Financial Reporting Council 財務匯報局

Inspection

Interim Inspection Report

3 November 2021

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.

Contact information
Email: general@frc.org.hk
Phone: (852) 2810 6321

FRC Financial Reporting Council 財務匯報局

Foreword from the Chief Executive Officer

I am pleased to share with the public our second interim inspection report, which includes information on findings from inspections of listed entity engagements and quality control systems in the middle of our inspection cycle. The report includes a description of the common deficiencies of the engagements and firm-wide systems of quality control that we have inspected to date, and the actions that we expect auditors and audit committees to take in response to them ahead of the next audit cycle. This report also sets out the actions we have taken in respect of inspections completed in 2020 and potential areas of inspection focus in 2022.

Our findings and their key drivers

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

Our inspections evaluate the quality of a selection of an auditor's engagements for listed entities and the effectiveness of the auditor's system of quality control. The report shows that, despite the still high level of deficiencies we have identified, there have been improvements in key areas of the audit compared to the full year results of inspections in 2020.

We found that 55%, or 12 of the 22 engagements, inspected to date had one or more deficiencies relating to the lack of exercise of professional scepticism in the audit. While this is still not acceptable, there has been a significant improvement compared with the 81% of engagements inspected in 2020 with deficiencies in this area.

There have been significant improvements in the number and significance of deficiencies in areas of the audit relating to Key Audit Matters, the testing of journal entries, the use of auditor's experts and the sufficiency of documentation. Furthermore, there has been a reduction in the level of deficiencies identified in inspections of Category A firms in all but one of the common areas of findings we report. This indicates that, as a group, the Category A firms are taking action to improve audit quality in response to our inspections of those firms in 2020.

In contrast, there has been a significant increase in the number and significance of deficiencies identified in the auditor's work on revenue recognition. This is an important area of the audit because of the significance of revenue as a performance indicator for investors and the complexity of many revenue recognition models. Of the 17 engagements where this was an area of our inspection focus, we found deficiencies in 11 cases (65%, up from 46% in 2020). Furthermore, in 9 of these 11 cases (82%, up from 33% in 2020), the significance of the deficiencies to the overall quality of the audit was high. Auditors urgently need to improve their work in this area. Audit committees also need to take action to challenge listed entity management as to the appropriateness of the design and implementation of the entity's revenue recognition policies and their auditors as to whether their audit work in this area is adequate to ensure that revenue is appropriately recognised.

We also highlight in this report the characteristics of the engagements to which we were able to award the highest audit quality rating for the first time. These characteristics include the early and substantial involvement of the audit partner throughout the audit, robust challenge of management around key estimates and significant assumptions, and high quality information provided by the listed entity. This last characteristic highlights the significant synergistic benefits for investor confidence in the audited financial statements that can accrue when the financial reporting process and the audit are both delivered with high quality. Audit committees have a key role in driving this outcome.

An effective system of quality control is essential in driving consistent, high quality audits. Deficiencies we find in an auditor's engagement inspections are a reflection of deficiencies we find in their quality control systems. The common deficiencies identified from ten Category B and C firms inspected to date are consistent with those disclosed in our 2020 Annual Inspection Report. They relate to internal monitoring, independence and promoting an internal culture of quality. Although these ten firms have not been inspected previously, the consistency of these findings indicates that firms have not yet taken sufficient appropriate action in response to our publication of these deficiencies in earlier reports.

The role of audit committees

The directors of a company are responsible for the preparation of financial statements, and for the effectiveness of internal controls to enable those financial statements to be prepared free from material misstatement. Audit committees assist the directors in discharging their responsibilities for overseeing the financial reporting process and have a pivotal role in both the preparation of the financial statements and in holding their auditor to account for high quality audits.

Audit committees need to take action to ensure that listed entities have adopted accounting policies consistent with the requirements of accounting standards, and that the entity has adequate resources and internal controls to prepare high quality financial information. Audit committees should consider the deficiencies described in this report to challenge the auditor as to whether and how they have appropriately addressed these issues in their ongoing audits and management as to whether they are providing the auditor with the quality and timeliness of information necessary to enable them to carry out their audit effectively.

Our follow up actions

All firms inspected in 2020 were required to perform an analysis of the root causes of the deficiencies identified in our inspections of their audits and systems of quality control, and to develop and execute a plan to remediate those deficiencies. The root cause analysis and remediation process is not sufficiently well understood by many firms and we will provide guidance to regulated audit firms ahead of our next inspection cycle.

Financial Reporting Council 財務匯報局

We have also evaluated those engagements where the quality of the audit fell short to determine the appropriate follow-up actions to be taken. The auditors of 24 engagements have been required to take a specified action to correct deficiencies identified, with the work of 16 of those engagements also being referred for possible enforcement action, including a recommendation to initiate an investigation into the work performed by the auditor or an enquiry into possible non-compliance with accounting standards by the listed entity.

We welcome constructive relationships with our regulated audit firms and commend their ambition to improve the quality of their work.

Marek Grabowski
Chief Executive Officer

Financial Reporting Council 財務匯報局

Table of contents

Section 1

Introduction

1.1 Purpose of this report

1.1.1 The purpose of this interim report is to provide timely public disclosure of common findings from our inspections to date of audit quality control systems of listed entity auditors and a sample of their audit engagements, and to set out our expectation that listed entity auditors and audit committees should take appropriate actions in response to our findings.

