Inspection Report.

## 3.2 Lack of adequate exercise of professional skepticism

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. It requires auditors being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Exercise of adequate professional skepticism by auditors is important throughout the audits. If exercised effectively, it enables auditors to obtain the evidence they need to evaluate the risks of misstatement, direct their work accordingly, and evaluate the evidence they obtain to determine whether the financial statements are materially misstated.

Without the adequate exercise of professional skepticism, auditors might not challenge management enough or be sufficiently critical in evaluating audit evidence. Therefore, they may not obtain or appropriately evaluate all the evidence needed to form the basis of their opinion.

3.2.1 The lack of adequate exercise of professional skepticism remains a common driver of poor audit quality due to the significance of the areas to which they related. Our inspection results show that 46%, or 23 of the 50 engagements inspected (2020: 81%, or 30 of the 37 engagements) have a deficiency related to the adequate exercise of professional skepticism and 74% (2020: 70%) of these deficiencies had a greater impact on overall audit quality rating.

3.2.2 Deficiencies were prevalent in areas where significant management judgements and estimates were applied in preparing the financial statements and where there was a higher risk of management bias or fraud. Examples include:

a. Insufficient challenge of key assumptions adopted by management

In assessing the value in use of a cash-generating unit or a group of cash-generating units, there were instances where the engagement teams did not obtain sufficient appropriate audit evidence to corroborate management's representations and critically challenge management on whether the cash flow projections were prepared based on realistic and achievable assumptions. This is particularly important for cases where management has, for example, projected a significant increase in revenue, substantial cost savings, a drastic decrease in the working capital turnover days, minimal capital outlays in the forecast period, which are even less than the annual depreciation charges, and no closure costs for closing down an operating unit.

- b. Insufficient challenge on the reliability and relevance of the information used by management

In determining the discount rate for the asset impairment test, there were instances where the engagement teams did not critically challenge management's choices of comparable companies having regard to the principal activities and location of operation of the listed entity, and the reasons why no adjustment was made to account for the differences in risk characteristics.

- c. Lack of evaluation and consideration of all available and/or contradictory evidence

We identified instances where the engagement teams did not consider the actual financial performance of an entity after the end of the reporting period in evaluating the reasonableness of the profit forecast prepared by the management.

There were also instances where the engagement teams did not consider and evaluate contradictory evidence obtained in other audit procedures. For example, subsequent sales information obtained in the inventory net realisable value test might suggest that inventory provision was overstated as of the end of the reporting period.

- d. Insufficient challenge of the business rationale for unusual transactions and the associated risk of fraud

In one engagement, the engagement team did not critically challenge management about the reasons for the listed entity to pay a substantial premium over the market price to purchase non-exclusive broadcast licenses. This might indicate the presence of fraud or misappropriation of assets involving related parties.

### Going concern

3.2.3 Going concern disclosure is a critical piece of information for investors when companies are experiencing financial distress. Auditors play a gatekeeper role with the responsibility to critically assess the appropriateness of management's judgement about the entity's ability to continue as a going concern and evaluate the adequacy of related disclosures. They also have a direct responsibility to conclude whether a material uncertainty in relation to going concern exists and, if so, to include a statement to that effect in their reports.

3.2.4 We identified deficiencies relating to the auditor's going concern assessment in 12%, or 6 of the 50 engagements (2020: 27%, or 10 of the 37 engagements), and all (2020: 60%) these deficiencies had a greater impact on overall audit quality rating. Findings in this area include:

- a. Failure to critically consider what events or conditions, individually or collectively, might cast significant doubt on the entity's ability to continue as a going concern and obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists through performing additional audit procedures.
- b. Insufficient evaluation of whether the plans for future actions formulated by management in relation to its going concern assessment were feasible when the entity was in an adverse financial position. Such planned actions included issuing new corporate bonds and/or additional shares, extending the repayment period of the existing bank and other borrowings, and/or obtaining new bank and other borrowings.
- c. Failure to evaluate whether the controlling shareholder, who is a natural person, had the financial capability to provide financial support to the entity. No or insufficient understanding was obtained about the personal indebtedness of the controlling shareholder.
- d. Failure to assess whether management had taken into account all available information about the future, including information about the entity's ability to service or refinance its medium to long-term debts.
- e. Failure to evaluate management's judgement about the entity's ongoing compliance with financial covenants despite there being indicators that loan covenants would be breached during the forecast period, leading to loans potentially becoming repayable on demand.
- f. Insufficient challenge on the adequacy of the disclosures about the principal events or conditions that gave rise to significant doubt about the entity's ability to continue in operation and management's plan to deal with these events or conditions in the financial statements.
- g. Inadequate basis for disclaimer of opinion relating to going concern

In two engagements we inspected where the auditors expressed a disclaimer of opinion in relation to multiple uncertainties relating to going concern, the engagement teams did not provide an adequate basis to support their conclusions that (i) there were multiple uncertainties relating to going concern; and (ii) it was an "extremely rare case" and therefore appropriate to issue a disclaimer of opinion under paragraph A33 of HKSA 570 (Revised) *Going Concern*.

Financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When an engagement team has obtained sufficient appropriate audit evidence regarding the appropriateness of the management's use of the going concern basis but considers that the disclosure on going concern is not adequate or is

inappropriate, it should express a qualified or adverse opinion rather than a disclaimer of opinion.

### 3.3 Deficiencies in evaluating the application of accounting standards

Without obtaining sufficient audit evidence on the appropriateness of an entity's accounting policies and their application, auditors may fail to identify a material misstatement in the financial statements or do not have an adequate basis for their conclusion.

#### Revenue recognition

- 3.3.1 Revenue recognition was selected as an area of inspection focus in the majority of the engagements we inspected in 2021. This is a crucial area of an audit because revenue is a key performance indicator for investors and auditing standards contain a rebuttable presumption that there are risks of fraud in revenue recognition.
- 3.3.2 Revenue recognition was selected as an area of inspection focus for 43 of the 50 engagements we inspected in 2021. We found that 20 engagement teams did not adequately assess the appropriateness of the entity's application of HKFRS 15 and 70% (2020: 33%) of these deficiencies had a greater impact on overall audit quality rating. The significance of the findings has risen sharply and there has been no improvement in the overall level of deficiencies.
- 3.3.3 Significant deficiencies identified in this area include:
- a. Failure to evaluate whether management identified all performance obligations such as complimentary goods and/or services offered under prepaid contracts and implicit promises based on customary business practice, and whether transaction prices were appropriately allocated to these performance obligations.
  - b. Insufficient understanding of the entity's policies over the issuance, redemption and expiry of discount vouchers and gift certificates and insufficient evaluation of the appropriateness of the allocation of transaction prices and accounting for the corresponding breakage (revenue from unexercised rights).
  - c. Failure to identify that the listed entity did not appropriately account for the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customers. There were also insufficient audit procedures to test the accuracy and completeness of the source data used by management in making the estimates.

- d. Failure to evaluate the appropriateness of management's accounting for warranties provided by the entity, i.e., whether the warranties were of the assurance type, for which the estimated costs of satisfying the warranty obligations should be accrued, or of the service type, for which the transaction price should be allocated to the warranty component and recognised over the warranty period. In two engagements where the entities did not make any provision to settle their obligations under warranties, the engagement teams did not obtain sufficient audit evidence to evaluate the appropriateness of management's estimates.
- e. Insufficient audit procedures over revenue recognition in relation to construction contracts. These include:
  - Input method under HKFRS 15 was adopted by the listed entities which their audits were subject to our inspection. The entities recorded revenue based on the actual costs incurred relative to the total estimated costs needed to satisfy the contracts. The engagement teams did not perform sufficient audit procedures on the total estimated contract costs to address the significant risk associated with this accounting estimate. They did not obtain a sufficient understanding of the controls pertaining to budgeting and did not appropriately evaluate the design and implementation of these controls. They also did not perform a retrospective review of the previous estimates.
  - Certain engagement teams did not evaluate material variation orders or significant changes in total estimated costs during the contract periods. They also did not obtain sufficient appropriate evidence on the allocation of staff costs to individual construction contracts.
- f. Failure to evaluate the appropriateness of management's accounting for contract modifications under HKFRS 15. Management is required to assess whether a change to an existing contract is a modification or creates a separate contract. In one engagement, contract modifications should have been accounted for as part of the existing contract. However, they were inappropriately accounted for as the creation of a separate contract by the listed entity and the outstanding balance of the contract liabilities for the original contract has been immediately recognised as revenue in profit or loss. The engagement team did not identify, accumulate and evaluate the misstatement.

