AFRC Accounting and Financial Reporting Council 會計及財務匯報局

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2022 Annual Inspection Report

Inspection

11 July 2023

About the Accounting and Financial Reporting Council

The Accounting and Financial Reporting Council (AFRC) is an independent body established under the Accounting and Financial Reporting Council Ordinance. As an independent regulator, AFRC spearheads and leads the accounting profession to constantly raise the level of quality of professional accountants, and thus protects the public interest.

For more information about the statutory functions of the AFRC, please visit www.afrc.org.hk.

Foreword

The completion of our 2022 inspections concludes our first three-year inspection cycle from 2020 to 2022 (**2020–22 Cycle**). By now, we have inspected the six Category A firms once in each year and each of the Category B and C firms at least once in the cycle. This enables us to present in this 2022 Annual Inspection Report a comprehensive review of our inspection results and findings for the complete 2020–22 Cycle, incorporating our 2022 inspections.

The 2020–22 Cycle covered public interest entity (**PIE**) audits completed in the period from the establishment of the AFRC's inspection function for PIE auditors on 1 October 2019 under the pre-amended AFRC Ordinance to 31 December 2021. With the further expansion of our functions since 1 October 2022, the AFRC has now assumed the inspection function for all practice units that are not PIE auditors. Our inspection efficiency was further enhanced with our greatest efforts to overcome the resource constraints. We continually hold firms accountable and drive improvements in audit quality.

Our 2022 inspections included our first six non-PIE engagements. We are progressively implementing our non-PIE inspection function and will use a common methodology and apply the principle of proportionality across all PIE and non-PIE practice units and engagements. Our allocation of resources will reflect our evolving assessment of the impact on public interest arising from the potential risks of audit quality. We will select practice units for inspection and areas of inspection focus using cycle and sampling approaches, with risk-based overlays.

In addition to exercising our statutory inspection powers to monitor audit quality of practice units, we will continue to be transparent in reporting our progress, findings, observations, expectations, and guidelines in order to provide impartial information to the users of financial statements. In doing so, our aim is to engage directors, audit committees, investors, and other public interest stakeholders to uphold audit quality. The ultimate beneficiaries are investors and other users of financial statements who will be able to rely with greater confidence on the quality of financial reporting for their decision-making.

During the 2020–22 Cycle, Category A firms continued to dominate the market for listed entity audits, thus our greatest focus is on them. We saw consistent progress in improving audit quality by four of the six Category A firms, but there are still further steps that need to be taken to improve and sustain audit quality. For the remaining two Category A firms, they need to take immediate and robust action to address the deficiencies identified both at the firm and engagement levels.

Some Category B and C firms have been taking on more listed entity clients with larger market capitalisations during the 2020–22 Cycle. On one hand we remain alert to the audit quality risks arising when there is a late change of auditors, especially when the resignation of a firm is associated with unresolved audit matters and we will continue to take a proactive approach to pre-empt audit risks and uphold audit quality. On the other hand, auditors should evaluate whether they have the necessary competence and capabilities to perform quality audits when considering the acceptance of engagements.

When we inspected the systems of quality control (**SQC**) in the 2020–22 Cycle, we found that the audit quality ratings of the engagements were directly correlated with the effectiveness of the SQC. We observed how the four Category A firms who have improved audit quality have achieved it by strengthening their policies and procedures for different elements of the SQC during the 2020–22 Cycle. However, we also found there were significant deficiencies in the SQC of the two Category A firms that showed no substantial difference in their audit quality ratings for the engagements inspected over the 2020–22 Cycle and most Category B and C firms. The leaders of these firms must take appropriate initiatives to improve their audit quality and to value the benefits that can be brought about by an effective SQC.

We are also alert to the fact that some PIE auditors have engaged other auditors to perform a substantial part of the audits of Hong Kong listed entities. There are potential risks to audit quality from such arrangements if the group auditors do not have sufficient oversight of the performance of other auditors and the other auditors do not have sufficient competence and capabilities to perform the audits on the listed entity.

The 2023–25 Cycle will focus on areas that are related to the recurring audit deficiencies we identified in the 2020–22 Cycle. Auditors should further consider whether there are any emerging risks, such as cyber-security risks and climate-related risks, and any new or revised auditing and accounting standards, which may have an implication on their financial statement audits and therefore on the quality of their audits.

Directors of listed entities and their audit committees have critical roles to play in supporting quality audits. They are responsible for ensuring that their companies are well governed with effective internal controls that support the preparation of quality financial information and that their auditors are competence to perform quality audits, including possessing relevant experiences and having adequate resources.

Last, but not least, cooperation with our inspections benefits all parties in terms of efficiency and effectiveness. Our inspections have served as a valuable input to practice units to assist in improving their audit quality. We ask that firm leaders deliver a clear message to their firms about the importance of cooperating with our inspections and emphasizing their commitment to deliver quality audits.

Improving audit quality is a journey, and we are a long way from arriving close to our destination. More practice units will have significant roles in relation to regulated entity audits and other non-PIE audits with a strong public interest. We will continue to refine our regulatory approach and integrate our inspection methodology for both PIE and non-PIE auditors.

To sustain the momentum of our work in the 2023–25 Cycle, we will continue to direct our inspection function to ensure that we are practical, transparent, and objective, with a primary goal of protecting public interest.

Janey Lai

Head of Inspection

Highlights of our Inspection Results

Inspections of the 2020–22 Cycle

During the 2020–22 Cycle, we continually enhanced our regulatory approach to drive improvements in audit quality. We also sought to improve our inspection efficiency.

2020 inspection	2021 inspection	2022 inspection
6 Category A firms inspected annually	6 Category A firms inspected annually	6 Category A firms inspected annually
audit 90%* of listed entities by market cap	audit 92%* of listed entities by market cap	audit 90%* of listed entities by market cap
37 Category B and C firms inspected over the cycle	37 Category B and C firms inspected over the cycle	37 Category B and C firms inspected over the cycle
audit 2%* of listed entities by market cap	audit 2%* of listed entities by market cap	audit 3%* of listed entities by market cap
37 PIE engagements inspected	50 PIE engagements inspected	55 PIE engagements inspected
Category A: 22 Category B: 8 Category C: 7	Category A: 31 Category B: 16 Category C: 3	Category A: 33 Category B: 15 Category C: 7

* *Figures as at 31 December 2019, 2020 and 2021 respectively*

Our findings are about the quality of an audit and not about the quality of financial reporting.

There was a progressive increase in inspections with satisfactory results, mainly attributable to improvements in Category A firm results, but there was still room for improvement.

Four Category A firms were more responsive to our previous years' inspection findings and were proactive in improving the quality of their audits. However, we saw recurring deficiencies in the other two Category A firms and there were no substantial differences in the inspection results of Category B and C firms inspected for the first time during the 2020–2022 Cycle. Such results were unacceptable and disappointing.

Overall inspection results [1]

Annual inspection results	**2020**	**2021**	**2022**
Average audit quality rating (**AAQR**)	3.1	2.9	2.8
All PIE auditors			
Total PIE engagement inspected	37	50	55
Percentage of inspected engagements with rating of 1 or 2	27%	32%	36%
Percentage of inspected engagements with rating of 3 or 4	73%	68%	64%
Category A firms			
AAQR	2.8	2.5	2.4
Percentage of inspected engagements with rating of 1 or 2	41%	45%	55%
Percentage of inspected engagements with rating of 3 or 4	59%	55%	45%
Remarks: Improvement was mainly from 4 Category A firms. The other 2 Category A firms' audit quality ratings remained unsatisfactory (rating 3 or 4) at 90% of inspected engagements in 2022 (2021: 88%; 2020: 83%).			
Category B and C firms			
Category B firms' AAQR	3.8	3.4	3.4
Category C firms' AAQR	3.3	3.7	3.4
Percentage of inspected engagements with rating of 1 or 2	7%	11%	9%
Percentage of inspected engagements with rating of 3 or 4	93%	89%	91%
Remarks: 4 Category B firms with significant quality issues in previous years were re-inspected in 2022. Their AAQR improved to 3.0 (2020: 3.9).			

[1] A quantitative audit quality either of 1, 2 3 or 4 was assigned to engagements rated **Good**, **Limited improvements required, Improvements required** and **Significant improvements required**, respectively. Therefore, 1 represents the highest score and 4 represents the lowest score for audit quality in the engagements we inspected.

Specific scope inspection on a Category B firm in 2022

- One Category B firm took on a significant number of 31 December 2021 year end listed entity audits and was selected for a specific scope inspection

- Significant deficiencies were identified in their policies and procedures for client and engagement acceptance:

  a. Insufficient assessment on the professional competence to deliver a quality audit

  b. Insufficient understanding of the significant unresolved matters identified by the outgoing auditors

  c. Insufficient resources to plan and conduct a proper audit

Key findings from our PIE engagement inspections

We identified **9 key areas of engagement findings (EF)** which are significant to audit quality during the 2020–22 Cycle.

	Percentage of PIE engagements inspected in which we identified relevant findings		
Year of inspection	**2020**	**2021**	**2022**
Most common findings that require special attention			
EF1 - Revenue recognition	46%	47%	**40%**
EF2 - Expected credit loss	55%	71%	**58%**
EF3 - Journal entry testing	57%	40%	**47%**
Findings with an increasing number of deficiencies			
EF4 - Group audits	50%	38%	**58%**
EF5 - Opening balances	30%	21%	**45%**
EF6 - Use of auditor's experts	46%	12%	**59%**
Findings with significant improvements			
EF7 - Exercise of professional skepticism	81%	46%	**49%**
EF8 - Sufficiency of audit documentation	68%	30%	**36%**
EF9 - Key audit matters	32%	12%	**2%**

With regard to the trend of deficiencies noted during our inspection, we have the following particular concerns:

- How do group auditors clearly demonstrate their direction and supervision, and their timely involvement in significant audit matters of components, particularly where significant parts of the audit are not performed by the group auditors?

- In the absence of appointed component auditors, how do group auditors who do not perform on-site work of the significant components demonstrate that they have performed their work appropriately and adequately under a remote working model?

- When there are late changes of auditors how do incoming auditors complete their audits within an exceptionally short timeframe, and demonstrate the sufficiency and appropriateness of audit procedures on opening balances and/or unresolved audit matters identified by the outgoing auditors?