1.1.2 This report also provides an update on the actions taken by auditors and by the FRC in respect of inspections completed in 2020. Furthermore, the report identifies potential areas where risks to the performance of high quality audit engagements may be higher in the coming audit cycle and on which we may place greater focus in our inspections in 2022.

1.1.3 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. The performance of high quality audits, and the maintenance of effective audit quality control systems, are crucial elements of the listed entity financial reporting ecosystem and contribute to ensuring Hong Kong remains a competitive international financial centre. A high quality audit is one that meets both the spirit and the letter of applicable laws and standards.

1.1.4 The FRC evaluates the quality of a selection of an auditor’s engagements for listed entities and the effectiveness of the auditor’s quality control system under our statutory duty and powers to carry out inspections. Our approach is designed to assess the quality of audit engagements and the systems of quality control and then require remediation and improvement where individual auditors fall short.

1.1.5 To date the FRC has completed 22 of 51 engagement inspections and 10 of the 17 inspections of the quality control systems of listed entity audit firms planned to be conducted in 2021. Although our inspection work is ongoing, we are making public disclosure of our interim findings now to provide timely feedback and set out our expectations for listed entity auditors (including those not yet inspected). This will enable them to respond to our market-wide findings and improve the effectiveness of their quality control systems and the quality of their individual engagements. We will report our findings from all inspections performed in this our second year of inspection, our engagement quality ratings and our expectations for actions to be taken by listed entity auditors and audit committees in our Annual Inspection Report to be issued in 2022.

1.1.6 Directors have the fiduciary duty to ensure that financial statements are prepared in accordance with the applicable financial reporting framework and they have a key role in understanding and approving key areas of judgement and estimation applied in preparing the financial statements. Audit committees are responsible for overseeing the entire financial reporting process, and have a pivotal role in monitoring the quality of information provided by management and evaluating and challenging the work performed by the external auditor. We continue to encourage directors and audit committees to consider the matters in this report and to challenge their auditor as to whether they will be appropriately addressed in the forthcoming audit cycle.

FRC Financial Reporting Council 財務匯報局

Section 2

Our Inspection of engagements

2.1 Introduction

2.1.1 Our inspection focuses on the quality of auditor's engagements for listed entities and assesses whether the applicable professional standards, laws and regulations have been complied with.

2.1.2 Our inspection methodology and approach are consistent with that as set out in section 5 of our 2020 Annual Inspection Report (see link).

2.1.3 The selection of engagements is risk-based. In response to the changing economic conditions, the continued effects of the COVID-19 pandemic and the experience from our inspections in 2020, we gave higher weighting to engagements which exhibited higher risks to audit quality in 2021. These include engagements:

- in those industries that were severely impacted by the COVID-19 pandemic;
- that had a change in auditor near or after the financial reporting date; and
- with a greater public interest, such as audits of listed entities with larger market capitalisation and capital market transaction engagements such as IPOs.

2.1.4 We set out below our most common significant findings across the engagements we have inspected as at the end of August 2021. We also highlight the factors that were present in inspected engagements rated as "Good".

2.1.5 We expect auditors to take into account the deficiencies we have identified when planning and performing their audits. In order to prevent these deficiencies from occurring in their next audit cycle, audit firms should take appropriate actions and consider the need to enhance their systems of quality control, including enhancing the management of their resources, the provision of training and providing updates to audit guidance and work programmes.

2.2 Overall inspection results

2.2.1 The lack of adequate exercise of professional scepticism remains a common driver of poor audit quality. Our inspection findings show that 55%, or 12 of the 22 engagements, have a deficiency related to professional scepticism and 67% of these deficiencies had a significant impact on audit quality rating. While this is still not acceptable, this is an improvement from 2020 where 81%, or 30 of the 37 engagements, had findings in this area, of which 70% had a greater impact on the audit quality rating. Significant improvement in this area was observed at Category A and B firms compared to the results from our 2020 Inspections.

2.2.2 We identified a significant increase in deficiencies in the auditor's evaluation of the application of accounting standards related to revenue recognition. Our inspection findings show that 53%, or 9 of the 17 engagements, had deficiencies which individually had a significant impact on audit quality rating (compared to 15%, or 4 of the 26 engagements, in our 2020 Inspection). While the incidence of deficiencies in this area remained constant at 56% of the engagements inspected at Category A firms where revenue recognition was an area of focus, there was a significant increase, from 0% to 80%, of such engagements at Category B firms.

2.2.3 We also identified significant deficiencies related to the auditor's evaluation of modifications of the terms of debt instruments in both of the two engagements we inspected where this was an area of inspection focus.

2.2.4 When compared to our 2020 Inspection we have identified improvements in the auditor's response to Key Audit Matters (**KAMs**), the testing of journal entries, the use of auditor's experts and sufficiency of documentation. Our inspection findings show that 14%, 36%, 8% and 41% of the engagements we inspected had deficiencies relating to KAMs, the testing of journal entries, the use of auditor's expert and documentation respectively (compared to 32%, 57%, 48% and 68%, in our 2020 Inspection respectively). With the exception of findings related to the testing of journal entries and Key Audit Matters by Category C firms, there were significant improvements in the level of deficiencies in these areas observed at all sizes of audit firms inspected.

2.2.5 We do not inspect the entire working paper file. Hence, the areas of focus for each engagement inspected are not necessarily consistent with those selected in 2020.

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

2.2.7 The tables on the following pages show the number of engagements we inspected by the end of August 2021 that had one or more findings in key areas, disaggregated by their significance in driving the audit quality rating (Table 1) and by the number of listed entity audits a firm completes annually (Table 2). To illustrate the trend of our findings, the tables also include comparative information as shown in our 2020 Annual Inspection Report.