#### 3.3.4 Other findings relating to the application of HKFRS 15 include:

- a. Failure to evaluate the appropriateness of capitalising contract costs with reference to the criteria under HKFRS 15.
- b. A lack of assessment of the appropriateness of accounting for sales with a right of return.

Expected credit loss

3.3.5 The ongoing COVID-19 pandemic has brought additional working capital pressure for many companies and, in turn, significantly increased the complexity in applying forward-looking judgements to estimate ECLs for receivables. Assessing the adequacy of ECLs under the current economic environment requires a robust challenge of management around significant judgements and estimates which is particularly important to achieve a quality audit.

3.3.6 We identified deficiencies in 71%, or 12 of the 17 engagements (2020: 55%, or 11 of the 20 engagements) where ECL was an area of inspection focus, and 67% (2020: 82%) of which had deficiencies with a greater impact on overall audit quality rating. Findings in this area include:

- a. A lack of consideration of the relevance and appropriateness of information used in forming the auditor's point estimate or a range of estimates in assessing management's assumptions.

In evaluating management's estimates of ECL for receivables from individual persons and unlisted entities, there were instances where the engagement teams developed their own point estimates with reference to historical default rates and recovery rates of receivables from listed entities. The engagement teams did not consider the relevance of the information they used to support their point estimates and whether listed entities were of the same or similar nature as the debtors concerned.

In addition, two engagement teams did not obtain an understanding about the basis of selection of macro-economic factors such as gross domestic product and unemployment rates in determining management's forward-looking adjustment, or evaluate the correlation of these factors with the entity's historical levels of default.

- b. A lack of evaluation of management's assessment of changes in credit risk for a financial asset since initial recognition.
- c. Insufficient audit procedures to test the values of the collaterals and personal guarantees which were taken into account by the management when determining the loss given default. The collaterals included shares of unlisted corporations and second-lien properties.
- d. A lack of evaluation of the appropriateness of management's rebuttal of the presumption that default would occur when a financial asset was 90 days past due and whether management's use of more lagging default criterion was reasonable and supportable.
- e. Insufficient audit procedures over the reliability of information used in estimating the ECL.

We identified instances where ECL for trade receivables were measured using a provision matrix and balances were grouped based on the number of days these receivables were past due. The engagement teams did not test the ageing schedule of the trade receivables or the historical default rates of these receivables on the basis of which the ECL was estimated. The engagement teams also did not take into account the available forward-looking information in evaluating the reasonableness of the default rates.

#### Modification of debt instruments

- 3.3.7 As reported in our 2021 Interim Inspection Report (see section 2.4.6), COVID-19 pandemic has impacted the ability of a number of listed entities to service their issued debt instruments, leading to modifications of their terms to improve liquidity. In the two engagements we inspected where modification of debt instruments was an area of inspection focus, both engagement teams did not evaluate the appropriateness of the accounting treatment for the modification of loan agreements.

### **3.4 Deficiencies in testing journal entries and other adjustments**

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Auditing standards require an auditor to test the appropriateness of journal entries and other adjustments made in the preparation of financial information in all audit engagements. Although the level of risk of management overriding controls will vary from entity to entity, the risk is nevertheless present in all entities, and such override of controls to process inappropriate journal entries has often been used to perpetrate fraud in the process of preparing the financial statements.

- 3.4.1 The number of engagements with deficiencies identified in this area decreased from 57% in 2020 to 40% in the current year, with a significant reduction in the number of findings in this area in engagements inspected at Category A firms. The nature of findings in this area are broadly consistent with those set out in our 2020 Annual Inspection Report and are described below:
- a. Failure to evaluate the completeness of the population of journal entries and other adjustments subject to test.
  - b. Insufficient understanding of the entity's financial reporting process and controls over journal entries, and failure to determine fraud risk factors specific to the listed entity to identify journal entries that contained fraudulent characteristics for testing.

- c. Failure to perform sufficient audit procedures to evaluate the appropriateness of the identified journal entries. There were instances where the engagement teams only documented a brief description of the nature of the identified journal entries and did not perform further audit procedures such as examining the authorisation of the identified journal entries and the underlying supporting documents to support their conclusions.
- d. Engagement teams applied a monetary threshold to select journal entries to test and could not explain why journal entries with amounts below the monetary threshold were not subject to a fraud risk. This could result in auditors not identifying fraudulent accounting entries perpetrated through processing multiple individually insignificant journals that were collectively material to the financial statements.
- e. Insufficient evaluation of the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and whether they reflected any fraud risk factors or indicators of possible management bias. In several engagements we inspected, the engagement teams only retained a list of consolidation adjustments with simple descriptions of their natures and did not perform any other audit procedures such as examining the underlying supporting documents to support the appropriateness of these adjustments.

### 3.5 Deficiencies relating to Key Audit Matters

Failure to appropriately identify or communicate how the auditor addressed KAMs undermines the value of the auditor's report in providing an understanding of the entity, areas of significant management judgement, and how the auditor dealt with the areas of most significance in the audit.

- 3.5.1 We identified significant deficiencies relating to KAMs in 12%, or 6 of the 50 engagements inspected (2020: 32%, or 12 of 37 engagements), with 67% (2020: 75%) of these findings being assessed as having a greater impact on overall audit quality rating. This was a considerable improvement from last year's inspection results. The nature of the findings in this area was consistent with those communicated in our 2020 Annual Inspection Report and relates to engagement teams not performing all the audit procedures described in the auditor's report to address KAMs. Deficiencies in this area may result in an unjustified auditor's report as the auditor incorrectly concluded that it had obtained sufficient appropriate evidence to draw its conclusion. Firms we inspected in 2020 and 2021 have shown improvements in this area as they mandated the use of internal audit working paper templates and issued guidance or reminders to engagement teams.

- 3.5.2 We also found that some engagement teams did not sufficiently document their determination of KAMs, including the rationale for matters that required significant auditor attention and which of those matters are of most significance in the audit and therefore are KAMs.

### **3.6 Deficiencies in using the work of an auditor's expert**

- 3.6.1 We identified deficiencies in 12%, or 3 of the 25 engagements inspected where the auditor used the work of an auditor's expert. There was a marked improvement from our 2020 inspections across all categories of firms (2020: 46%, or 11 of 24 engagements). Findings in this area were consistent with the results we reported in our 2021 Interim Inspection Report and related to the engagement teams' failure to evaluate the appropriateness and reasonableness of the source data, assumptions and methods used by the auditor's expert. These deficiencies could result in the auditor obtaining insufficient audit evidence to support their conclusions.
- 3.6.2 Firms we inspected in 2020 and 2021 that have shown improvements in this area mandated the use of internal audit working paper templates and issued guidance or reminders to the engagement teams.