- How do auditors determine whether an auditor's expert has the necessary competence, capabilities and objectivity and do the auditors evaluate that the source data used by the expert is relevant and reliable before placing reliance on the expert?

Common causes of deficiencies

We found there were common causes of identified deficiencies:

- Insufficient assessment of competence and capabilities before client acceptance

- Insufficient reviews by engagement partners and/or engagement quality reviewers (**EQRs**)

- Lack of professional skepticism and questioning mindset

- Lack of knowledge and experience of engagement team members

- Insufficient training and guidance on accounting knowledge and auditing skills

- Ineffective project management on the reporting timeline

Factors contributing to improved audit quality of certain PIE auditors

We saw that most Category A firms and re-inspected Category B and C firms benefited from our inspection findings and continued to refine their policies and procedures. Our continuous efforts over the 2020–22 Cycle have driven those PIE auditors to:

- Place more emphasis on audit quality by their leadership

- Have early audit planning and robust risk assessment by setting a timeline for key audit planning procedures

- Place continuous focus on enhancing competence and capabilities of their resources, by providing training that incorporated our inspection findings and areas of inspection focus

- Have proper assignment of partners and staff to engagements by implementing information systems that contain qualifications and relevant experience of audit personnel

Results from our inspections of system of quality control

During the 2020–2022 Cycle, significant deficiencies were found in the SQC of two Category A firms and most of the Category B and C firms that had unsatisfactory audit ratings on the engagement inspections. On the other hand, enhanced policies and procedures of the SQC were implemented by those Category A firms which have a better AAQR of inspected engagements during the 2020–22 Cycle.

Category A firms

- A number of significant deficiencies were identified in the SQC of the two Category A firms for which their AAQR remained at least at 3.0

- Good practices were observed in those Category A firms with better AAQRs

Category B and C firms

- More than half of the Category B and C firms inspected during the 2020–22 Cycle had a number of deficiencies identified in different elements of their SQC, and in particular the elements of a) acceptance and continuance of client relationships and specific engagements, b) engagement performance and c) human resources

- In particular, the number of Category B and C firms with deficiencies found on acceptance and continuance of client relationships and specific engagements, had increased substantially to 71% in 2022 from 33% in 2020

- The significance and number of deficiencies in their SQC were directly correlated with the quality of audit engagements inspected

- Violation of independence rules undermined the auditor's independence and objectivity in our 2022 inspection, for the first time in the 2020–22 Cycle

Ignorance of rules and standards is no excuse. Practice units should act now to ensure the deficiencies found at their SQCs were properly remediated, particularly when implementing their systems of quality management (**SoQM**) under the new or revised quality management standards (**QMSs**).

On the one hand, we urge auditors to take robust action urgently to improve the quality of their work by addressing our inspection findings. It is important for all practice units to set the right tone at the top and strengthen the policies and procedures to address the issues highlighted in this report. At the same time, we remind audit committees that it is their primary responsibility to ensure the quality of financial reporting. They are urged to challenge listed entity's management on key audit risk areas such as the implementation of the entity's revenue recognition policies and appropriateness of the assumptions used in critical accounting estimates, and to assess their auditors on the sufficiency and appropriateness of audit work so as to ensure that they are capable and competent to address significant audit risks and also our inspection findings.

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Section 1
Introduction

1.1 Purpose of our 2022 annual inspection report

1.1.1 This report includes the results of our inspections of PIE auditors for 2022, which have not been reported on in full previously. For 2022, we inspected the SQC of **26 PIE auditors** (2021: 17; 2020: 18) and **55 PIE engagements** (2021: 50; 2020: 37). We also inspected, for the first time, six of their non-PIE engagements. This was the final year of our first three-year inspection cycle (**2020–22 Cycle**) and so we also compare the results of our 2022 inspections with those for 2020 and 2021 in this report.

1.1.2 The purpose of this report is to:

a. Provide an **overview of the inspection results** of the 2020–22 Cycle. (Section 2)

b. Highlight the **common deficiencies** we identified in engagement and SQC inspections and their **common causes**. (Sections 3 and 4)

c. Summarise the **good practices** we identified so that auditors can learn from them and take immediate action. (Section 4)

d. Provide our observations from reviewing **root cause analysis (RCA) and remediation plans**, and our related follow-up actions and expectations. (Section 5)

e. Set out our **2023 inspection approach** and proactive measures and actions we are taking to monitor and uphold audit quality. (Section 6)

f. Give **directional guidance** to key aspects of the audit that auditors should consider in order to perform a quality audit. (Section 6.4)

g. Emphasise the respective **roles of auditors, directors and audit committees of listed entities** and set out **our expectations** of them when fulfilling their respective responsibilities to uphold the quality of financial reporting and audits. (Section 6.5)

1.2 Inspection focus in 2020–22 Cycle

1.2.1 The PIE auditors and the number of PIE and non-PIE engagements inspected in an inspection year for each category of firm depend on the number, complexity and audit quality risks of their PIE engagements.

Table 1 Inspection frequency and number of engagements inspected

Category of PIE Auditors	Number of engagements inspected for each firm	Inspection frequency
Category A PIE engagements Non-PIE engagements	 4–7 1	 Annually Only since October 2022
Category B PIE engagements	1-2	At least once in a three-year inspection cycle
Category C PIE engagements	1	At least once in a three-year inspection cycle

1.2.2 Our inspections of PIE auditors focused on their engagement performance quality and the effectiveness of their SQCs, by evaluating their compliance with the applicable professional standards and legal and regulatory requirements.

1.2.3 An overview of our inspection methodology and information on the follow-up action that we may take in response to our inspection findings is contained in Annex 1 to this report.

1.2.4 In view of our growing concerns over the surge in the number of late changes of auditors, we have been taking proactive measures and action to ensure all PIE auditors understand our concerns and adequately address them (Section 2.2.23 and Section 6.3.2).

1.2.5 Following the further reform in 2022, we now include all practice units in our inspection programme. We are progressively implementing our inspections of practice units that are not PIE auditors by adopting the principle of proportionality and a risk-based approach.

Section 2
Overview of inspection results in 2020–22 Cycle

2.1 Introduction

2.1.1 The AAQR for all PIE engagements inspected improved to 2.8 in 2022 from 2.9 in 2021 and 3.1 in 2020. Details of the AAQR are shown in **Table 3**.

2.1.2 There were over 2,500 listed entities as of 31 December 2021. Category A firms, which we inspect annually, continued to dominate the listed entity audit market, with a market share of 90% by market capitalisation as of 31 December 2021 (2020: 92%; 2019: 90%). The AAQR of PIE engagements of Category A firms inspected improved to 2.4 in 2022 (2021: 2.5; 2020: 2.8).

The market share by market capitalisation of Category B and C firms, which we inspect at least once in a three-year cycle, was 3% (2020: 2%; 2019: 2%) and less than 0.1% (2020 and 2019: 0.1%) respectively as of 31 December 2021. The AAQR for PIE engagements inspected in 2022 for Category B firms was 3.4 (2021: 3.4; 2020: 3.8) and for Category C firms was 3.4 (2021: 3.7; 2020: 3.3).

2.1.3 In 2022, we further enhanced our inspection efficiency with the experience gained from our 2020 and 2021 inspections. We inspected six Category A firms, 11 Category B firms[2] (2021: 8 and 2020: 4) and 9 Category C firms[2] (2021: 3 and 2020: 8) for 2022. We inspected 55 PIE engagements in 2022 (2021: 50; 2020: 37). These included 33, 15 and 7 inspections of Category A, B and C firm PIE engagements respectively (2021: 31, 16 and 3; 2020: 22, 8 and 7).

[2] Firms under common management and control were subject to an inspection at the same time, one engagement was selected for inspection.

Table 2 Market share of listed entity audits by auditor appointments, market cap and audit fees and location of their auditors as at 31 December 2021

PIE auditor types and Categories	Number of PIE auditor firms	Market share of listed entity audits			
		By auditor appointments[3]		By market cap[3]	By audit fees[4]
		Number	%	%	%
Registered firms					
— Hong Kong	**44**	**2,430**	**94.8**	**93.5**	**85.9**
Category A[5]	**6**	**1,672**	**65.2**	**90.3**	**77.5**
▪ *BDO*[6]		*213*	*8.3*	*0.7*	*2.6*
▪ *Deloitte*[6]		*277*	*10.8*	*17.0*	*12.1*
▪ *EY*[6]		*388*	*15.1*	*18.1*	*18.5*
▪ *HLB*[6]		*125*	*4.9*	*0.4*	*0.9*
▪ *KPMG*[6]		*229*	*8.9*	*10.0*	*10.4*
▪ *PWC*[6]		*440*	*17.2*	*44.1*	*33.0*
Category B[5]	19	694	27.1	3.1	7.9
Category C[5]	19	64	2.5	0.1	0.5
Recognised firms					
— Mainland China	**10**	**86**	**3.4**	**1.3**	**3.6**
— Overseas	**25**	**47**	**1.8**	**5.2**	**10.5**
Total	**79**	**2,563**	**100**	**100**	**100**

2.1.4 We re-inspected five Category B firms and one Category C firm in 2022 either because of unsatisfactory results from a previous inspection or to introduce some unpredictability into our selections (Sections 2.2.20 to 2.2.22). We also conducted a specific scope inspection of one Category B firm due to audit quality concerns about late changes in auditors (Sections 2.2.23 and 2.2.24). Our ongoing measures and actions to uphold audit quality are set out in Section 6.3.

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[3] The number of listed entities audited and the market capitalisation include all equity securities, as of 31 December 2021 (excluding the listed entities which suspended trading at the Stock Exchange of Hong Kong). Other listed securities such as real estate investment funds, bonds, and exchange-Traded Funds are excluded from the above data analysis.

[4] Source: *Audit fees paid by listed companies in Hong Kong in 2020/2021*

[5] Category A, B, and C firms completed more than 100, between 10 and 100, and at least one but less than 10 listed entity audits annually, respectively.

[6] The firms are: BDO Limited (**BDO**), Deloitte Touche Tohmatsu (**Deloitte**), Ernst & Young (**EY**), HLB Hodgson Impey Cheng Limited (**HLB**), KPMG and PricewaterhouseCoopers (**PwC**)

2.1.5 There are 11 mainland audit firms endorsed under the mutual recognition agreement in force since 9 December 2010 as qualified to be the auditor of a mainland incorporated company listed in Hong Kong and recognised as PIE auditors under the Accounting and Financial Reporting Council Ordinance (**AFRCO**). One of these mainland audit firms did not have any Hong Kong listed entity audit as at 31 December 2021.