2.2.8 Auditors and audit committees should pay particular attention to those common findings which have a greater impact on audit quality as these deficiencies indicate significant shortcomings in the work of the auditor and generally relate to key areas of the financial statements. Audit committees also need to challenge listed entity management as to the appropriateness of the design and implementation of the entity's accounting policies over revenue recognition and expected credit losses, and to challenge the auditor's work in these areas. Our inspections have identified instances where the listed entity has not applied the relevant accounting standard appropriately, and the auditor has not complied with applicable professional standards, leading to a potential material misstatement in the financial statements.

2.2.9 In interpreting the data in the following tables, **it is important to recognise that our 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 work.** As a policy, where we consider it reasonably possible that the financial statements are materially misstated, we refer the matter internally for enforcement action and share the relevant information with the Securities and Futures Commission (**SFC**) for its consideration of appropriate follow-up action.

Table 1 Significance of findings on audit quality rating

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected:					
	2021 Interim			2020 Annual		
	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
Lack of professional scepticism	**12 / 22 55%**	8 / 12 67%	4 / 12 33%	**30 / 37 81%**	21 / 30 70%	9 / 30 30%
Deficiencies in evaluating the application of accounting standards						
Revenue recognition	**11 / 17 65%**	9 / 11 82%	2 / 11 18%	**12 / 26 46%**	4 / 12 33%	8 / 12 67%
Expected credit loss impairment	**5 / 9 56%**	3 / 5 60%	2 / 5 40%	**11 / 20 55%**	9 / 11 82%	2 / 11 18%
Modification of debt instruments	**2 / 2 100%**	2 / 2 100%	-	-	-	-
Deficiencies in testing of journal entries	**8 / 22 36%**	2 / 8 25%	6 / 8 75%	**21 / 37 57%**	4 / 21 19%	17 / 21 81%
Deficiencies relating to Key Audit Matters	**3 / 22 14%**	2 / 3 67%	1 / 3 33%	**12 / 37 32%**	9 / 12 75%	3 / 12 25%
Deficiencies in using the work of an auditor's expert	**1 / 12 8%**	1 / 1 100%	-	**11 / 24 46%**	3 / 11 27%	8 / 11 73%
Inadequate documentation	**9 / 22 41%**	0 / 9 0%	9 / 9 100%	**25 / 37 68%**	0 / 25 0%	25 / 25 100%

FRC Financial Reporting Council 財務匯報局

Table 2 Findings disaggregated by category of firm

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected:				
	2021 Interim				2020 Annual
	Total	Category A[1]	Category B[1]	Category C[1]	Total
Lack of professional scepticism					
- Going concern - Asset impairment - Business rationale - Fraud	**12 / 22 55%**	5 / 12 42% *(73%)*[2]	4 / 7 57% *(100%)*	3 / 3 100% *(86%)*	**30 / 37 81%**
Deficiencies in evaluating the application of accounting standards					
Revenue recognition					
- Performance obligations - Determination and allocation of transaction price - Construction contracts	**11 / 17 65%**	5 / 9 56% *(56%)*	4 / 5 80% *(0%)*	2 / 3 67% *(50%)*	**12 / 26 46%**
Expected credit loss impairment					
- Credit quality assessment - Recoverability	**5 / 9 56%**	2 / 3 67% *(50%)*	1 / 3 33% *(80%)*	2 / 3 67% *(40%)*	**11 / 20 55%**
Modification of debt instruments	**2 / 2 100%**	-	2 / 2 100% *(N/A)*	-	**-**
Deficiencies in testing of journal entries	**8 / 22 36%**	2 / 12 17% *(50%)*	4 / 7 57% *(75%)*	2 / 3 67% *(57%)*	**21 / 37 57%**
Deficiencies relating to Key Audit Matters	**3 / 22 14%**	1 / 12 8% *(23%)*	0 / 7 0% *(50%)*	2 / 3 67% *(43%)*	**12 / 37 32%**
Deficiencies in using the work of an auditor's expert	**1 / 12 8%**	1 / 9 11% *(41%)*	0 / 3 0% *(100%)*	0 / 0 0% *(40%)*	**11 / 24 46%**
Inadequate documentation	**9 / 22 41%**	4 / 12 33% *(55%)*	4 / 7 57% *(75%)*	1 / 3 33% *(100%)*	**25 / 37 68%**

1 Category A, B and C firms audit more than 100, between 10 and 100, and at least one and 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 The percentage in the bracket denotes the comparative figure as shown in our 2020 Annual Inspection Report.

2.3 Lack of adequate exercise of professional scepticism

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

Exercise of professional scepticism by an auditor is important throughout the audit engagement. If exercised effectively, it enables auditors to obtain the evidence they need to evaluate the potential risks of misstatement, plan their work in response to the assessed risks, and evaluate the evidence they obtain to determine whether the financial statements are materially misstated.

Without adequate exercise of professional scepticism, auditors might not have challenged management sufficiently or be sufficiently critical in their evaluation of audit evidence, and therefore might not have obtained or properly evaluated all the evidence needed to form the basis for their opinion.

2.3.1 We continue to identify deficiencies in areas where management assumptions used in preparing the financial statements have a material impact and where there is a higher risk of management bias or fraud. 55%, or 12 of the 22 engagements we inspected to date had one or more deficiencies in this area and 67% of these deficiencies had a significant impact on audit quality. Examples include:

- The engagement team placed excessive or even sole reliance on management representations and failed to critically challenge management's assumptions used in going concern and asset impairment assessments such as substantial growth in revenue, cost savings, decrease in turnover days and minimal capital expenditure incurred during the forecast period.