### **3.7 Inadequate documentation**

- 3.7.1 Significant improvements were observed in audit documentation where deficiencies were identified in 30% (2020: 68%), or 15 of the 50 engagements inspected (2020: 25 of the 37 engagements). Findings in this area relate to engagement teams' failure to prepare audit documentation that was sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing and extent of the audit procedures performed, the results of those procedures and the basis of the conclusion reached.
- 3.7.2 Undocumented work was considered as not performed unless there was other persuasive evidence and oral representation alone was not considered as "other persuasive evidence". Where the engagement teams did not obtain sufficient appropriate evidence over the matters concerned, findings are classified and discussed under the corresponding inspection focus areas.
- 3.7.3 In most of these engagements, the engagement teams only documented a brief description of the procedures performed. There were insufficient details of the purpose of the tests, the extent of the tests, the source documents examined, or information in the source documents that was considered in reaching their conclusions.

### 3.8 Deficiencies in the audit of opening balances

Deficiencies in this area may result in the auditor not having sufficient appropriate evidence to conclude whether the opening balances contain misstatements that materially affect the current period's financial statements.

- 3.8.1 Auditors should maintain sufficient professional skepticism recognising that the opening balances may be misstated and appropriately plan and perform necessary audit procedures to obtain sufficient appropriate audit evidence regarding the opening balances.
- 3.8.2 We inspected 19 (2020:10) audit engagements and identified deficiencies relating to the audit of opening balances in 21% (2020: 30%) or 4 (2020: 3) of them. 50% (2020: nil) of these deficiencies had a greater impact on overall audit quality rating and related to engagement teams' failure to obtain sufficient understanding of management's assumptions used in asset impairment assessment and ECL estimation in respect of opening balances, and perform sufficient audit procedures to evaluate their appropriateness and reasonableness.

### 3.9 Other findings

#### Audit sampling

Insufficient sampling could result in auditors not identifying material misstatements in the financial statements.

- 3.9.1 We identified deficiencies relating to audit sampling in 14%, or 7 of the 50 engagements inspected. Of these, four engagements had a number of deficiencies in areas of inspection focus that collectively had a greater impact on overall audit quality rating. Findings in this area include:
- a. Failure to test the completeness of the population from which audit samples were selected.
  - b. Placing inappropriate reliance on the results of other audit procedures and reducing the extent of tests of details. Examples included placing reliance on the operating effectiveness of the entity's controls which did not address the assertions with significant risk, or on the results of trend or fluctuation analysis which did not satisfy the requirements of being a substantive analytical procedure.

### Related party transactions

Auditing standards require an auditor to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements.

- 3.9.2 We identified deficiencies relating to related party transactions in 16%, or 8 of the 50 engagements inspected. However, these deficiencies did not have a greater impact on overall audit quality rating. Findings in this area include:
- a. Insufficient understanding and evaluation of the entity's policies and procedures for identifying related parties and related party transactions.
  - b. Insufficient audit procedures to address the completeness of related party transaction disclosures.

### External confirmations

Auditors frequently use external confirmations as they provide more reliable evidence than evidence generated internally by the entity.

- 3.9.3 There were a number of engagements where the engagement teams did not critically evaluate whether the confirming parties were the ones who returned the audit confirmations when they were received through electronic means, e.g. by electronic mail or by fax. There were also instances where the engagement teams did not verify whether the respondents were appropriately authorised to respond to the confirmation requests.

### 3.10 Common causes of the identified deficiencies

3.10.1 We set out below the common causes of the identified deficiencies described in Tables 3 and 4:

a. Insufficient risk assessment

A robust risk assessment is crucial to an effective and efficient audit. In most of these engagements, the engagement teams did not obtain a sufficient understanding of the entity's business and internal controls, and plan and design appropriate audit procedures which are responsive to the assessed risk.

Auditors should ensure that risk assessment procedures are performed on a timely basis and with the appropriate involvement of senior members of the engagement teams. When there is a significant change in the entity's operations during the audit, the auditor should assess its implications and revisit the audit strategy to ensure that it is appropriately adjusted to address all newly identified assessed risks.

b. Knowledge or skills gap

There were instances where audits of complex or highly judgemental areas were assigned and performed by junior team members who did not possess the appropriate knowledge and skills, and there was a lack of proper supervision and review.

c. High staff turnover and loss of experienced staff

High staff turnover and loss of experienced staff create operational inconveniences, impact staff morale and productivity, and eventually affect the firm's audit quality and services. It is also the most commonly cited reason for audit work not being performed properly and supervision and review not being performed on a timely basis and sufficiently.

Our outreach to listed entity auditors earlier this year revealed the acuteness of the challenges that the auditors are facing in maintaining their audit staff resources at appropriate levels in this challenging environment. Despite this, we reiterate our expectations for the pivotal role that auditors play in ensuring that the quality of financial reporting by listed entities is not compromised.

Firms should ensure that they have sufficient time and appropriate resources to effectively plan and conduct an audit. This is especially important when a firm is considering accepting an engagement near or after the end of the financial reporting period of a prospective audit client. Firms should decline an engagement when they do not have the time and resources to conduct a high quality audit.

In addition, auditors should start their audits early. By doing so, they can identify and resolve key accounting and auditing issues in the early stage of the audit, and alleviate the pressure on the resources during the audit peak season. Timely and extensive partner involvement is essential, especially when there is a high turnover or a loss of experienced engagement team members.

- d. Inadequate involvement and supervision by the engagement partner and EQCR in the audit

When the engagement partner and the EQCR were not sufficiently involved in audit planning, directing and supervising the engagement team members and reviewing their work, the audit was generally of lower quality.

- e. Lack of quality information provided by listed entities

Auditors should proactively communicate the quality of information required from management. Directors are responsible for the quality of the financial statements. They have a crucial role in ensuring that management provides auditors with the information requested in connection with the audit in a timely manner and that the listed entities have adequate resources and expertise to do so. Auditors should report to the directors and audit committees if the quality of the entities' financial reporting function and the information provided for their audits did not meet their standards.

### **3.11 Factors contributing to good quality audits**

3.11.1 Good quality audits provide investors and other stakeholders with confidence in the integrity of financial reporting. In 2021, there has been a marked improvement in the audit quality of engagements at Category A firms as four of their engagements were rated "Good", the highest audit quality rating (2020: nil). Key factors contributing to these high quality audits include:

- a. An in-depth understanding of the entity's business and a good knowledge of the developments and emerging issues relevant to the entity's industry.
- b. Comprehensive audit planning and robust risk assessment to identify key audit risks at an early stage and design appropriate audit procedures in response to those risks. Re-assessment of audit risk on a regular basis with proper changes to audit strategy in response to any new assessed risks.
- c. Timely and significant partner involvement and clear communication of the importance of audit quality throughout the audit.

- d. High quality information was requested and provided by listed entities, including extensive documentation and support for key assumptions used by management in determining significant accounting judgements and estimates.
- e. Strong oversight of the financial reporting process exercised by audit committees. Directors and audit committees play an important role in driving audit quality. An engaged and informed audit committee asks insightful questions to the management and challenges the sufficiency of the work performed by the auditors throughout the financial reporting and audit processes.
- f. A robust exercise of professional skepticism and a rigorous challenge of management around key estimates and significant assumptions with reference to internal and external sources of information.
- g. Clear and well-structured audit documentation (using the firm's standard templates and guidance) was prepared by the engagement teams for significant matters. The documentation provided sufficient details of the purpose of the audit test, nature, timing and extent of the audit procedures performed, the testing results, and the conclusions, including the basis for the conclusion, reached by the engagement teams.
- h. Engagement teams were adequately resourced with personnel who have relevant industry knowledge and experience and with timely support from in-house experts for complex accounting and auditing matters.
- i. EQCRs with the relevant industry experience and expertise critically challenged and evaluated the significant judgments made by the engagement teams. EQCRs had timely and appropriate involvement throughout the audit, with their involvement adequately evidenced.
- j. Reasonable reporting timeframes allowed sufficient time for management, Boards, auditors and audit committees to conduct comprehensive and robust reviews of the financial statements.