The PIE engagements completed by recognised mainland audit firms were not selected for inspection in the 2020–22 Cycle due to their relatively small share of listed entity audits, which represented approximately 1% by market capitalisation and 3% by number of listed entity audits as of 31 December 2021 (2020: 1% and 3%; 2019: 1% and 3%). We will collaborate with the Supervision and Evaluation Bureau of the Ministry of Finance of the People's Republic of China (**SEB**) to regulate the audit quality of the PIE engagements performed by recognised mainland audit firms appointed as the auditor of a Hong Kong listed entity, whenever necessary.

2.1.6 Many of the recognised mainland audit firms and overseas audit firms are network firms of the Category A firms which share significant professional resources and are subject to our inspections annually. We did not select the PIE engagements completed by recognised overseas auditors for inspection in the 2020–22 Cycle due to their relatively small market share. Their market share was 5% by market capitalisation and 2% by number of listed entity audits as of 31 December 2021 (2020: 5% and 3%; 2019: 7% and 3%).

2.2 Engagement inspection results and analysis

Overview of engagement inspection results for 2020–22 Cycle

All PIE auditors

2.2.1 The AAQR for all PIE engagements inspected in 2022 improved to 2.8 (2021: 2.9; 2020: 3.1).

2.2.2 In selecting engagements for inspection we use a risk-based approach to selections. Our selection of engagements does not necessarily constitute a representative sample of the firm's total population of audits. In addition, our inspection findings are specific to our areas of focus and are not an assessment of all of the firm's audit work. **The AAQR for a firm or category does not necessarily reflect the overall audit quality of engagements performed by that firm or category of firms.**

Table 3 Average audit quality rating by category of audit firm

	Average audit quality rating[7] (The lower the average rating the higher the audit quality we observed)		
Category of audit firm	**2020**	**2021**	**2022**
Category A	***2.8***	***2.5***	***2.4***
BDO	*3.3*	*3.3*	*3.2*
Deloitte	*3.0*	*2.4*	*2.0*
EY	*2.8*	*2.5*	*2.0*
HLB	*3.0*	*3.3*	*3.0*
KPMG	*2.3*	*2.0*	*2.2*
PwC	*2.6*	*2.1*	*2.3*
Category B	***3.8***	***3.4***	***3.4***
Category C	***3.3***	***3.7***	***3.4***
Average	***3.1***	***2.9***	***2.8***

2.2.3 The AAQR for five out of six Category A firms improved from 2020 to 2022. For four of the six Category A firms, their individual AAQR for 2022 was better than 2.5 (2021: three firms; 2020: one firm); and the percentage of the engagements completed by four Category A firms rated 1 or 2 was at or over 60% for 2022 (2021: two firms; 2020: one firm). These improvements reflect initiatives taken by these firms to positively influence the quality of their engagements.

2.2.4 For the other two Category A firms, there was no improvement in their AAQR in the first two years of inspections. Their individual AAQR for 2022 remained at least 3.0, and the individual percentage of their engagements rated 1 or 2 remained at or deteriorated to below 20% for 2022.

2.2.5 Category B and C firms are not inspected annually but six (five Category B and one Category C) firms were re-inspected in 2022. Therefore, the inspection results of Category B and C firms in 2022 should not be directly compared with the results of previous years, except for these six firms.

[7] Audit quality rating of either 1, 2, 3 or 4 was assigned to engagements rated **Good**, **Limited improvements required**, **Improvements required** and **Significant improvements required**, respectively. **1 represents the highest score and 4 the lowest score for audit quality** in the engagements we inspected.

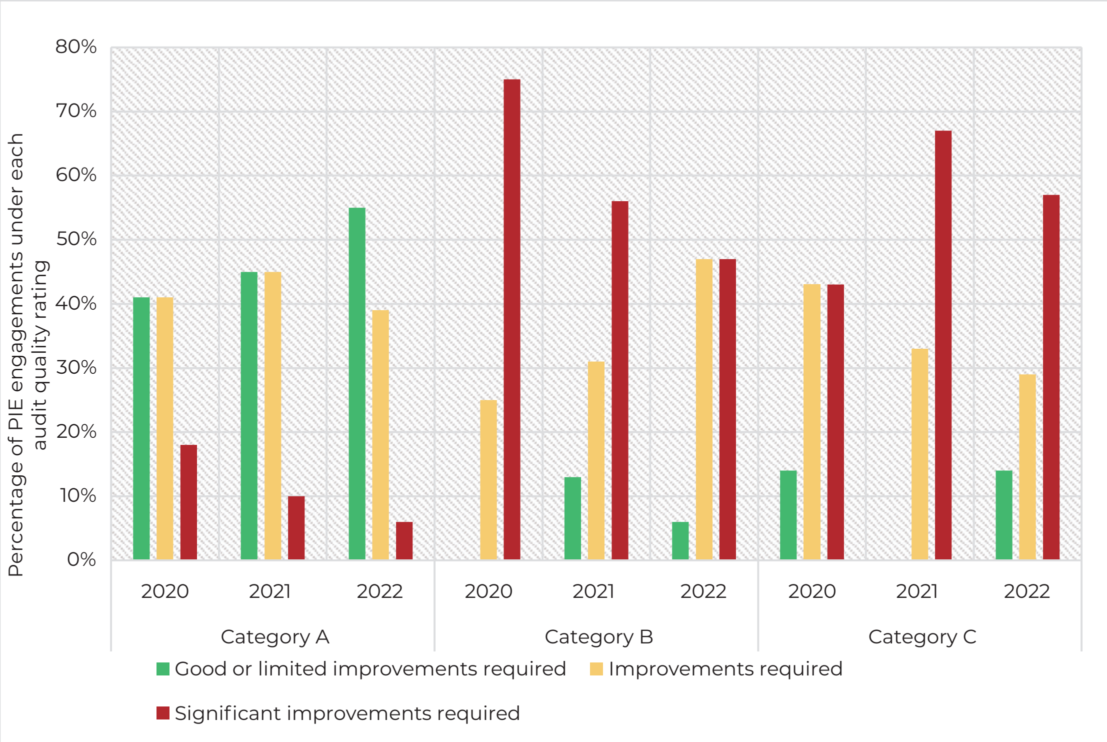
2.2.6 For the other Category B and C firms inspected in 2022, it was their only inspection of the 2020–22 Cycle. Of the 16 engagements of Category B and C firms inspected for the first time in 2022 (2021: 19; 2020: 15), 94% were rated 3 or 4 (2021: 89%; 2020: 93%). There is no substantial difference in the quality of engagements inspected for Category B and C firms first inspected at any time during the 2020–2022 Cycle.

2.2.7 The AAQR of Category A firms has improved to 2.4 in 2022 (2021: 2.5; 2020: 2.8). We noted that the four Category A firms with an AAQR better than 2.4 in 2022 have invested considerable time and effort in addressing the inspection findings we identified in our 2020 and 2021 inspections.

2.2.8 Transparency about the AAQR of individual firms reduces information asymmetry about the quality of a firm's audit engagements. This enables investors, audit committees and the wider public to observe differentiation in audit quality and hold firms accountable for their performance. We believe that this provides a powerful incentive for firms to improve. Such improvements can enhance the confidence of financial statement users when relying on the accuracy and integrity of financial reporting to make investment decisions.

2.2.9 Of the 55 Category A, B and C firm engagement inspections in 2022, respectively 18, 1 and 1, or in total 36%, were rated as 1 or 2 (2021: 32%; 2020: 27%). There has been a progressive increase in inspections with satisfactory results and a corresponding decrease in inspections with significant deficiencies, indicating that audit quality improved during the 2020–22 Cycle. This was mainly due to Category A firm engagement inspections, of which 55% were rated 1 or 2 in 2022 (2021: 45%; 2020: 41%). **Figure 1** sets out the percentage of PIE engagements inspected disaggregated by the audit quality rating of 1 or 2, 3 and 4.

Figure 1 Overall engagement inspection results by category of firm



2.2.10 Of the 55 engagement inspections in 2022, 22 related to the firm's initial audit after appointment as auditor of the listed entity (**initial engagements**). In initial engagements, the new auditor has a steep learning curve to understand the listed entity and any previous audit issues. 15 of the initial engagements resulted from a late appointment of the auditor, which restricts the time available to the auditor for effective planning.

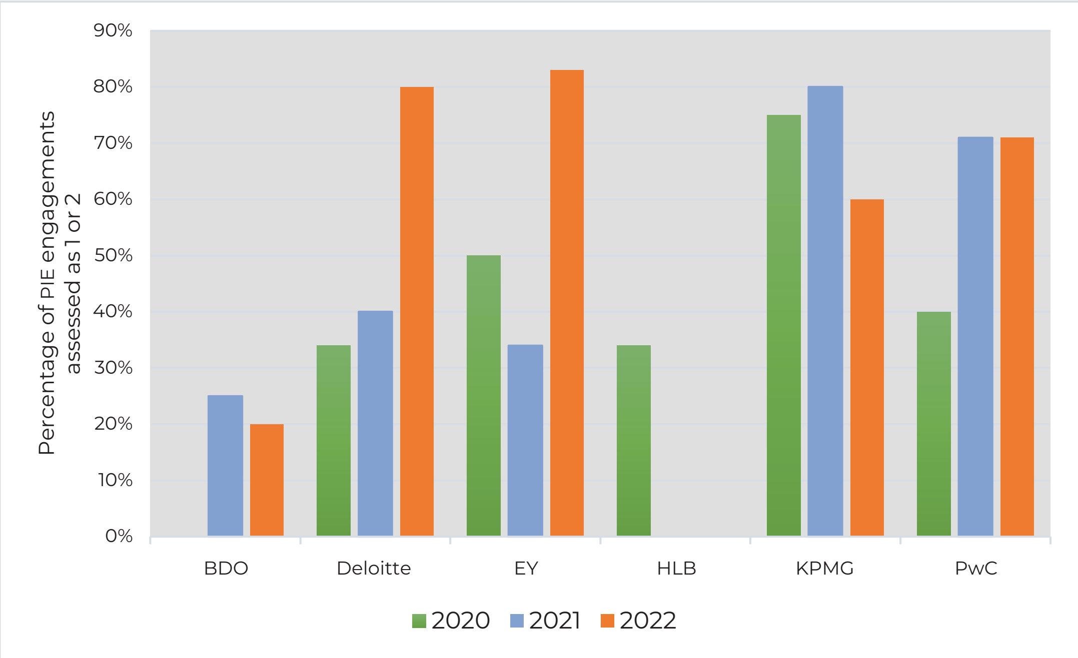
2.2.11 We rated 18 out of 22 (82%) initial engagements including 13 out of 15 (87%) of those resulting from a late appointment of the auditor as 3 or 4. The significant deficiencies we identified in the initial engagement inspections indicate that auditors should allocate and apply a higher level of time, resources, and technical knowledge to initial engagements than they would need to in subsequent audits to perform a quality audit.