- Where management forecast deferring the repayment of corporate bonds issued by the entity in making its going concern assessment, the engagement team did not challenge whether the repayment extension would be agreed by the bondholders and or obtain evidence to support this intention.

- The engagement team did not evaluate the judgement involved in the entity's compliance with financial covenants as part of the going concern assessment despite indications that loan covenants would be breached during the forecast period, leading to loans potentially becoming repayable on demand.

- The assessment of impairment of assets was sensitive to the probabilities assigned to the different scenarios of financial performance, as a small change in the relative probability of each scenario occurring would lead to a material impairment loss. The engagement team failed to perform sufficient appropriate audit procedures to evaluate management's key assumptions used in determining the relative probability of each scenario and assess whether the entity had appropriately disclosed the sensitivity of carrying amounts to the assumptions and estimates underlying the assessment.

- Failure to evaluate all available and/or disconfirming information, such as not considering the entity's actual performance after the financial period end which indicated that certain estimates used to support the going concern and asset impairment assessments were unrealistic.

- The engagement team did not maintain a questioning mind to critically challenge the commercial substance of transactions undertaken by the entity's money lending business, the lack of which might indicate the existence of fraud. Examples include a significantly higher cost of funding compared to the interest rates charged to customers and frequent loan extensions without additional consideration or security.

2.3.2 Directors have a key role in understanding and approving significant areas of judgement and estimation in preparing the financial statements. They should obtain an understanding of the key assumptions used in significant estimates that are material to the financial statements and challenge the entity's management where judgement or estimates did not reflect their knowledge and understanding of the business, its industry and/or the wider environment.

2.4 Deficiencies in evaluating the application of accounting standards

A failure to obtain sufficient, appropriate evidence that a listed entity has applied the requirements of financial reporting standards may result in the auditor failing to identify a material misstatement of financial statements or having an inadequate basis for their conclusion.

2.4.1 The deficiencies identified in the work of the auditors set out below in some instances also indicate that listed entity management has not applied relevant accounting standards appropriately, and that directors and audit committees have not sufficiently challenged the entity's accounting policies in areas which have a material impact on the financial statements.

Revenue recognition

2.4.2 We determined revenue recognition as an area of inspection focus in the majority of the engagements inspected due to the complexity of revenue models, the prevalence of significant findings identified in our 2020 inspections, and because revenue is a key performance indicator used in evaluating the financial performance of an entity. The application of relevant accounting principles to revenue can be complex and auditing standards contain a rebuttable presumption of the existence of a significant risk of fraud associated with revenue recognition.

2.4.3 We identified deficiencies relating to the application of HKFRS 15 *Revenue from Contracts with Customers* (**HKFRS 15**) in 65% of those engagement where revenue was an area of inspection focus. 82% of the findings in this area were a key driver of the overall audit quality rating, including:

- Insufficient audit procedures over revenue recognition in relation to construction contracts

  In two of the engagements we inspected, the listed entity recognised revenue based on the actual costs incurred relative to the total estimated costs needed to satisfy the contract (**Input Method**). The engagement teams did not obtain sufficient audit evidence in response to the significant risk relating to the key accounting estimate of total estimated contract costs, for example, not obtaining sufficient understanding of controls related to budgeting and evaluating the design and implementation of these controls, and not performing a retrospective review over the previous estimates.

  In addition, the engagement team of one of the above engagements did not evaluate the material variation orders or significant changes in total estimated costs during the life of contracts, and had not obtained evidence on the allocation of staff costs to individual contracts.

- Failure to identify that management had not considered discounts and rebates when determining the transaction price of contracts. This may result in overstating revenue.

- Failure to evaluate the appropriateness of management's accounting for contract modifications under HKFRS 15. Management is required to apply judgement in determining whether a change to the terms of a contract creates a new, separate contract or modifies the original contract. The engagement team failed to identify that the entity had incorrectly accounted for the contract modification as a separate contract and recognised the outstanding balance of the contract liabilities of the existing contract as revenue in profit or loss. This resulted in a material misstatement in the financial statements.

- Failure to evaluate whether management had identified all the performance obligations in prepaid packages which comprised numerous goods and/or services, and had allocated the transaction price to these performance obligations accordingly.

2.4.4 Other findings relating to the application of HKFRS 15 include:

- Failure to evaluate the appropriateness of capitalising contract costs incurred.

Expected credit loss (ECL)

2.4.5 We identified deficiencies in 56%, or 5 of the 9 engagements where ECL was an area of inspection focus, and 60% of which had deficiencies with a significant impact on the overall audit quality rating. Findings in this area include:

- Instances where the ECL for trade receivables was measured using a provision matrix and balances were grouped based on the number of days that they were past due. The engagement teams had not tested the reliability of the ageing of receivables on which ECL was calculated, nor taken into account available forward looking information in the determination of default rates.

- Engagement teams did not perform sufficient audit procedures to assess the reasonableness of the default rates determined by management with reference to external sources of information or where contradictory evidence obtained in other audit procedures indicated that the historical default rates were substantially higher than the rates adopted by the listed entity.

- A lack of consideration of the appropriateness of the information used in forming the auditor's point estimates or ranges in assessing management's assumptions.