## Section 4

### Results from our inspections of systems of quality control

#### 4.1 Introduction

An effective system of quality control drives consistent, high quality audits. It provides an audit with reasonable assurance that its performance complies with professional standards and applicable regulatory and legal requirements; and that reports issued by the firm or engagement partners are appropriate in the circumstances. We inspect a firm's system of quality control to determine if it meets the requirements of HKSQC 1 and other relevant standards.

- 4.1.1 As set out in the 2021 Interim Inspection Report, we focused on the policies and procedures over Human Resources and Monitoring (including dealing with complaints and allegations) in our inspections of the systems of quality control of Category A firms (the **Thematic Review**) in 2021. We inspected all six elements of HKSQC 1 of a firm's system of quality control of Category B and C firms (the **Full Review**) in 2021.
- 4.1.2 Highlighted in section 4.2 are the areas for improvement and good practices identified in the Thematic Review. Section 4.3 sets out the common areas for improvements identified across eleven Category B and C firms inspected in 2021. As we had substantially completed the inspections of the systems of quality control of Category B and C firms by the time the 2021 Interim Inspection Report was issued, common areas for improvement in section 4.3 are broadly similar to those communicated in our 2021 Interim Inspection Report, aside from the areas for improvement in relation to internal monitoring in section 4.3.2 and integrity, accessibility and retrievability of engagement documentation in section 4.3.8. These findings were identified from our final evaluation of the results of our inspections of systems of quality control and selected engagements in relation to these firms.
- 4.1.3 As mentioned in the 2021 Interim Inspection Report, the Category B and C firms we inspected in 2021 were not inspected in 2020. Still, the findings we identified for the systems of quality control for these two categories of firms in both years are broadly consistent. This result indicates that these two categories of firms have yet to respond proactively to strengthen their policies and procedures in response to the observations reported in our previous publications. We urge these firms to take prompt and concrete action in response to our findings described in this and our previous reports, including evaluating the effectiveness of their current policies and procedures, identifying areas where improvements are required and taking all necessary actions for improvement.

- 4.1.4 Firms are also reminded that, in determining the actions to be taken to enhance their systems of quality control, due consideration should be given to the requirements of the new quality management standards, which will be effective on 15 December 2022.

## 4.2 Results of the Thematic Review on Category A firms

### 4.2.1 Performance evaluation

- 4.2.1.1 Audit quality is usually one of the considerations in the performance evaluation of audit partners and staff in Category A firms. Assessment of audit quality for an audit partner usually takes into consideration the results of internal and external engagement inspections and feedback from different sources such as audit clients and partners from the Technical Department who discussed contentious and difficult audit matters with the partner. Audit quality of staff is, in general, assessed concerning feedback on their performance in each engagement from their appraisers. An overall performance rating is assigned to each audit personnel in the annual performance evaluation based on the assessment results of various performance measures, including audit quality. This performance rating further serves as the basis for determining compensation and promotion of audit partners and staff.

#### *Areas for improvement*

- 4.2.1.2 We identified that more than half of the firms did not provide specific guidance on how the audit quality of staff should be assessed, including when and how the results of internal and external engagement inspections should be considered, in order to ensure that the audit quality of the staff was evaluated in a consistent and timely manner.
- 4.2.1.3 In addition, audit quality was not a key consideration, or not even a consideration, in the annual performance evaluation of audit partners in one of these firms.

#### *Areas of good practice*

- 4.2.1.4 We identified the following good practices in some of these firms:
- a. Audit quality was the only or primary performance goal for audit partners, and a detailed performance evaluation framework, which set out factors to be considered when measuring audit quality in partners' performance, was developed.

- b. Firms set out clear consequences for their audit partners when any of their engagements was assessed as not meeting the required audit quality standard from internal or external engagement inspection. Such consequences could not be alleviated by outperformance in other performance aspects.
- c. Counsellors were assigned to assist audit partners and staff rated as “underperformed” against the firm’s expectations to develop specific performance improvement goals for further career progression. Firms also provided support, such as reassigning client and engagement portfolios where appropriate, to facilitate these partners and staff to achieve their performance improvement goals.

#### 4.2.2 **Workload monitoring**

4.2.2.1 All Category A firms have policies and procedures to monitor the workload of their audit partners. Typical parameters for workload monitoring include the number of audit engagements an audit partner was assigned as the engagement partner and the EQCR, time incurred for each engagement by the partner, and other roles and responsibilities of the partner.

##### *Areas for improvement*

4.2.2.2 Certain parameters for workload monitoring were assessed with reference to time charged. However, we identified situations where audit personnel did not record or only partially record their time incurred for the audit engagements they worked on. This raises concern over the effectiveness of the firms’ workload monitoring processes as the time charge records may not be sufficiently accurate to warrant reliance.

4.2.2.3 In two of the firms, information included in the tool for partners’ workload monitoring was limited to the number of engagements where the audit partner was the engagement partner or the EQCR and the audit period for each engagement. These firms could not demonstrate how other factors, such as the complexity of an audit engagement, were considered in their workload monitoring processes.

##### *Areas of good practice*

4.2.2.4 Examples of good practices include:

- a. Regular endorsement of the accuracy and completeness of client and engagement portfolios by audit partners such that any changes to their portfolios and workload could be identified and managed timely.
- b. Frequent monitoring of audit partners’ workload, in particular, audit partners who worked more than a predefined number of hours.

### 4.2.3 Internal monitoring

4.2.3.1 All Category A firms established a monitoring process, which includes inspections of a sample of completed engagements, to evaluate their systems of quality control. The monitoring process is performed annually by a designated central team. Some even include audit partners and staff from other network firms in the established central teams. Firms usually adopt a risk-based approach to determine the scope of review in the Monitoring Process.

#### *Areas for improvement*

4.2.3.2 We inspected six engagements subject to these firms' internal monitoring programs, which were all rated "Satisfactory" by these firms. However, we categorised two of these engagements as "Improvements required" (3 of the 4 engagements inspected were rated "Improvements required" or "Significant improvements required" in 2020). The two firms should perform a robust review to identify the underlying causes for the differences in the assessments and take corresponding remedial action to improve the effectiveness of their internal monitoring program.

#### *Areas of good practice*

4.2.3.3 We identified the following good practices in some of these firms:

- a. Reviews of completed engagements were performed by a dedicated team which comprised solely, or a high proportion of, audit partners and staff from other network firms. This practice ensured the objectivity of the reviewers and enhanced the effectiveness of the monitoring process.
- b. Clear guidelines were established on the number of completed engagements required for review. Such guidelines ensured that the scope of review was sufficient to provide reasonable assurance on the effectiveness of the firm's monitoring process. For example, in one of the firms, the aggregate engagement hours of all selected engagements for review were required to represent a predefined percentage of the total engagement hours for all listed entity audits in a year.
- c. Comprehensive monitoring programmes and checklists, which set out the detailed purposes and procedures of each test, were developed to evaluate the relevance, adequacy and operating effectiveness of the firm's system of quality control.

#### 4.2.4 Evaluation and remediation of identified deficiencies

4.2.4.1 Regarding the deficiencies identified from the Monitoring Process and the external inspections, firms should perform a RCA to identify underlying causes of the deficiencies and to determine appropriate remedial action.

##### *Areas for improvement*

4.2.4.2 A Category A firm did not perform a holistic and structured review on the complaints and allegations it received to evaluate whether there were any deficiencies in the design or the operation of the firm's quality control policies and procedures.

##### *Areas of good practice*

4.2.4.3 We observed good practices from two firms where RCA was performed with sufficient thoroughness. These include:

- a. RCA was undertaken not only on the deficiencies identified from internal and external inspections but also on feedback, complaints and allegations received from different channels.
- b. Retrospective review was conducted on the RCA performed in the prior period to evaluate whether the actual root causes had been appropriately identified for the deficiencies and to monitor the effectiveness of remedial actions implemented in the prior period.