Annual inspections of Category A firms

2.2.12 In 2022, we inspected 33 PIE engagements of Category A firms (2021: 31; 2020: 22). Details are shown in **Figure 2a** and **Figure 2b**.

2.2.13 We rated 18 out of 33 (55%) Category A firm engagements inspected as 1 or 2 (2021: 14 of 31 (45%); 2020: 9 of 22 (41%)). **Figure 2a** shows that four out of six Category A firms delivered higher audit quality over the 2020–22 Cycle than the other two.

Figure 2a Percentage of PIE engagements assessed as 1 or 2 by individual Category A firms



Inspection year	Number of engagements rated as 1 or 2 / total number of PIE engagements inspected (Percentage)					
	BDO	Deloitte	EY	HLB	KPMG	PwC
2020	0%	1/3 (34%)	2/4 (50%)	1/3 (34%)	3/4 (75%)	2/5 (40%)
2021	1/4 (25%)	2/5 (40%)	2/6 (34%)	0%	4/5 (80%)	5/7 (71%)
2022	1/5 (20%)	4/5 (80%)	5/6 (83%)	0%	3/5 (60%)	5/7 (71%)

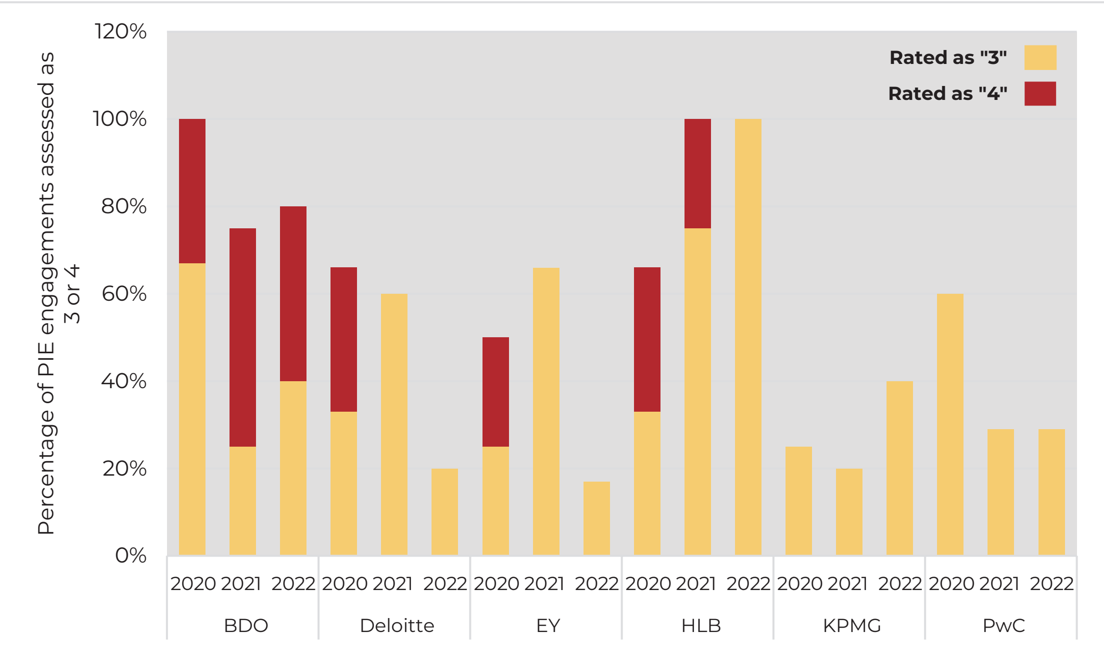
2.2.14 We observed that the four Category A firms previously referred to implemented initiatives to positively impact audit quality. Such initiatives included the firm's leadership emphasising to the audit partners and staff the importance of focusing on audit quality, and the need for early planning and timely response to audit risks, continuous focus on enhancing competence and capabilities, and assignment of partners and staff with appropriate experience and knowledge.

Setting the right tone at the top with respect to audit quality and fully embracing leadership's responsibilities for audit quality are vital considerations for sound governance that supports the effective operation of the firm's SQC and creates an environment for engagement performance that can positively influence audit quality of the firm. Details of factors that contribute to such an environment through actions taken by the firms are set out in Section 3.2.

2.2.15 The other two Category A firms showed no substantial improvement in their AAQR over the 2020–22 Cycle. 90% of their engagements inspected in 2022 were assessed as 3 or 4 (2021: 88% and 2020: 83%). Such results are unacceptable and disappointing.

2.2.16 The most common weaknesses identified across Category A firm engagement inspections are included under "Common causes of the identified findings" in Section 3.2. Due to the significance of the deficiencies in applying relevant professional standards that led to our ratings of 3 or 4, we have referred 3 out of 33 engagements of Category A firms inspected in 2022 (2021: 5 of 31; 2020: 5 of 22) for consideration of initiation of a possible disciplinary sanction.

Figure 2b Percentage of PIE engagements assessed as 3 or 4 by individual Category A firms



Inspection year	Number of engagements rated as 3 or 4 / total number of PIE engagements inspected (Percentage)					
	BDO	Deloitte	EY	HLB	KPMG	PwC
2020	3/3 (100%)	2/3 (66%)	2/4 (50%)	2/3 (66%)	1/4 (25%)	3/5 (60%)
2021	3/4 (75%)	3/5 (60%)	4/6 (66%)	4/4 (100%)	1/5 (20%)	2/7 (29%)
2022	4/5 (80%)	1/5 (20%)	1/6 (17%)	5/5 (100%)	2/5 (40%)	2/7 (29%)

Annual inspections of Category B and C firms

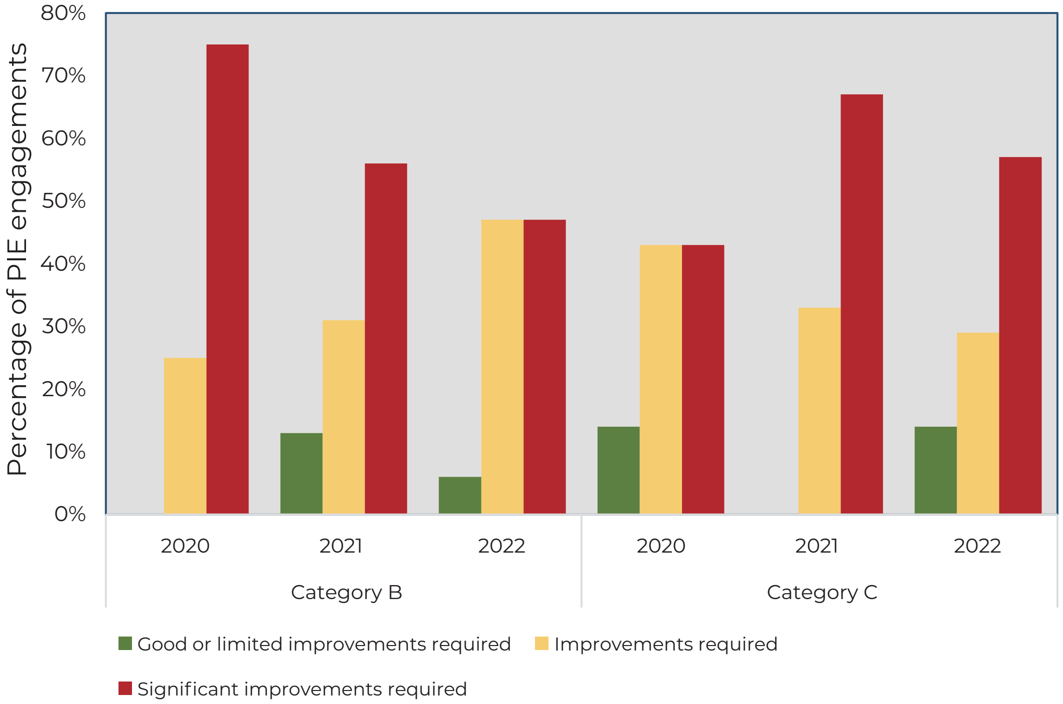
2.2.17 In 2022, we inspected 22 PIE engagements (2021: 19; 2020: 15) of Category B and C firms and rated 91% as 3 or 4, which was quite consistent with the previous two years. Details are shown in **Figure 3**.

2.2.18 The inspection results for 16 engagements of Category B and C firms inspected for the first time in 2022 were relatively more unsatisfactory than the results of 6 engagements of firms in those categories that were re-inspected in 2022 (Section 2.2.20 to 2.2.22).

There is no substantial difference in the quality of engagements inspected for Category B and C firms first inspected at any time during the 2020-2022 Cycle.

2.2.19 In 2022, a total of 11 engagements (2021: 12 and 2020: 11) rated 3 or 4 due to significant deficiencies in applying relevant professional standards were referred for consideration of initiation of a possible disciplinary sanction.

Figure 3 Percentage of PIE engagements by audit quality ratings for Category B and C firms



Re-inspections of Category B and C firms

2.2.20 We increased the frequency of our inspections of four Category B firms at which we had identified significant quality issues in previous years, and conducted second inspections of them in 2022. Although the results were still unsatisfactory, there was an improvement in their audit quality ratings compared with their previous inspections. The AAQR of the engagements inspected for these four Category B firms was 3.0 in 2022 (2020: 3.9).