Modification of debt instruments

2.4.6 The economic effects of the COVID-19 pandemic have 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 failed to evaluate the appropriateness of the accounting treatment for modifications such as deferral of the payment of interest and/or principal or the decrease in interest rates, resulting in potential material misstatement of the financial statements. The deficiencies identified include insufficient evaluation of:

- Whether the modification of the terms of the debt instruments were "substantial" or "non-substantial" under HKFRS 9 *Financial Instruments* with reference to both qualitative and quantitative factors.

In an engagement we inspected, the maturity date of debt instruments was extended to perpetuity. The engagement team did not perform a qualitative test to assess whether the changes in the terms and conditions of the debt instruments was so significant that they constituted a "substantial" modification. Where the modification is considered to be "substantial", the entity accounts for the modification as an extinguishment of the existing liability and recognises a new liability. The difference between the fair value of the new liability and the carrying amount of the existing liability is recognised as a gain/loss in profit or loss (**Gain/Loss on Extinguishment**). Conversely, where the modification is considered to be "non-substantial", the entity restates the existing liability to the net present value of the revised cash flows, discounted at the original effective interest rate, and recognises the adjustment to the amortised cost of the liability in profit or loss. The two accounting treatments have a materially different impact on the amounts of gain/loss and the liability recognised in the financial statements.

- Whether the holder of the debt instruments was acting in the capacity as an equity participant or as a creditor in the modification arrangements

  Engagement teams did not evaluate the substance of the modification arrangements and challenge management as to why the instrument holder, if acting in the capacity as a creditor, was willing to accept a zero coupon rate or a very low interest rate to compensate for the credit or default risk borne as a result of granting a longer repayment period. Should the instrument holder act in the capacity of an equity participant in the arrangement, the Gain/Loss on Extinguishment might not satisfy the definition of "income" as defined in the *Conceptual Framework for Financial Reporting 2018* and therefore should be recognised within equity only.

2.5 Deficiencies in testing of 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 information by overriding controls that otherwise appear to be operating effectively.

Auditing standards require the auditor to test the appropriateness of journal entries and other adjustments made in the preparation of financial information in all audit engagements. This is because 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.

2.5.1 The number of engagements with deficiencies in testing of journal entries and other adjustments decreased from 57% in our 2020 Inspections to 36%, with significant reductions in the incidence of findings in this area in engagements inspected at Category A and B firms. The nature of findings in this area are broadly consistent with those of our 2020 Annual Inspection Report and firms should provide training and guidance to engagement teams so that appropriate audit evidence is obtained.

2.5.2 The areas where deficiencies were identified include:

- Failure to evaluate the completeness of the population of journal entries subject to testing.
- A lack of documentation on the correlation between fraud risk factors that are specific to the listed entity and the criteria used to identify journal entries with fraudulent characteristics determined by the engagement teams for testing.
- Insufficient documentation on the assessment of the appropriateness of consolidation adjustments and journal entries that contained fraudulent characteristics determined by the engagement teams, including the nature of the identified high-risk journals and the details of supporting documents examined.

2.6 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, of areas of significant management judgement, and how the auditor dealt with the areas of most significance in the audit.

2.6.1 We identified deficiencies relating to KAMs in 14%, or 3 of the 22 engagements we inspected, with 67% of these findings being assessed as having a significant impact on audit quality. This is a significant improvement from last year's inspection results. The nature of findings in this area was consistent with our 2020 Annual Inspection Report and relates to engagement teams not performing all of the procedures that were described in the auditor's report to address the KAM, and which may result in the auditor obtaining insufficient audit evidence to support their conclusions.

2.7 Deficiencies in using the work of an auditor's expert

2.7.1 We identified deficiencies in 8%, or 1 of the 12 engagements inspected where the auditor relied upon the work of an auditor's expert, a marked improvement on the 46%, or 11 of 24 engagements in which a deficiency was identified in this area in our 2020 Inspections. In this case, the engagement team placed sole reliance on the expert's work without evaluating the appropriateness and reasonableness of their source data and the assumptions and methods used. Firms we inspected in both 2020 and 2021 have shown improvement in this area and we expect deficiencies relating to the use of auditor's experts to decrease as firms continue to develop internal working paper templates and issue guidance to engagement teams.

2.8 Inadequate documentation

2.8.1 While improvements were observed in the area of documentation, we identified deficiencies in the extent of documentation in 41%, or 9 of the 22 engagements we inspected. Although the inspection results show improvement in this area, the high incidence of deficiencies identified indicates firms need to take further actions to improve the clarity and extent of documentation over the detailed procedures performed, evidence obtained and the matters considered in reaching conclusions.

2.8.2 As communicated with the auditors of listed entities at our debriefing sections in June 2021, "inadequate documentation" does not necessarily indicate that engagement teams did not obtain sufficient appropriate evidence but rather that the audit documentation was insufficient 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 conclusions reached. Where engagement teams have not obtained sufficient appropriate evidence over the matters concerned, findings are classified under the corresponding areas of focus.

2.9 Factors contributing to good quality audits

2.9.1 Our inspections to date show some improvement on last year's inspection results and a small number of engagements inspected were rated as being of "Good" audit quality. Factors contributing to these high quality engagements include:

- Early and significant partner involvement throughout the audit.

- Comprehensive planning to identify key audit risks at an early stage and design appropriate audit procedures in response to those risks.

- Good quality of information provided by the listed entity, including extensive documentation and support for key assumptions used by management in determining significant estimates.