#### 4.2.5 Handling of complaints and allegations

4.2.5.1 Firms are required to establish clearly defined channels for their personnel to raise concerns in a manner that enables them to come forward without fear of reprisals. In Category A firms, complaints and allegations handling are usually led by the firm's Risk Management Department or designated ethics team, with the assistance of other experts where necessary. In one of the Category A firms, the investigations are required to be led by a member of the firm's Legal Department.

##### *Areas for improvement*

4.2.5.2 We identified areas for improvement where more structured training should be provided to the investigation teams and evaluation of their independence should be strengthened in two Category A firms. These include:

- a. There was an instance where a complainant made an allegation about the ethical misconduct of certain audit personnel. The investigation team did not stay alert for the red flags that suggested audit quality issues.

- b. Insufficient evaluation of the self-review threat in assigning the engagement partner and the EQCR as the investigators to perform an initial assessment of the matter.

4.2.5.3 In addition, in one of the firms inspected, the firm did not have the policy to determine whether and to what extent the scope of investigation should be extended to other engagements handled by the persons under investigation.

*Areas of good practice*

4.2.5.4 We observed the following good practices relating to the investigation of and follow-up actions on complaints and allegations:

- a. Investigations of complaints and allegations were required to be led by a member of the firm's Legal Department so that disciplinary matters were considered from a more integrated perspective, including from a legal point of view.
- b. An investigation tool that set out investigation procedures and areas for consideration during an investigation was established to ensure that complaints and allegations were investigated consistently with sufficient thoroughness.
- c. One firm conducted regular follow-up discussions with the whistle-blowers (complainants) and periodic reviews of their performance assessment to ensure that they were not retaliated against and assessed unfairly.

## **4.3 Results of the Full Review on Category B and C firms**

### **4.3.1 Table of deficiencies**

4.3.1.1 The table on the following page show the total number of Category B and C firms we inspected in 2021 that had one or more findings in key areas. Comparative information was included to illustrate the trend of our findings.

**Table 6 Findings disaggregated by key areas of deficiencies**

Key areas of deficiencies	Total number of Category B and C firms to which deficiencies relate / total number of firms inspected	
	2021	2020
<b>Internal monitoring</b>		
Discrepancies between the internal and external inspection results	7 / 11 64%	2 / 12 17%
Ineffective design and implementation of internal monitoring processes	10 / 11 91%	4 / 12 33%
<b>Evaluation and remediation of identified deficiencies</b>		
No (or superficial) RCA and/or remediation plan	8 / 11 73%	3 / 12 25%
<b>Handling of complaints and allegations</b>		
Lack of a clearly defined channel for raising concerns	5 / 11 45%	3 / 12 25%
Lack of a holistic review to identify common and systematic deficiencies underlying the complaints and allegations received	3 / 11 27%	N/A
<b>Promoting a culture of audit quality within the firm</b>		
Insufficient consideration of audit quality as part of the performance evaluation of audit partners and staff, partners' admission and staff's promotion	6 / 11 55%	8 / 12 67%
<b>Independence</b>		
Lack of effective controls over personal confirmations of independence	8 / 11 73%	7 / 12 58%
<b>Training</b>		
Insufficient internal trainings and/or insufficient monitoring of external trainings attended by audit personnel	8 / 11 73%	5 / 12 42%
<b>Integrity, accessibility, or retrievability of engagement documentation</b>		
No or insufficient control to avoid unauthorised alteration or loss of archived hardcopy engagement documentation after retrieval	7 / 11 64%	3 / 12 25%

## 4.3.2 Internal monitoring

4.3.2.1 Firms are required to establish a monitoring process to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively. An effective monitoring process, which includes an ongoing consideration and evaluation of the firm's system of quality control and a cyclical inspection of completed engagements, is essential to support consistently high quality professional work in a firm.

### *Common areas for improvement*

4.3.2.2 In seven of the eleven firms inspected, the number of deficiencies identified by these firms in their internal monitoring processes were substantially less than the deficiencies we identified in our inspections. This raises concerns about the effectiveness of their monitoring process.

4.3.2.3 In addition, we identified other deficiencies in the monitoring process in ten of the eleven firms inspected. Common deficiencies included:

- a. Review of the firm's system of quality control was conducted by a person in charge of some elements of the system of quality control or by an individual whose performance was evaluated by the Quality Control System Responsible Person. These arrangements may impair the objectivity of the reviewers and raise concerns about the authority of the reviewers.
- b. The procedural checklists used for the monitoring process did not provide sufficient details and guidance on the nature and extent of monitoring procedures to be performed by the reviewers.
- c. Firms' guidance on assessing the severity of deficiencies and determining the overall audit quality rating was insufficient.

### *Our recommendations*

4.3.2.4 Firms should assign appropriate personnel with sufficient authority to perform an objective review to be the reviewers in their monitoring process. In addition, firms should provide their reviewers with adequate guidance to ensure consistent evaluation of the firms' policies and procedures and completed engagements.

4.3.2.5 Reviewers in the monitoring process should clearly document the nature and extent of the monitoring procedures performed. These include their evaluation of the design and implementation of the firm's quality control policies and procedures with respect to the compliance with HKSQC 1 and their assessment

of whether the inspected engagements were performed following the firm's quality control policies and procedures and were in compliance with the applicable professional standards.

#### **4.3.3 Evaluation and remediation of identified deficiencies**

4.3.3.1 Firms are required to evaluate and determine whether deficiencies identified from the monitoring process are systemic, repetitive or significant that require prompt remedial action. A robust RCA is important to facilitate such evaluation and determination of appropriate remedial actions that target the deficiencies' underlying causes.

##### *Common areas for improvement*

4.3.3.2 Eight of eleven firms we inspected did not perform RCA over the deficiencies identified from internal and external inspections or, where an analysis was completed, the root causes identified and remedial actions proposed were inappropriate or too generic.

##### *Our recommendation*

4.3.3.3 Firms should carry out a robust RCA over the deficiencies identified from internal and external inspections and from the complaints and allegations received, and determine appropriate remedial actions to improve audit quality.

#### **4.3.4 Handling of complaints and allegations**

4.3.4.1 Firms are required to establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals. When firms identify deficiencies in the design or operation of their firm's quality control policies and procedures during their investigations into complaints and allegations, they shall take appropriate actions.

##### *Common areas for improvement*

4.3.4.2 Consistent with the findings in our 2021 Interim Inspection Report, five of the eleven firms we inspected did not establish clearly defined channels for individuals to raise their concerns. In addition, three of these firms did not conduct a holistic review to identify if there were any common and systematic deficiencies underlying complaints and allegations received.

##### *Our recommendation*

4.3.4.3 Firms should establish clearly defined reporting channels according to the requirements of HKSQC 1. Such channels should be coupled with a process to investigate complaints and allegations in a timely manner thoroughly. Together

with the findings from external and internal inspections, results of investigations should be subject to the firms' RCA.

#### **4.3.5 Promoting a culture of quality within the firm**

4.3.5.1 The promotion of a quality-oriented internal culture depends on the tone set by a firm's leadership that emphasises the need to achieve quality in all the engagements that it performs. Such a culture, if effective, should result in audit quality being a key consideration in all decision-making and operations of the firm, from senior management to engagement teams. This culture can be developed by an audit firm by implementing policies over performance evaluation, compensation and promotion that demonstrate its overriding commitment to quality.

##### *Common areas for improvement*

4.3.5.2 In six of the eleven firms inspected, quality of audit work, including the results of internal or external engagement inspections, was either not a consideration, or not a primary consideration, in the performance evaluation of audit partners and staff, partners' admission and staff's promotion. In addition, five of these six firms did not establish a formal appraisal process for audit partners' performance evaluation.

##### *Our recommendation*

4.3.5.3 Firms should strengthen their policies and establish formal procedures to evaluate audit quality as part of their audit partners' and staff's performance evaluation, partner admission and promotion processes.