2.2.21 In addition, we incorporated unpredictability into the 2020–22 Cycle and therefore one Category B firm and one Category C firm, which were also inspected in previous years, were randomly selected for second inspections in 2022. The engagements of the Category C firm inspected in 2022 and 2020 were both rated as 2. But the engagement of the Category B firm inspected was rated as 4 in 2022 (3 in 2020). This was referred for consideration of initiation of a possible disciplinary action.

2.2.22 The engagement inspection result of the Category C firm re-inspected during the cycle shows that, despite their smaller size compared with Category A firms, it is feasible for smaller scale firms to maintain audit quality at an acceptable level.

Specific scope inspection

2.2.23 In view of our growing concerns over a surge in the number of late changes of auditors, especially when they result from the auditor's resignation due to significant unresolved matters, we took proactive measures to ensure that all PIE auditors understand our concerns and adequately address them. These include:

a. Making specific enquiries with both the incoming and outgoing auditors to understand the underlying reasons for changes and how the incoming auditor planned to address any unresolved audit issues;

b. Conducting a specific scope inspection of a PIE auditor in relation to the client and engagement acceptance policies and procedures in its SQC (Section 2.2.24); and

c. Collaborating with the Hong Kong Stock Exchange when significant issues are identified.

2.2.24 In 2022, we conducted a specific scope inspection of a Category B firm which had taken on a significant number of listed entity audits with a December 2021 year-end. This increased the number of its PIE engagements by 48%. Over one-third of this firm's December 2021 year-end audit appointments were made shortly before or subsequent to 31 December 2021 (**Late Appointments**).

The scope of this specific inspection was to evaluate the design of and compliance with the firm's SQC policies and procedures on client and engagement acceptance and continuance. This included evaluating whether the firm had sufficient capabilities and resources to perform quality PIE audits. Our inspection findings from the specific scope inspection are summarised in Section 4.4.

2.3 Our responses to the engagement inspection results

We continue to take robust actions to drive improvements in audit quality by PIE auditors.

Our inspection approach

2.3.1 During the 2020–22 Cycle, we increasingly selected higher risk audits for inspection based on our risk assessments. We responded to the changing economic environment and the impact of the coronavirus disease 2019 (**COVID-19**) pandemic, including travel restrictions, and leveraged the experience we gained in our previous inspections. During the 2020–22 Cycle, we:

a. Inspected PIE engagements with greater public interest, such as audits of listed entities with higher market capitalisation and those related to capital market transactions, such as initial public offerings.

b. Inspected engagements that had changes in auditors shortly before or after the end of the reporting period or that issued audit opinions in challenging circumstances and timeframes following acceptance of new audit appointments.

c. Inspected engagements of listed entities in industries adversely impacted by the economic environment. One particular area of inspection focus was the audit of going concern assessments and disclosures.

d. Increased the frequency of inspection of smaller firms where we identified audit quality risks, and re-inspected firms within the 2020–22 Cycle where earlier inspections had identified very significant deficiencies.

e. Conducted a specific scope inspection on an audit firm to inspect the effectiveness of its client and engagement acceptance policies and procedures as this firm took up more and higher-risk PIE engagements from its peers (Section 2.2.23 to 2.2.24).

2.3.2 We will continue to review our inspection focus in response to the changing environment, and we will consider and respond to new and evolving risk factors that present a higher risk to audit quality, in order to uphold audit quality and protect the public interest.

Review of root cause analysis by PIE auditors

2.3.3 PIE auditors we have inspected are required to conduct an effective RCA to understand the underlying causes of audit deficiencies and to establish appropriate corrective actions to prevent them from reoccurring (**a remediation plan**).

2.3.4 We reviewed each firm's RCA and proposed remediation plan and assessed whether the proposed corrective actions could address our inspection findings. We agreed with each firm deadlines for completion of the remedial actions. We also evaluated the ability of the firm to implement its remediation plan and the effectiveness of the remedial action taken.

2.3.5 If a firm presents a remediation plan that is not appropriate or if a firm lacks the capability to execute the remediation plan, we will issue a requirement letter specifying remediation actions they should take together with deadline. We summarise our observations, key findings and good practices identified in our review of the RCAs presented by the PIE auditors in Section 5.2.

Collaboration work

2.3.6 We take robust action in relation to engagements rated as 3 and 4. Engagements rated 4 will be referred to our Investigation and Compliance Department (**INC Department**) who will consider whether or not to initiate an investigation, which may result in a disciplinary sanction. Engagements rated 3 are also considered for referral to INC Department, depending on the nature and significance of our findings. Where our inspections identify potential material misstatements in the financial statements and/or indications of fraud committed by a listed entity, we will refer the potential non-compliance with financial reporting standards to our INC Department who will consider initiating an enquiry with the listed entity and sharing relevant information with the Securities and Futures Commission (**SFC**) for its consideration.

2.3.7 We discuss our observations from inspections with our Policy, Registration and Oversight Department. This facilitates its oversight of the performance of the Hong Kong Institute of Certified Public Accountants (**HKICPA**)'s functions under the Professional Accountants Ordinance in relation to training and guidance for auditors. It also highlights matters in relation to which it may be appropriate to carry out policy research or issue guidelines for auditors, directors, and audit committees or other stakeholders to address market dysfunction.

Our inspection publications and briefing sessions

2.3.8 We engage with a wider stakeholder audience, including company directors and audit committee members. The purpose of which is to draw attention to our expectations for the proper functioning of the market for audit services, and to uphold audit quality and the quality of financial reporting. We may highlight our findings, evolving risks to audit quality, good practices we have observed, or our recommendations for management and those in governance roles to promote an environment that fosters the performance of high quality audits and financial reporting.

2.3.9 In 2022, we issued the following publications and conducted several briefing or debriefing sessions with the objectives summarised below. We will continue to adopt a proactive approach to pre-empt audit risks and uphold audit quality in the next inspection cycle and beyond.

Our work in 2022	Our objectives
An External Auditor's Guide to Performing Root Cause Analysis (June 2022)	This provides guidance to practice units which are required to prepare an appropriate and robust RCA and formulate a plan of action to remediate audit quality deficiencies and improve the quality of their audits.
Open letter regarding late auditor resignations (October 2022)	This letter sets out our analysis of the late changes of auditors for listed entities for the year ended 31 December 2021. We highlighted our growing concerns that audit quality may be compromised by late auditor resignations because the incoming auditor will have limited time to plan and conduct a proper audit. PIE auditors should take action to respond to our expectations of outgoing auditors and incoming auditors.
New and revised quality management standards follow-up survey on implementation progress by PIE Auditors (November 2022)	In view of the QMSs that became effective on 15 December 2022, we conducted two surveys to understand and monitor the implementation progress of QMSs of all PIE auditors before the effective date. We highlighted the key challenges encountered by different categories of firms, and shared good practices and reminders for firms at their final stage of the implementation journey.

Our work in 2022	Our objectives
Debriefing session on *interim inspection report* to PIE auditors (December 2022)	The debriefing highlighted (a) the most significant deficiencies identified in the 2022 interim inspections, (b) key reminders for 2022 year-end audits; (c) potential areas of inspection focus in 2023; (d) our expectations of outgoing and incoming auditors; and (e) key reminders for implementation of the new QMSs. This enables firms to consideration these matters when planning and performing audits and improve audit quality.
Audit Focus: 2022 financial year-end audits reminders (December 2022)	We issued the Audit Focus to alert all auditors to key audit issues and areas they should pay attention to. We also set out our expectations for auditors when performing 2022 financial year-end audits. Auditors are reminded to remain alert to the impact of risks faced by their audit clients, such as the impact of interest rate increases and inflationary pressure.
Follow-up open letter on auditor changes (January 2023)	This follow-up letter sets out our analysis of the late changes of auditors for listed entities covering the period from 1 November 2022 to 31 December 2022. We highlighted our expectations of audit committees as well as our expectation of auditors. Firms should take actions to meet our expectations.
Briefing session for all PIE auditors (February 2023)	The briefing highlighted (a) common audit deficiencies identified from our 2022 annual inspections, (b) common findings identified from the SQC inspections, (c) our views on audit focus for 2022 year-end audits and (d) key reminders for current and upcoming audits, in order to provide all PIE auditors with greater transparency about our inspection findings and to reiterate our expectations on auditors in upholding audit quality.

Section 3
Key findings from our engagement inspections

3.1 Introduction

3.1.1 Our engagement inspections focus on whether auditors complied with the requirements of applicable professional standards, laws and regulations when performing audit engagements, and on the quality of audit work for the areas selected for review. We adopt a risk-based approach to selecting engagements for inspection with a focus on engagements that exhibit high-risk factors.

3.1.2 Since our 2020 inspection there have been improvements in the exercise of professional skepticism, audit documentation and responses to key audit matters (**KAM**). However, we continue to identify recurring deficiencies in journal entry testing, in auditing the application of accounting standards for revenue recognition and in auditing estimates with high estimation uncertainty and complex valuation models such as expected credit losses (**ECL**). This recurrence is not acceptable as it undermines the confidence of financial reporting users.