  Auditors should proactively communicate the quality of information required from management and ensure that this standard is met. Directors are responsible for the quality of the financial statements and have a key role in ensuring that management provide auditors with the information requested in connection with the audit and that the listed entity has adequate resources and expertise to do so. Auditors should report to the directors and audit committee on the quality of the entity's financial reporting function and the information provided.

- Evidence of rigorous challenge of management around key estimates and significant assumptions with reference to internal and external sources of information.

- Clear and well-structured documentation of the matters considered, procedures performed and conclusions reached in key audit areas.

- The engagement team being adequately resourced, with sufficient and appropriate knowledge and experience.

FRC Financial Reporting Council 財務匯報局

Section 3

Our inspections of systems of quality control

3.1 Introduction

An effective system of quality control drives consistent, high quality audits. It should provide the firm with reasonable assurance that it and its personnel comply 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 Hong Kong Standard on Quality Control 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* (**HKSQC 1**) and other relevant standards, to identify and share good practices and to make recommendations for improvements.

3.1.1 In 2020 we inspected all of HKSQC1's six elements of a firm's system of quality control across all categories of firms. To align with the frequency of inspections at Category B and C firms, we now inspect the six elements of each Category A firm's system of quality control over a three-year cycle. In 2021, we are focusing our inspection on Category A firms' policies and procedures over Human Resources and Monitoring (including whistleblowing) with an aim to identify and share good practices and areas for improvements across these firms.

3.1.2 To date we have not completed our inspections of all Category A firms' systems of quality control and the results of our thematic review will be shared in our 2021 Annual Inspection Report.

3.1.3 Highlighted below are the common areas for improvement identified across the ten Category B and C firms inspected to date. Our findings are consistent with those disclosed in our 2020 Interim and Annual Inspection Reports and relate to internal monitoring, independence and promoting an internal culture of quality. These firms were not inspected in 2020 and the results of our inspection indicate that they had not responded proactively to strengthen their policies and procedures in connection with our findings reported in our previous publications. We also identified deficiencies in areas relating to complaints and allegations, and training.

3.1.4 Firms should take prompt and concrete action in response to our findings, including evaluating the effectiveness of policies and procedures currently in place and identifying areas where improvements are required.

3.1.5 Firms are 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.

3.2 Complaints and allegations

3.2.1 Firms are required to establish policies and procedures designed to provide with reasonable assurance that they deal appropriately with complaints and allegations that the work performed by the firm fails to comply with professional standards and applicable legal and regulatory requirements, and allegations of non-compliance with the firm's system of quality control. As part of this process, the firm must establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

Common areas for improvement

3.2.2 Five of the ten firms we inspected did not establish clearly defined channels for individuals to raise their concerns. In addition, three of the firms did not conduct a holistic review to identify if there were any common and systematic deficiencies underlying complaints and allegations received.

Our recommendation

3.2.3 Firms are required under HKSQC 1 to establish reporting channels which enable its personnel, clients or other third parties to raise concerns and report misconduct. An effective process should be set up to thoroughly investigate and report complaints and allegations in a timely manner. Results of investigations, together with the findings from external and internal inspections, should be subject to the firms' root cause analysis (**RCA**) exercise.

3.3 Internal monitoring

3.3.1 Firms are required to establish a monitoring process to provide reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively. An effective monitoring process is required to include a robust RCA which enables the firm to determine appropriate actions to enhance the effectiveness of its system of quality control and support consistently high quality professional work.

Common areas for improvement

3.3.2 Consistent with our findings in 2020, seven of ten firms we inspected did not perform a RCA over the deficiencies identified from internal and external inspections or, where an analysis was performed, the root causes identified and remedial actions proposed were inappropriate or too generic.

Our recommendation

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

3.4 Promoting a culture of audit quality

3.4.1 The promotion of a quality-oriented internal culture depends on a tone being set by a firm's management that emphasizes the need to achieve quality in all the engagements that the firm 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.

Common areas for improvement

3.4.2 Consistent with the findings from our 2020 Annual Inspection Report, in six of the ten firms we inspected the quality of work, including the results of internal or external engagement inspections, was either not a consideration, or not a primary consideration, in audit partners' performance evaluation and admission assessment. The lack of clear assessment on audit quality in performance assessment and progression evaluation was also identified at the staff level in three of the ten firms we inspected.

Our recommendation

3.4.3 Firms should re-evaluate and strengthen the policies that address the performance evaluation of audit partners and staff, partner candidate admissions and staff promotion to ensure that they appropriately promote a culture of quality and drive high quality work.

3.5 Independence

3.5.1 Independence of mind and in appearance are necessary to enable auditors to express a conclusion without bias, conflict of interest, or undue influence. In nine out of the ten firms inspected, deficiencies were identified in respect of the firms' policies and procedures designed to provide them with reasonable assurance on the independence of the firm, its personnel, or auditor's experts involved in engagements.

Common areas for improvement

3.5.2 Eight of the ten firms inspected lacked effective controls over the personal confirmations of independence and similar findings were broadly highlighted in our 2020 Annual Inspection Report. Common deficiencies included:

- Firms did not maintain a full list of entities related to its listed entity audit clients to enable its professional personnel to readily determine whether they satisfy the applicable independence requirements.
- The confirmation of personal 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.
- The timeliness of completing the confirmations was not effectively monitored.
- Firms did not carry out checks to test the accuracy of information submitted by individuals in their personal confirmations of independence.

Our recommendation

3.5.3 Firms should take action to strengthen their policies over the completeness and accuracy of its register for listed entity audit clients and their related entities, and actively monitor the independence compliance of its personnel and their immediate and close family members.