#### **4.3.6 Independence**

4.3.6.1 Independence in mind and appearance are necessary to enable auditors to express a conclusion without bias, conflict of interest, or undue influence. Firms are required to design policies and procedures to allow them, their personnel, or auditor's experts involved in audit engagements to identify independence issues and assess the overall impact, including relevant threats and safeguards, on their independence, if any.

##### *Common areas for improvement*

4.3.6.2 Consistent with the findings from our 2021 Interim Inspection Report, eight of eleven firms inspected lacked effective controls over personal confirmations of independence. Common deficiencies included:

- a. Firms did not maintain a complete list of entities related to their listed entity audit clients to enable their professional personnel to determine whether they satisfy the applicable independence requirements.
- b. The confirmation of independence did not cover all the potential areas of conflict, such as immediate and close family members' financial interests in, and business relationships with, audit clients and their related entities.
- c. Completion of the confirmations was not effectively monitored.
- d. Firms did not carry out verification procedures to test the accuracy of the information in their personnel's confirmations of independence.

#### *Our recommendations*

4.3.6.3 Firms should strengthen their policies regarding the completeness and accuracy of their register for listed entity audit clients and their related entities. They should also actively monitor the independence compliance of their personnel and their immediate and close family members.

4.3.6.4 We also recommend that firms perform periodic personal independence checks on selected personnel to ensure their compliance with the firms' independence requirements. Firms should clearly communicate the consequences of non-compliance to emphasise the importance of independence.

#### **4.3.7 Training**

4.3.7.1 Firm's personnel can develop their competence and capabilities through various methods, one of which is attending an appropriate level of CPD such as training. Firms should put in place effective policies and procedures to ensure that their audit personnel comply with their professional CPD requirements. They should also provide the necessary training resources and assistance to enable their audit personnel to develop and maintain the required level of competence and capability.

#### *Common areas for improvement*

4.3.7.2 Consistent with the findings from our 2021 Interim Inspection Report, eight of the eleven firms we inspected neither provided sufficient internal training nor implemented appropriate measures to ensure their audit personnel undertook relevant external training provided by professional bodies or training intuitions to develop and maintained the necessary competence in conducting audits of listed entities.

*Our recommendation*

4.3.7.3 Firms should implement measures to monitor and assist their audit personnel in attaining and maintaining the necessary competence and capabilities.

**4.3.8 Integrity, accessibility, or retrievability of engagement documentation**

4.3.8.1 Integrity, accessibility, or retrievability of engagement documentation may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. On this basis, firms shall design and implement controls to avoid unauthorised alteration or loss of engagement documentation.

*Common areas for improvement*

4.3.8.2 Seven of the eleven firms inspected had no or insufficient controls to avoid unauthorised alteration or loss of archived hardcopy engagement documentation after they are archived.

*Our recommendation*

4.3.8.3 Firms should re-evaluate and strengthen their policies and procedures in maintaining integrity and managing accessibility and retrievability of archived hardcopy engagement documentation. The aim is to avoid unnecessary retrieval and minimise the risk of unauthorised alteration or loss of archived hardcopy engagement documentation after they are archived.

## Section 5

### Updates on the 2020 inspections

#### 5.1 Remediation plans for the 2020 inspections

- 5.1.1 As mentioned in the 2021 Interim Inspection Report, audit firms are required to conduct RCA and submit a plan to address deficiencies identified from our inspections of the systems of quality control and selected engagements (**Remediation Plan**). Remedial actions include but are not limited to strengthening quality control policies and procedures, enhancing audit methodology, developing new audit tools and guidance, and providing training to audit personnel on areas where deficiencies were identified in our inspections.
- 5.1.2 We reviewed the Remediation Plans submitted by all the 18 audit firms we inspected in 2020 and provided feedback on their Remediation Plans. Many firms were responsive and proactive in improving their audits.
- 5.1.3 Common areas for improvement and good practices observed in relation to RCA and Remediation Plans were set out in the 2021 Interim Inspection Report. We received positive feedback that our sharing of good practices observed from firms of similar size was insightful and valuable. They helped auditors fill the knowledge gaps and reduce the time it takes to develop responses to address the deficiencies identified.
- 5.1.4 All the 18 audit firms inspected in 2020 confirmed that they completed the remedial actions in the Remediation Plans. We will assess the effectiveness of these remedial actions in the next inspection.

#### 5.2 Follow-up actions on engagements with significant findings

- 5.2.1 27 engagements inspected in 2020 were rated “Improvements required” or “Significant improvements required”. Considering the nature and significance of the deficiencies identified in these engagements, we referred 16 of them to the Department of Investigation and Compliance for its consideration of initiating an enquiry and/or investigation. These 16 engagements related to financial statements which may be misstated or there were significant deficiencies in the conduct of the audit.
- 5.2.2 Auditors of 14 of the 27 engagements were required to perform additional procedures to obtain more audit evidence to assess whether any change of audit opinion or a prior period adjustment was necessary to correct an error in the financial statements in response to the significant findings we identified from our inspections.

- 5.2.3 After performing additional audit procedures, these auditors confirmed that no change of audit opinion nor prior period adjustments was required. However, following our review of their additional work, we identified that the further procedures performed by two engagement teams still did not provide sufficient audit evidence to support such conclusions. We have provided the additional information obtained from these two engagement teams to the Department of Investigation and Compliance for consideration. In addition, we will consider conducting further inspections on the related audit firms.
- 5.2.4 Auditors of 8 of the 16 engagements discussed under section 5.2.1 were required to perform RCA to identify the underlying root causes of the significant findings identified in the engagement inspections as they resigned as the auditors subsequent to our inspections. In addition, we encouraged these auditors to share the information on the significant findings identified from our inspections with the relevant audit committees so that they could take follow up actions regarding these matters with their successor auditors.
- 5.2.5 Majority of auditors mentioned in section 5.2.4 attributed their resignation due to their inability to reach an agreement with the management about the audit fee and their insufficient resources. While they all determined insufficient resources as one of the problems underlying the deficiencies identified during our engagement inspections, there are other root causes, including lack of required technical knowledge and experience, insufficient supervision and review, etc.
- 5.2.6 Listed entity auditors have to recognise that they serve a public interest and therefore they have to be committed to perform quality audits. Firms should only accept their client relationships and engagements when their engagement teams are competent to perform the audit engagements and have the necessary capabilities, including time and resources. We would not hesitate to take actions against firms which failed to do so.
- 5.2.7 We observed the following good practices with respect to the additional procedures and assessment performed by the auditors in addressing the significant findings we identified:
- a. Substantial involvement of independent reviewers to ensure that the nature and extent of the additional audit procedures performed were sufficient and appropriate to address the significant findings.
  - b. Standard templates were developed by some auditors, which assisted the engagement teams in comprehensively documenting additional audit procedures performed in response to our significant findings. The engagement teams also assessed and clearly documented in these templates the financial impact of the significant findings based on the additional procedures performed.

## Section 6

### Looking ahead

#### 6.1 Introduction

6.1.1 This section sets out our directional observations for audit firms on the implementation of the new quality management standards and revised auditing standards for identifying and assessing the risks of material misstatement, as well as our approach for the preparation of the further reform of the accounting profession.

#### 6.2 Quality Management Standards

6.2.1 As highlighted in section 6 of our 2020 Annual Inspection Report, firms are required to have their new system of quality management designed and implemented by 15 December 2022. We are monitoring the progress of listed entity auditors in implementing the transition to the new and revised quality management standards (the **New QMSs**). On 31 March 2022, we published the results of our survey with respect to the implementation progress of listed entity auditors for the New QMSs. The results of the survey highlighted the expected impact of the New QMSs on firms, the status of implementation and the key challenges to be addressed by them by different categories of firms. The survey results enable listed entity auditors of different sizes and nature to benchmark their own progress against that of their peers. The survey results are available in the FRC's website.