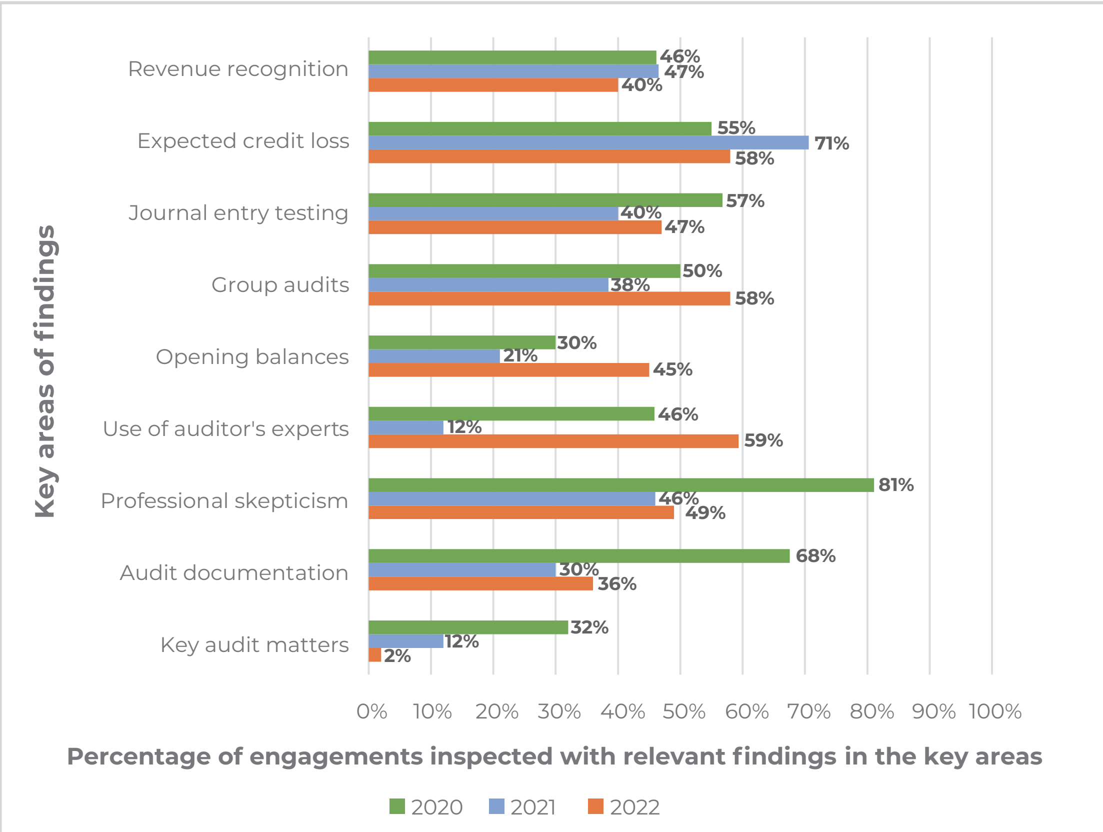
We have also identified risks of a deterioration in audit quality and indications of an increasing number of deficiencies in audit quality in relation to: (a) group audits, (b) the use of auditor's experts and (c) the audit of opening balances in initial engagements.

3.1.3 Our inspections of non-PIE engagements commenced from 1 October 2022. In applying our risk-based approach to non-PIE engagements, our initial focus has been on regulated entity audits and related compliance assurance engagements. We have adopted the same inspection methodology for PIE and non-PIE engagement inspections. Our inspection approach to and findings from our non-PIE engagement inspections are set out in Section 3.3.

3.1.4 **Figure 4a** shows the percentage of PIE engagements inspected in which we identified relevant findings in each key area that was covered in the 2020–22 Cycle.

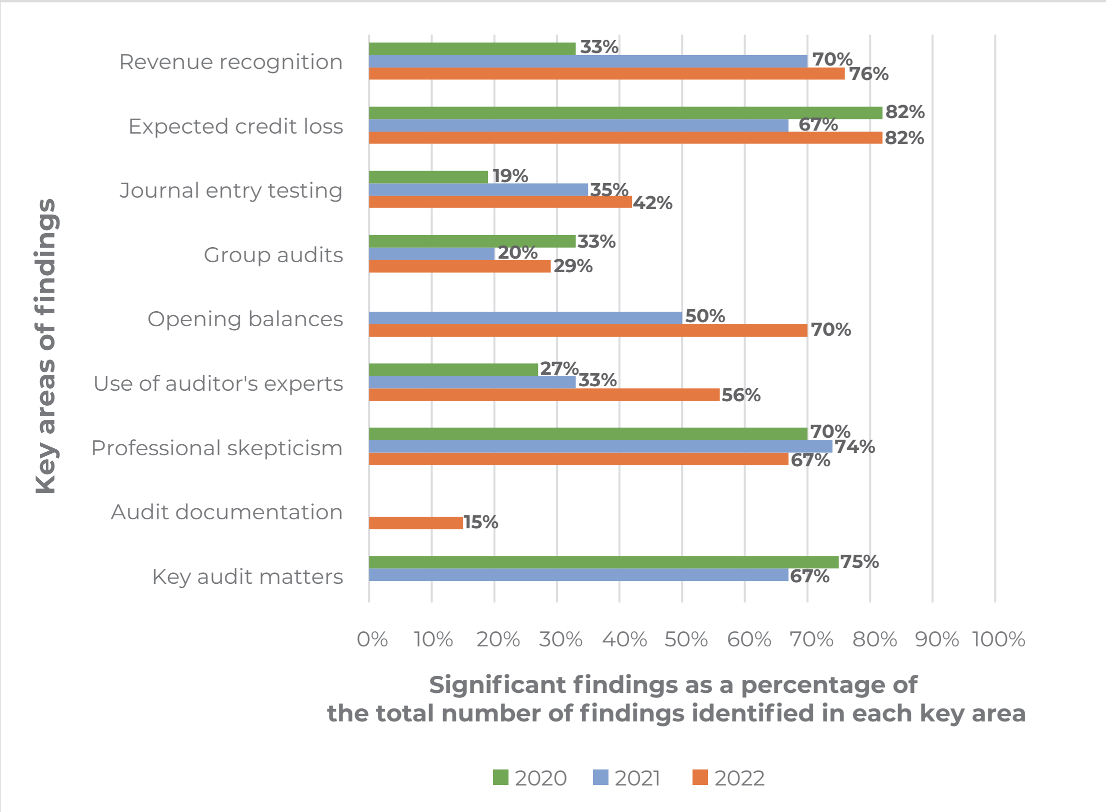
3.1.5 In interpreting the data in the following Figures, it is important to recognise that our findings **do not necessarily indicate that the financial statements are materially misstated** but rather that the quality of the audit has been affected by deficiencies in important aspects of the work. Auditors are expected to take robust action to prevent these deficiencies from occurring or recurring in their next audit cycle.

Figure 4a Common findings over the 2020–22 Cycle



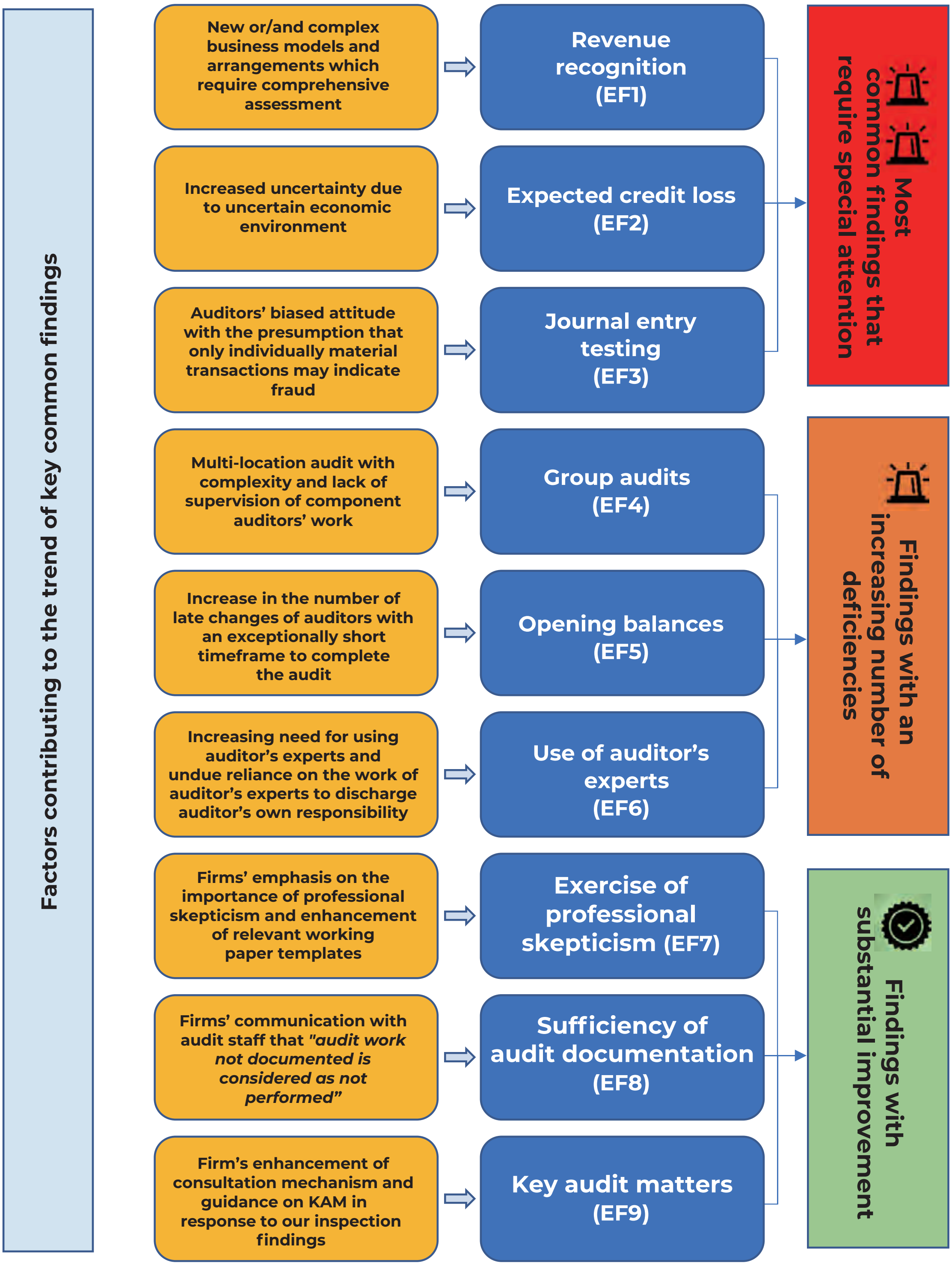
3.1.6 **Figure 4b** shows the percentage of findings in each key area that are significant findings. Significant findings drive our assessment of audit quality ratings for engagement inspections.

Figure 4b Significant findings as a percentage of the total number of findings identified



3.2 Key common findings in public interest entity engagement inspections

Summary of key common engagement findings (EF) and causes



Most common findings that require special attention

EF1 — Revenue recognition

Revenue is a key performance indicator for listed entities and there is a rebuttable presumption that each entity has a risk of fraud in revenue recognition. Management's incentive or pressure to manipulate revenue has increased during the economic downturn in recent years. Therefore, revenue recognition was identified as a key area of inspection focus for the majority of engagements inspected during the 2020–22 Cycle.

Understanding the listed entity's business models, contractual arrangements and business practices are vital in auditing revenue recognition and measurement. These may be complex and may give rise to different performance obligations and variable consideration. This is particularly important when management has changed or is exploring changes to address new business opportunities or develop new business models to enhance financial performance.