3.5.4 We also recommend firms perform periodic personal independence checks on selected personnel to ensure their compliance with independence requirements, and to clearly communicate the consequences of non-compliance to emphasise the importance of independence.

3.6 Training

3.6.1 The continuing competence of a firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for continuous training for all levels of firm personnel, and provide the necessary training resources and assistance to enable personnel to develop and maintain the required level competence and capability.

Common areas for improvement

3.6.2 Eight of ten firms we inspected neither provided sufficient internal training nor implemented appropriate measures to ensure its audit personnel undertook relevant external training to develop and maintain the necessary competence in conducting listed entity audits.

Our recommendation

3.6.3 Firms should implement measures to monitor and assist its audit personnel to attain and maintain the necessary competence and capabilities.

3.6.4 We identified good practices whereby personnel are not permitted to participate in engagements, for example in IPO and other capital market transaction engagements, until they have received training relevant to the work to be performed.

Section 4

Updates on 2020 inspections

4.1 Remediation plan for the 2020 inspection year

4.1.1 Listed entity auditors are required to conduct a root cause analysis (**RCA**) and submit a plan to remediate deficiencies identified from our inspections of the quality control system and engagements. Auditors are also required to evaluate significant findings on engagement inspections and perform further work to obtain sufficient appropriate audit evidence to support their conclusions where needed. We review proposed remediation actions and the timeframe for implementing them proposed by the firm, and evaluate whether the proposed measures or corrective actions will address the inspection findings, before agreeing to them.

4.1.2 All 18 listed entity audit firms inspected in 2020 submitted a remediation plan to address our findings on both their firm-wide quality control system and the engagements inspected. We have agreed or substantially agreed the remediation plans submitted by all 18 firms.

4.1.3 Of the 24 engagements inspected in 2020 where we identified one or more significant findings, the auditors of 15 engagements have completed remedial actions, including performing additional audit procedures, supplementing the documentation of their work in the engagement work papers, and re-evaluating whether the financial statements were materially misstated. The auditor of 1 engagement is performing further work and evaluating its implication to the auditor's report.

4.1.4 Of the remaining 8 engagements with significant findings identified, the auditors of 6 engagements resigned as auditor before we issued our inspection report and the auditors of the other 2 engagements resigned while they were developing their remediation plans. Additional audit procedures and evaluation on the financial statements could not be performed for these engagements due an inability to obtain further information from the listed entity. Notwithstanding these restrictions, the firms are still required to perform a holistic evaluation on the deficiencies identified and propose measures to prevent these deficiencies from re-occurring in their engagements in the future. In such cases, we will refer the engagement to the Department of Investigation and Compliance and the Department of Discipline for enforcement action where we believe there is a reasonable possibility that the financial statements may be materially misstated.

4.1.5 We are inspecting and evaluating the additional work performed and the evidence obtained by the auditor to remediate significant findings on both quality control systems and engagements, and their conclusions on whether the financial statements were materially misstated. We will further report on the results of the remediation undertaken and whether restatements of financial statements were required in our Annual Inspection Report.

Common areas for improvement

4.1.6 A robust RCA assists the listed entity auditor in identifying the underlying factors leading to audit deficiencies and enables them to design appropriate corrective measures to prevent their reoccurrence across the engagements performed by the firm.

4.1.7 The RCA performed by 9 out of the 18 firms was insufficiently thorough, leading to inappropriate or poorly designed actions to remediate the deficiencies identified. In addition, firms proposed remediation actions that were insufficiently well designed or precise, or that were due to be implemented over an unreasonably long timeframe. In such cases, we required firms to revise and resubmit their remediation plans before we agreed to them. Examples of poorly performed RCAs and inappropriate remediation actions we identified include:

- Overreliance on training to remediate deficiencies without considering underlying factors such as insufficient time to plan and conduct the audit or the lack of resources.
- Acknowledging the findings identified without proposing specific, appropriate actions.
- Proposing an excessively long timeframe in which to implement remediation actions which reduced the ability of the firm to prevent the same deficiencies from re-occurring before the next audit cycle.

4.1.8 The RCA and remediation process is not sufficiently well understood by many firms. The FRC will provide guidance to all listed entity audit firms on the factors expected to be considered in the RCA and the determination of appropriate corrective measures to address inspection findings. A copy of our guidance will be uploaded to our website prior to the commencement of the next inspection cycle.

Good practice identified

4.1.9 We observed good practices in 8 of the firms inspected, including:

- Communication of inspection findings across the firm during the course of our inspections to enable engagement teams to take prompt action and prevent reoccurrence of such deficiencies.

- Performing a thorough RCA by interviewing the relevant engagement teams to understand the causes of the deficiencies and considering a wide range of factors and remediation actions.

- Undertaking a holistic review of the deficiencies identified and considering improvements required in the firm's quality control policies.

- Conducting internal monitoring reviews on similar engagements to determine whether deficiencies were isolated or systematic.

4.2 Determination of follow-up actions

4.2.1 As set out in our 2020 Annual Inspection Report, the FRC may, having regard to an inspection report, take a range of follow-up actions under section 21H of the Financial Reporting Council Ordinance (**FRCO**), including

- requiring the auditor to take a measure or corrective action;

- conducting a further inspection;

- 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;

- imposing a sanction where there is evidence that the listed entity auditor has committed a misconduct; and

- taking any other follow-up action that is considered appropriate.