6.2.2 The survey results also facilitated our Department of Oversight, Policy and Governance's oversight of the performance of the HKICPA in relation to the provision of sufficient timely training and appropriate reference materials to the audit profession. We will conduct a further survey of all listed entity auditors in September 2022 to ascertain their readiness to implement the New QMSs 15 December and will publish the results.

### **6.3 Revised auditing standards for identifying and assessing the risks of material misstatement**

- 6.3.1 HKSA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*, which became effective for audits of annual financial statements beginning on or after 15 December 2021, establishes more robust requirements and detailed guidance to drive auditors to perform consistent and effective risk assessment processes that provide the basis for the design and performance of further audit procedures. The revised standard focus on enhancing the auditor’s approach to understanding the entity, its environment and the risk assessment process in light of the changing environment and reinforces the need for the auditor to exercise professional skepticism. Depending on the nature, size and complexity of the entity, the implementation of the new requirements may require a considerable amount of time and effort. With less than a year to the audit of the relevant annual financial statements, we urge firms to start identifying and implementing changes to the audit methodology and provide training for the engagement teams to ensure they understand and comply with the revised standard.

### **6.4 Further reform**

- 6.4.1 Under the further reform of the accounting profession, we will take over from the HKICPA the responsibility for conducting inspections of practice units. This will add to our existing inspection functions in relation to listed entity audits completed by listed entity auditors. To prepare for this expanded role, we will work closely with the HKICPA to ensure a smooth and seamless transition of this new responsibility to the FRC. The future Accounting and Financial Reporting Council will adopt a proportionality approach to regulate the practice units. The assumption of this expanded function will not only enhance regulatory efficiency and ensure consistency with the international practice but also promotes the sustainable development of the accounting profession. Details about our regulatory principles with respect to inspection under the new regime can be found in our Engagement and Consultation Paper on further reform of the accounting profession which is available in the FRC’s website.

## Annex 1

### Overview of our inspection

#### 1.1 Introduction

1.1.1 Our inspection methodology and approach are broadly consistent with last year's. This section sets out an overview of our inspection methodology and approach, including how we conduct inspections, evaluate our findings and assign audit quality ratings, and the actions that can be taken in response. We also describe the oversight of the inspection function and cooperation within the FRC.

#### 1.2 Our inspection methodology

1.2.1 The FRC is responsible for inspecting listed entity auditors and the objectives of an inspection are to monitor and promote audit quality. An inspection focuses on how a listed entity auditor conducted listed entity engagements and on the effectiveness of that auditor's system of quality control, to determine whether the applicable professional standards and legal and regulatory requirements have been complied with.

1.2.2 The FRC has a responsibility to inspect all listed entity auditors wherever they may be located. Where the FRC wishes to inspect a Mainland auditor we would request assistance from the SEB under the Memorandum of Understanding signed with them. Overseas auditors may be inspected directly by the FRC or through reliance on inspections performed by a firm's home regulator.

1.2.3 Hong Kong listed entity auditors that audit more than 100 listed entities are selected for inspection annually and the remaining auditors are selected for inspection at least once every three years. These auditors, however, will not necessarily be visited on a strict three-year cycle as they may be selected for an inspection ahead of the three-year cycle if there are any indications of a potential risk to audit quality that needs to be addressed.

1.2.4 For firms selected for inspection, we inspect the firm's system of quality control and a number of individual listed entity engagements. These engagements may include audits of listed entities and listed collective investment schemes, reports to be included in listing documents, and reports to be included in circulars issued in respect of very substantial acquisitions and reverse takeovers under the Listing Rules of The Stock Exchange of Hong Kong.

- 1.2.5 The FRC's methodology for selecting engagements and the areas of our inspection focus in each engagement are weighted towards engagements and areas we consider to have a higher risk to audit quality. Such risk factors include but are not limited to the following:
- a. the nature or principal activities of the PIE;
  - b. whether the PIE has significant operations in certain emerging businesses or markets;
  - c. those industries that were severely impacted by the COVID-19 pandemic;
  - d. areas that present audit challenges and/or significant audit risks;
  - e. whether the engagement partners or EQCRs are subject to investigation or sanction;
  - f. that the auditor's report was issued shortly after the appointment; and
  - g. the level of public interest, such as audits of listed entities with larger market capitalisation and capital market transaction engagements such as IPOs.
- 1.2.6 We also incorporate an element of unpredictability during the selection process, such as selecting engagements on a discretionary basis or with reference to the auditors' internal monitoring results.
- 1.2.7 In addition, we exchange information with our Department of Investigation and Compliance and take into consideration complaints or referrals received by them and the results of their financial statements review program in our engagement selection processes.
- 1.2.8 We maintain a database of all entities listed in Hong Kong. The database is updated continuously and comprises information on the listed entity's businesses and governance, its auditor and key information from its published financial information and auditor reports. Prior to the commencement of an inspection, the listed entity auditor is required to provide further information specific to each of their listed entity engagements.
- 1.2.9 We identify the presence of audit quality risk factors in engagements from the information we maintain and have received from the auditor. A weighting is applied to these risk factors to generate a shortlist of engagements. Each engagement on the shortlist is individually reviewed to determine the final list of engagements to inspect.
- 1.2.10 To maintain our objectivity and impartiality, each inspector is required to sign a confirmation declaring he or she has no conflict of interest with both the audit firm and the listed entity engagement to be inspected.

### **1.3 Audit working papers located in the Mainland**

- 1.3.1 Data from The Stock Exchange of Hong Kong shows that as at 31 December 2021 approximately 53% of the listed companies in Hong Kong were Mainland enterprises, representing 79% of the market's capitalisation. Furthermore, approximately 80% of the audits conducted by the seventeen auditors we inspected in 2021 involved work performed in the Mainland. These auditors collectively audit entities representing 89% of the market's capitalisation.
- 1.3.2 To further enhance our effectiveness as an independent auditor regulator, the ability to effectively inspect audit working papers located in the Mainland is of paramount importance to the FRC. During the review period, we have maintained regular contact with the SEB to discuss a collaborative framework for conducting inspections of cross-border engagements. Positive progress is being made with the support of the SEB. We also continued to closely collaborate with the SEB through regular knowledge sharing and information exchange and cooperation on matters of mutual interest.

### **1.4 How we conduct our inspections**

- 1.4.1 Our inspections cover a firm's system of quality control and a selection of listed entity engagements.
- 1.4.2 An inspection of the system of quality control covers how that system is designed and operates in practice, and how it impacts listed entity engagements. We assess the compliance of the auditor's system of quality control with HKSQC 1.
- 1.4.3 An inspection of the system of quality control is carried out principally through discussions with the auditor's leadership and management, review of the required documentation to be maintained by the auditor and by evaluating and testing the auditor's relevant policies and procedures.
- 1.4.4 An inspection of a listed entity engagement is performed by assessing the auditor's compliance with any statement on professional ethics, or standards on accounting, auditing or assurance practices, issued by the HKICPA and international bodies such as the IAASB and IESBA or specified under the Listing Rules, or comparable standards allowed by the Securities and Futures Commission or by Hong Kong Exchanges and Clearing. An inspection is conducted through review of the required documentation to be maintained by the auditor and discussions with the engagement team.

- 1.4.5 An engagement inspection does not involve review of all the audit working papers of the selected engagement, nor is it designed to identify every weakness/and or deficiency of the selected engagement. We generally focus our attention on audit areas we believe to be of greater complexity and areas of greater significance or with a heightened risk of material misstatement to the financial statements. An inspector focuses on the appropriateness of key judgements made in reaching a conclusion and the sufficiency and appropriateness of the evidence obtained.