In 2022 we identified deficiencies in relation to the application of Hong Kong Financial Reporting Standard (**HKFRS**) 15 *Revenue from Contracts with Customers* in 40% or 17 of the 43 engagements where revenue was an area of inspection focus (2021: 47%; 2020: 46%). 76% of these deficiencies were significant findings (2021: 70%; 2020: 33%). Common findings include:

a. Insufficient evaluation of the appropriateness of management's accounting for the performance obligations promised in contracts. More specifically, the engagement teams did not critically assess contract terms to determine whether warranties give rise to a separate performance obligation (providing an incremental maintenance service beyond ensuring that the product could function as intended) or a safeguard for customers against defective products.

b. Failure to critically evaluate management's assessment of whether the entity was acting as principal or agent. The engagement teams did not challenge management's assessment by considering potential indicators of whether the entity controls the specified goods or services before transferring them to customers.

c. Insufficient evaluation of contract terms that include variable consideration, for example, performance penalties imposed on the entity and incentive discounts such as early settlement discounts offered to customers, resulting in failure to identify such variable consideration in the determination of the transaction price.

d. Insufficient evaluation of the appropriateness of management's determination as to when the control of goods or services was transferred to customers, i.e., at a point in time or over time, and the method used by management in measuring the progress towards the complete satisfaction of the performance obligation when the revenue was recognized over time for long-term contracts.

Our expectations
✓ Obtain a thorough understanding of the listed entity's business, accounting policies and relevant controls in relation to all key revenue streams of the listed entity.
✓ Sufficiently evaluate the design and implementation of relevant controls over the revenue process (including IT application controls).
✓ Sufficiently assess the customer contract terms to evaluate management's accounting for the performance obligations (including principal versus agent considerations), determination of the transaction price and the timing of recognition of revenue.

EF2 — Expected credit loss

The audit of ECL has become more challenging due to the increased uncertainty resulting from the current uncertain economic environment. The ECL assessment requires consideration of all available information, including past events, current and future economic conditions and their implications on ECL. Failure to perform sufficient audit procedures to obtain evidence from all relevant sources and to challenge the completeness and relevance of management's data sources and reasonableness of their assumptions may result in the auditor failing to identify ECL provisions that do not accurately reflect the credit quality and recoverability of the entity's financial assets.

In 2022, we identified deficiencies in auditing ECL estimates in 58% or 11 of 19 engagements where ECL was an area of inspection focus (2021: 71%; 2020: 55%). 82% of the identified deficiencies were significant findings (2021: 67%; 2020: 82%). Significant deficiencies in this area include:

a. Failure to obtain supportable and reasonably available evidence to evaluate whether it was appropriate for the entity to use a more lagging default criterion and rebut the presumption that default does not occur later than when a financial asset is 90 days past due.

b. Failure to test the reliability of information prepared by management for ECL assessment. There were instances where engagement teams used aging information prepared by management as audit evidence to evaluate the appropriateness of grouping trade receivables. However, they did so without testing the reliability of issuance dates and credit terms of sales invoices and repayment history of debtors to ascertain the accuracy and completeness of the information used.

c. A lack of evaluation of whether management sufficiently assessed the changes in credit risk for a financial asset since initial recognition, particularly when borrowers were in significant financial difficulties and extensions of loan repayment dates had been granted to the borrowers and had deferred repayment obligations.

d. Insufficient evaluation of the appropriateness of the probability of default, for example, how the external credit rating and the corresponding average global default rate published by an international credit rating agency could reflect the credit characteristics of the corresponding financial assets.

e. Insufficient challenge of the basis of management's benchmarking of receivables against certain types of debts without considering the difference in their credit risk characteristics and the relevance of applying the recovery rate of the benchmark published by an international credit rating agency directly in determining the loss given default.

f. Failure to challenge management on the correlation between selected macroeconomic factors such as gross domestic product and the entity's historical default rate in evaluating the appropriateness of a forward-looking adjustment. There were instances where the engagement teams concurred with management on the forward-looking adjustments without obtaining an understanding of management's basis in assessing the appropriateness of such adjustments.

Our expectations

- ✓ Challenge the appropriateness of management's rebuttal of presumptions on significant increase in credit risk and default of financial assets and obtain sufficient appropriate audit evidence.
- ✓ Sufficiently evaluate management's ECL model, including the appropriateness of grouping of debtors and the relevance, accuracy and completeness of information used by management to determine the probability of default and loss given default.
- ✓ Robustly challenge management on whether the ECL estimate appropriately reflects the entity's exposure to credit risks arising from current and future economic conditions.

EF3 — Journal entry testing

In response to the presumed fraud risk of management overriding controls, auditors perform journal entry testing to evaluate the appropriateness of journal entries as a key audit procedure. Deficiencies in journal entry testing may result in failure to identify fraudulent journal entries prepared by management.

We continued to identify deficiencies in journal entry testing in 47% or 26 of the 55 engagements inspected (2021: 40%; 2020: 57%). The findings in this area have been broadly consistent throughout the 2020–22 Cycle and common deficiencies in this area are:

a. Failure to test journal entries with fraudulent characteristics for significant components as determined in the audit scope by the group engagement teams.

b. Failure to obtain sufficient audit evidence on the completeness of the journal entry population. For instance, the engagement teams only included general statements which described the audit procedures performed to test the completeness of journal entries with no details of such procedures in the audit working papers.

c. Failure to evaluate the appropriateness of applying a monetary threshold for the selection of journal entries. In most instances where this deficiency was identified, the engagement teams applied a monetary threshold based on performance materiality or a clearly trivial amount. However, the engagement teams were not able to explain why journal entries below the monetary threshold did not contain potential fraud risks related to management override of controls.

d. Failure to make use of the understanding of the entity's financial reporting process to identify the types of journal entries which should be tested. Certain engagement teams directly quoted the characteristics of fraudulent journal entries or other adjustments as set out in paragraph A44 of Hong Kong Standard on Auditing (**HKSA**) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* without evaluating whether those criteria were entity specific and defining what were *"unrelated, unusual, or seldom-used accounts"*, and/or who were *"individuals who typically do not make journal entries"*, etc.

e. Insufficient documentation of the audit procedures performed and the details of journal entries identified for testing. There were instances where the engagement teams did not document the general ledger accounts, complete double entries and details of the underlying supporting documents inspected to evaluate and conclude on the appropriateness of the journal entries.

Our expectations

- ✓ Evaluate the design and implementation of controls related to the financial reporting process.
- ✓ Ensure that the scope of journal entry testing for components is consistent with the group audit scope as determined by the group engagement teams.
- ✓ Consider entity specific circumstances when determining high-risk criteria used to identify journal entries for testing.
- ✓ Document the extent of audit procedures performed to ascertain the completeness of journal entries, details of the journal entries selected for testing and the underlying supporting documents inspected to evaluate and conclude on the appropriateness of the journal entries.

Findings with an increasing number of deficiencies

EF4 — Group audits

Audits of large groups which involve many components across multiple locations can be complex, especially when group engagement teams perform remote audits on business units or operations that are located outside their jurisdictions. Audit quality will significantly depend on how the group engagement teams direct and supervise the component auditors to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

The number of engagements with deficiencies in group audits has increased to 58% or 7 of the 12 engagements inspected which involved component auditors, compared to previous years of inspection (2021: 38%; 2020: 50%). Common deficiencies in this area include:

a. Insufficient involvement in the work of the component auditors by the group engagement teams and insufficient direction and supervision of component auditors and review of their work to evaluate whether the work performed by component auditors in response to the significant risks of material misstatement is adequate and appropriate. There were instances where the group engagement teams identified certain components with individual financial significance to the group and revenue as having a significant risk of material misstatement but the group engagement teams did not identify the following deficiencies in the component auditors' work:

i. Failure to understand and evaluate the contract terms in relation to the identification of performance obligations and timing of revenue recognition;

ii. Failure to obtain sufficient audit evidence from tests of operating effectiveness of controls while placing reliance on the entity's internal controls; and

iii. Failure to perform sufficient substantive procedures to ascertain the occurrence, accuracy, and cut-off of revenue.

b. Insufficient documentation on how the group engagement teams evaluated the work performed by the component auditors. There were three instances where the group engagement teams reviewed the work of the component auditors but did not sufficiently document the nature and extent of audit procedures performed by component auditors to support the conclusion that the work performed by component auditors was adequate and appropriate.

Our expectations

✓ The group engagement team should maintain ongoing and effective two-way communication with the component auditors on its requirements.

✓ The group engagement team should sufficiently review the audit documentation prepared by the component auditors, evaluate the audit evidence obtained by component auditors and clearly document such evaluation in the group audit file.

Further special considerations on group audits using the work of component auditors are set out in Section 6.4.

EF5 — Opening balances

For initial engagements, obtaining sufficient appropriate audit evidence on opening balances is crucial as misstatements in opening balances could materially impact the financial statements for the current year. Deficiencies in the audit of opening balances were found in some audits where auditors were required to complete the audit within an exceptionally short timeframe upon initial appointment of auditors.

The number of engagements having deficiencies in the audit of opening balances has been increasing over the 2020–22 Cycle. We identified deficiencies in 45% or 10 of the 22 engagements which were initial engagements (2021: 21%; 2020: 30%). Findings which have a significant impact on audit quality have risen sharply to 70% in 2022 from 0% in 2020. Significant deficiencies identified in this area include:

a. Failure to obtain sufficient appropriate audit evidence on the existence and valuation of assets with significant balances in the opening balance sheet. For instance, the engagement teams did not receive confirmations from confirming parties or perform any alternative procedures to ascertain the existence of financial assets or did not evaluate how the management justified the key assumptions used in the asset impairment assessment for the prior period to ascertain the valuation of assets.

b. Lack of evaluation of the appropriateness of the consolidation adjustments brought forward from the previous year. The engagement teams failed to understand the nature of prior year consolidation adjustments and failed to perform audit procedures to evaluate whether such adjustments were appropriate and whether they could have a material impact on the current year's financial statements.

c. Failure to obtain sufficient appropriate evidence to evaluate whether opening balances contained a misstatement that could materially affect the current period's financial statements, where the predecessor auditor had expressed a disclaimer of opinion on the prior year's financial statements.

d. Failure to perform further audit procedures to address whether any identified cut-off misstatements in the current year indicated the existence of possible cut-off misstatements in the prior year financial statements audited by a predecessor auditor.