Inspected engagements rated as "Significant improvements required" have been considered for enforcement action. Engagements rated as "Improvements required" have also been considered for enforcement action, depending on the nature of the findings identified.

4.2.2 We consider engagements rated as “Improvements required” and “Significant improvements required” to determine the appropriate follow-up actions to be taken. Where there is reason to believe that, following an inspection, the financial statements may be misstated or that there were significant deficiencies in the conduct of the audit in a prior period, we will consider recommending the initiation of an enquiry or investigation into the work performed, or we may recommend that a case may be referred directly to the Department of Discipline to consider whether enforcement action is appropriate.

4.2.3 There were 27 engagements rated as “Improvements required” and “Significant improvements required” in the 2020 inspection year. Three of these engagements did not contain individual findings which had a significant impact on the audit quality rating and consequently the FRC did not request those auditors to take a specified measure or corrective action other than the remediation required of all firms. The following table shows the follow-up actions on the remaining 24 engagements (Table 3).

Table 3 Summary of follow-up actions

Follow-up actions	Number of engagements
Requiring the auditor to take a measure or corrective action	24
Referred to the Department of Investigation and Compliance for possible enforcement action	16

4.2.4 The FRC has required the auditor to take specified actions in response to the significant findings identified from our inspections in 24 engagements. Specified actions are considered in conjunction with the remediation actions proposed by the auditor and agreed by the Department of Inspection and may include a requirement to obtain additional audit evidence to support the auditor’s opinion on the financial statements.

4.2.5 For 11 of the engagements classified as “Significant improvements required” or “Improvements required” consideration is being given to the initiation of an investigation into the conduct of the engagement by the auditor. For a further 5 engagements, consideration is being given to the initiation of an enquiry into possible non-compliance with accounting requirements in the financial report of the listed entity and also an investigation into the way in which the engagement was carried out.

4.3 Cooperation with the Securities and Futures Commission (SFC)

4.3.1 As an effective auditor regulator of a leading capital market, it is important that the FRC acts as an integrated organisation, and connects and collaborates with other financial regulators to protect the public interest.

4.3.2 Where our inspections identified potential material misstatements in the financial statements and/or indications of fraud committed by a listed entity, we have shared relevant information with the SFC under our Memorandum of Understanding so that the SFC can consider taking action against the listed entity and its officers. Information on four such engagements inspected in 2020 has been shared with the SFC.

Section 5

Looking ahead

5.1 Potential areas of inspection of engagements in 2022

5.1.1 To uphold the quality of financial reporting of listed entities, we expect continuous improvement in audit quality. Potential areas of inspection focus in 2022 will primarily relate to common findings identified from inspections to date and the auditor's response to current economic conditions throughout the engagement.

Professional scepticism

5.1.2 Given the prevalence of deficiencies identified from inspections to date, the application of professional scepticism to key management judgements and estimates will continue to be an area of inspection focus.

5.1.3 The exercise of professional scepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty, complexity, subjectivity or other inherent risk factors. We will evaluate engagement teams' assessment of inherent risk and control risk for the purposes of identifying the risk of material misstatement at the assertion level for accounting estimates, and the further procedures performed in response to the assessed risk of material misstatement.

5.1.4 The exercise of professional scepticism is also important when there is greater susceptibility to misstatement due to management bias or fraud and we will also evaluate engagement teams' identification and responses to the risk of fraud throughout the audit, particularly where transactions are conducted outside the normal course of business, with related parties, or with little business rationale.

Related party transactions

5.1.5 Listed entity management, audit committees and auditors all have a responsibility to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that the financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

5.1.6 Engagement teams should remain alert for arrangements or other information that indicate the possible existence of related party relationships or transactions that management has not previously identified or disclosed. We will evaluate engagement team's identification and assessment of the risk of material misstatement associated with related party relationships and the application of professional scepticism in the audit.

Going concern

5.1.7 The ongoing impact of the COVID-19 coronavirus pandemic continues to cause a significant deterioration in economic conditions for many companies and an increase in economic uncertainty for others. Management needs to assess whether these events or conditions, either individually or collectively, may cast significant doubt on the company's ability to continue as a going concern. Management is also required to make appropriate disclosures on the significant judgements that may have been exercised in arriving at the determination of the company's ability to continue as a going concern and about the related significant uncertainties. External auditors play a key gatekeeper role with a responsibility to evaluate the adequacy of disclosures and assess the appropriateness of management's judgment about the entity's ability to continue as a going concern. This is especially important under the current uncertain economic environment.

5.1.8 We will evaluate the work performed by engagement teams over going concern given the fundamental importance of management's going concern assessment and the appropriateness of related disclosures in the preparation of the financial statements. We also remind engagement teams of the requirement to remain alert to, and inquire of management about their knowledge of, all information available about the future that the auditor can reasonably access from external sources, or that management has taken into account in addressing other aspects of the entity's accounting for events or conditions that may occur beyond management's period of assessment, that may bring into question the appropriateness of management's use and disclosure of the going concern basis of accounting.

Revenue

5.1.9 Given the prevalence of deficiencies identified in inspections to date, application of HKFRS 15 *Revenue from Contracts with Customers* will continue to be an area of inspection focus.

5.2 Inspection of systems of quality control in 2022

5.2.1 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. The majority of the ten Category B and C firms inspected to date have not made sufficient progress in their transition to the new quality management standards and urgent action is required. In response, the FRC will issue a questionnaire to all listed entity auditors in the fourth quarter of 2021 to ascertain their progress and implementation plans for ensuring compliance with the quality management standards in 2022.