## **1.5 Evaluation of engagement quality and firm-wide systems of quality control**

- 1.5.1 A finding relating to the systems of quality control represents a significant deficiency relating to the firm's policies and procedures in complying with or applying HKSQC 1. We also make recommendations based on our experience and observed best practice, and provide insights to improve the overall system of quality control. In addition, we evaluate whether the engagement findings identified indicate issues only at the level of particular engagements or at the level of the system of quality control that are required to be addressed at a firm-wide level.
- 1.5.2 An observation represents a deficiency that does not amount to a finding but should be drawn to the attention to the auditor. Observations are discussed with the auditor at the final stage of inspection and are not included in the inspection report.
- 1.5.3 A finding relating to an engagement represents a significant deficiency in applying applicable professional standards that amounts to a significant deficiency on its own or that may do so in combination with other deficiencies. The significance of individual deficiencies to the quality of an audit varies widely. Our judgement on the significance of a deficiency takes into account the nature and extent of a deficiency together with the facts and circumstances giving rise to the deficiency.
- 1.5.4 At the conclusion of an inspection, we consider findings or the combined impact of the number or nature of findings to arrive at an overall evaluation of the audit quality of that engagement and determine an audit quality rating.

1.5.5 The system of quality control of a listed entity auditor is not rated, however, individual engagements which are selected for inspection are rated for audit quality based on their inspection findings. There are four ratings of audit quality that can be assigned to each individual listed entity engagement. The four ratings of audit quality are:

Category 1	Good
Category 2	Limited improvements required
.....	
Category 3 #	Improvements required
Category 4 #	Significant improvements required

# *Indicates a less than satisfactory inspection result*

1.5.6 It is important to note that an inspection may not involve review of all the audit working papers of a listed entity engagement nor is it designed to identify every weakness/and or deficiency of the selected listed entity engagement. Accordingly, the FRC’s inspection report should not be understood to provide any assurance on the audit work of the listed entity auditor or to indicate that the financial statements of the selected listed entities are free from any inaccuracy or misrepresentation not specified in the inspection reports.

1.5.7 The quality rating for each engagement and the deficiencies identified in a firm’s system of quality control are compared and calibrated to inspections conducted at the same and other firms to ensure their consistency. Before being issued, each firm-wide and engagement inspection report is reviewed by the Head of Inspection or, where there is a conflict of interest, by the Chief Executive Officer, for quality and the appropriateness of the deficiencies identified and ratings assigned to engagements.

1.5.8 During the course of our inspection, we hold frequent meetings with the engagement team and the auditor to discuss our findings. Prior to the conclusion of the inspection visit, we discuss and agree with the auditor factual information on the procedures performed during the engagement to address the area of concern relating to each finding, so that the inspector makes an assessment of the severity of the finding and the overall audit quality of the engagement on a fair and accurate basis.

1.5.9 At the conclusion of each inspection, we issue a draft inspection report, which sets out the findings from our system of quality control and engagement inspections, our quality ratings and key rating drivers for each engagement inspected, and any good practice observations, to the individual listed entity auditors inspected to provide them a reasonable opportunity to be heard in respect of the matters set out in the report.

- 1.5.10 When all written representations have been received or the deadline for making representations has otherwise passed, the inspector will consider any representations from the auditor which have been submitted and may modify the draft inspection report in the light of such representations before finalising it.
- 1.5.11 The auditor is required to perform an analysis of the root causes of the deficiencies identified in our inspections of the system of quality control and engagements, and to develop and execute a plan to remediate those deficiencies. The auditor is also required to evaluate the findings on engagement inspections and perform further work to obtain sufficient appropriate audit evidence to support its conclusions where needed. We evaluate the proposed remediation plan and discuss and agree the timeframe for implementing the remediation steps with the auditor. We may also inspect and evaluate the additional work performed and evidence obtained by the auditor to remediate significant findings on both the system of quality control and engagement, and test the effectiveness of these remediation actions in the subsequent inspection year.

## **1.6 Consequences of inspection**

- 1.6.1 The FRC may take a range of follow-up actions in respect of an inspection report under section 21H of the FRCO, including:
- a. requiring the auditor to take a measure or corrective action;
  - b. conducting a further inspection;
  - c. initiating an investigation where a possible practice irregularity is identified, for example, the listed entity auditor has been negligent in its work which results in potential misstatements in the financial statements and/or an inappropriate audit opinion;
  - d. imposing a sanction where there is evidence that the listed entity auditor has committed a misconduct; and
  - e. taking any other follow-up action that is considered appropriate.
- 1.6.2 We determine appropriate follow-up actions to be taken against engagements rated 3 and 4. Where possible misconduct as defined under the FRCO is identified, the case may be referred to the Department of Investigation and Compliance for appropriate action. Where there is sufficient evidence of misconduct on the part of an auditor, for instance, where a breach of ethics is clearly identified, the case may be referred to the Department of Discipline directly for consideration of sanctions.

- 1.6.3 Where our inspections identified potential material misstatements in the financial statements and/or indications of fraud committed by a listed entity, we will also share the relevant information with the SFC for its consideration of appropriate follow-up action.

## **1.7 Oversight**

- 1.7.1 Our inspection processes are subject to an appropriate level of oversight by the Inspection Committee and the Process Review Panel.
- 1.7.2 The Inspection Committee advises the Board on matters concerning the inspection function and comprises Board directors and Honorary Advisors with relevant expertise. The Committee also provides oversight of the work of the inspection function and, where requested, advises on the evaluation of individual findings, the overall audit quality rating of inspected engagements and on our assessment of deficiencies in systems of quality control.
- 1.7.3 The Inspection Committee also undertakes an ex post review of a sample of completed inspections, the aim of which is to ensure that the FRC maintained fairness and consistency in its inspection process, properly used its regulatory powers, and provide recommendations on how the Inspection Department might enhance their practices and procedures.
- 1.7.4 The PRP for the FRC is an independent body appointed by the Chief Executive of the HKSAR to provide an external check and balance with the aim to ensure that individual inspections were handled consistently and in accordance with internal procedures and guidelines. In its 2021 review, the PRP reviewed three engagement inspections and three inspections of systems of quality control conducted by the FRC during the period from 1 October 2019 to 31 December 2020, and concluded that these cases were handled in accordance with the internal procedures.
- 1.7.5 In view of the public interest involved in the inspection processes, and in addition to the oversights conducted by the Inspection Committee and the PRP in 2021, the ICAC also conducted a detailed study in respect of the practices and procedures of the inspection function to ensure that adequate corruption prevention safeguards were in place. The ICAC concluded that the FRC had put in place safeguards to mitigate the possible risks of corruption.

## **1.8 Working with the Department of Oversight, Policy and Governance**

- 1.8.1 We discuss our observations from inspections with the Department of Oversight, Policy and Governance of the FRC to provide input to FRC policy and governance initiatives, including addressing systemic issues in the audit market, oversight of the performance of the HKICPA in relation to the provision of training and reference materials to auditors, audit committees and other stakeholders.

## Annex 2

### Glossary

This glossary provides definitions of the acronyms, abbreviations and key terms used in this Report:

COVID-19	Coronavirus disease 2019
CPD	Continuing professional development
ECL	Expected credit loss
EQC	Engagement quality control
EQCR	EQC reviewer
FRC	Financial Reporting Council of Hong Kong
FRCO	Financial Reporting Council Ordinance
HKFRS	Hong Kong Financial Reporting Standard
HKFRS 15	Revenue from Contracts with Customers
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSA	Hong Kong Standard on Auditing
HKSQC	Hong Kong Standard on Quality Control
ICAC	Independent Commission Against Corruption
KAM	Key Audit Matter
MOF	Ministry of Finance of the People's Republic of China
PRP	Process Review Panel
RCA	Root cause analysis
SEB	Supervision and Evaluation Bureau of the Ministry of Finance
SFC	Securities and Futures Commission