Our expectations

- ✓ Review the predecessor auditor's working papers and evaluate whether such review of working papers provides sufficient appropriate audit evidence regarding the opening balances.
- ✓ Evaluate the audit implications during the prospective client acceptance procedures and perform appropriate specific audit procedures to obtain sufficient audit evidence regarding the opening balances when access to the predecessor auditor's working papers is denied.
- ✓ Consider carefully whether the firm has the necessary competence, adequate capabilities, and a reasonable timeframe to resolve any audit matters raised by the predecessor auditors in relation to their resignation.

EF6 — Use of auditor's experts

Economic uncertainty and the impact of the COVID-19 pandemic resulted in impairment indicators for assets and increased the risks and challenges for auditors in relation to auditing valuations of assets and businesses during the 2020–22 Cycle. There has been an increasing need for auditors to use auditor's experts to assist them in obtaining sufficient appropriate audit evidence. Where such assistance is obtained, the auditors must determine whether the work of an auditor's expert is adequate for the auditor's purposes.

In 2022, we identified deficiencies in 59% or 16 of the 27 engagements inspected where the auditors used an auditor's expert to assist them in obtaining sufficient appropriate audit evidence (2021: 12%; 2020: 46%). The scope of the expert's work covers significant account balances which may involve complex matters requiring specialist skills and knowledge, such as the valuation of investment properties, or ECL models for calculation of impairment allowances for financial assets. The number of engagements inspected which had findings in this area has significantly increased to 16 in 2022 compared to 2021 and 2020 inspection results (2021: 3; 2020: 11).

The engagement teams did not sufficiently evaluate the relevance, completeness and accuracy of the input data, and the relevance and reasonableness of the key assumptions and the valuation methodology. More specifically:

a. When using the work of an auditor's expert for valuation of investment properties or other non-current assets, the engagement teams did not adequately evaluate the appropriateness of the market comparables selected by the auditor's experts to use in developing a range for its estimate. For example, the engagement teams did not adequately evaluate whether the selected comparable properties were of similar size, location, age, and quality of the entity's item being valued, and whether the selected comparable companies used for estimating a discount rate were of similar scale, principal place of operation and business of the entity. We also identified instances where the engagement teams did not further evaluate whether the differences between management's point estimate and the nearest point of the auditor's expert's range constituted misstatements.

b. We identified instances relating to the valuation of properties under development where the engagement teams did not evaluate the reasonableness of the estimated development costs prepared by management, by comparing the costs with related contracts and agreements, taking into consideration the costs incurred to date and construction progress, particularly when there were changes in design plans or development schedules.

c. When evaluating the reasonableness of the valuation of investment properties determined by using the income approach, the engagement teams did not explain the significant disparity between the rental information used by the auditors' experts and recent market transaction data of comparable properties.

d. In many cases, where the engagement team is using an auditor's expert to assist in obtaining audit evidence about an ECL estimate for financial assets, the engagement teams simply checked the accuracy of input data used by the auditor's expert, such as the average probability of default and recovery rate of certain types of debts, to reports published by an international credit rating agency. However, they did not evaluate whether the input data was relevant, and complete and accurate by reference to the underlying financial assets.

Our expectations

- ✓ Bear in mind that auditors have sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.
- ✓ Determine whether to use the work of an auditor's expert if expertise in a field other than accounting or auditing is necessary to obtain sufficient audit evidence.
- ✓ Obtain a sufficient understanding of the auditor's expert's field of expertise to determine the scope of the expert's work and evaluate the adequacy of the auditor's expert's work for the auditor's purpose.

Findings with substantial improvements

EF7 — Exercise of professional skepticism

Maintaining a questioning mind is particularly important when auditing areas which involve significant judgement because of a high risk of management bias. One such judgement area is the evaluation of an entity's ability to continue as a going concern which is the fundamental basis for preparing the financial statements.

We continue to emphasise the importance of professional skepticism. Firms have enhanced their guidance and working paper templates for areas that require significant judgement. There has been a notable improvement in audit areas which require the exercise of professional skepticism, such as asset impairment, fair value measurement of assets and going concern assessment.

However, we still identified deficiencies in this area in 49%, or 27 of 55 engagements inspected in 2022, which has reduced from 81% in 2020. 67% of these deficiencies had a significant impact on the overall audit quality rating (2021: 74%; 2020: 70%).

Findings relating to impairment assessment and fair value measurement of assets in this area include:

a. Failure to critically challenge management about the basis of key assumptions and the probability of alternative scenarios. The engagement teams did not sufficiently evaluate the following:

   i. Whether it was appropriate for management to adopt a forecast period which was longer than the useful life of assets;

   ii. Whether the revenue growth rate was in line with the entity's financial performance in prior years and incorporated changes in economic conditions; or

   iii. Whether management had sufficiently assessed the probability of alternative scenarios before adopting the best-case scenario which resulted in a higher value-in-use.

b. Insufficient evaluation of contradictory audit evidence obtained by engagement teams in other audit procedures, for example, substantial capital expenditure in the cash flow projection for asset impairment assessment but no capital expenditure in the cash flow projection for the going concern assessment.

c. Lack of consideration as to whether the discount rate reflects the specific risks of the assets and time value of money. The engagement teams failed to evaluate whether adjustments such as specific risk premium and the comparable companies selected by management were relevant to the territory and industry in which the entity operated.

d. Failure to evaluate whether the key inputs adopted by management in the sensitivity analysis were reasonably possible alternatives and whether the effect of changes of key inputs, such as the discount rate, exceeded the acceptable range of outcomes determined by the engagement teams.

Findings relating to going concern assessment include:

a. Failure to critically evaluate the feasibility and outcome of management's plan for future action in relation to the going concern assessment. Such plans included obtaining new bank borrowings, subscription of new shares or additional funding provided by the major shareholders.

b. Insufficient evaluation of the adequacy of the disclosures on material uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and management's mitigating plan in response to those events and conditions in the financial statements.

c. Failure to establish an adequate basis for a disclaimer of opinion. The engagement teams disclosed in the independent auditor's report that the existence of material uncertainties or their inability to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting were the basis for the disclaimer of opinion. More specifically, the engagement teams did not perform the following:

    i. Identify that the existence of material uncertainties itself would not contribute to a disclaimer of opinion. Where the disclaimer of opinion results from multiple uncertainties which were significant to the financial statements as a whole, the engagement teams should sufficiently explain what the multiple uncertainties are and why the disclaimer should be considered to be an "extremely rare case".

    ii. Explain and document why they had not been able to obtain sufficient appropriate audit evidence in relation to management's use of the going concern basis of accounting if the disclaimer of opinion was due to inability to obtain sufficient appropriate audit evidence in this respect.

Our expectations	
✓	Always maintain an attitude that includes a questioning mind and remain alert to conditions which may indicate possible management biases towards optimistic assumptions, and a critical assessment of audit evidence.
✓	Critically challenge management's assumptions through procedures such as using experts to review valuation methodology and performing independent research.
✓	Critically evaluate the information and explanations provided by management, obtain evidence from all reasonably available sources which may support or corroborate management's assumptions and evaluate any contradictory evidence identified throughout the audit.
✓	Robustly challenge management's going concern assessment, obtain sufficient appropriate audit evidence to evaluate the entity's ability to raise additional financing, when applicable, and evaluate the adequacy of management's going concern disclosures.

EF8 — Sufficiency of audit documentation

The adequacy of audit documentation is a key area that we have emphasised during the 2020–22 Cycle. Verbal explanations by the auditors, on their own, cannot provide adequate support for the work performed or conclusions reached.

Audit work not documented is considered not to have been performed unless the engagement teams can provide other persuasive audit evidence obtained on or before the auditor's report date.

There have been improvements in audit documentation where the deficiencies identified have reduced to 36% in 2022 (2021: 30%; 2020: 68%). Common findings in this area relate to the following:

a. Insufficient documentation of the nature, timing and extent of audit procedures performed, with only brief descriptions of the audit procedures performed to reach audit conclusions. This is common for areas such as other information and the subsequent events review, where the engagement teams simply completed checklists for audit procedures and did not document the details of relevant procedures.

b. Failure to assemble all relevant documentation or supporting evidence in the final audit file which the engagement teams subsequently referred to during our inspections.

Our expectations	
✓	Maintain sufficient and appropriate written record of the audit procedures performed to provide the basis for the auditor's conclusions, with appropriate cross-referencing to other audit working papers across the audit file where necessary.

EF9 — Key audit matters

Deficiencies in this area may result in insufficient and inappropriate evidence to draw audit conclusions on matters that are of most significance to the audit of the financial statements.

This is another key area that we inspected during the 2020–22 Cycle. Some firms enhanced their consultation and guidance in response to our findings in this area and there have been continuous improvements in auditors' responses to KAM. In 2022, we only identified deficiencies in this area in 2% or 1 of the 55 engagements inspected (2021: 12%; 2020: 32%).

Our expectations	
✓	Clearly document the rationale for matters that required significant auditor's attention and which of those matters are of most significance in the audit and therefore are KAM.
✓	Ensure that the planned audit procedures addressing KAM are responsive to the identified significant risks and the audit procedures were appropriately performed to obtain sufficient audit evidence.

Common causes of the identified findings

The common causes of the deficiencies identified from our inspections are as follows.

a. Insufficient assessment of the competence and capabilities of the firms before client acceptance

Firms did not critically consider the following factors before accepting or continuing client relationships and critically assess whether they had the necessary competence and capabilities to perform quality audits.

i. Size and complexity of the business operations of the prospective clients.

ii. Circumstances leading to the outgoing auditor's resignation and the related audit implications.

iii. Whether there are any indicators of lack of management integrity.

iv. Knowledge and experience of the industries relevant to the prospective clients and the regulatory and reporting requirements.

It is particularly important for firms to ensure that they have sufficient and appropriate resources to conduct quality audits before accepting an engagement.

b. Insufficient supervision and review

The engagement partners or EQRs who failed to perform the following in engagements were generally associated with engagements of lower audit quality.

i. Be involved in audit planning at an early stage. This includes being involved in obtaining an understanding of the significant transactions and changes in business operations of the entity. Any business changes late in the financial year may increase susceptibility to management fraud. Be involved in the discussion among engagement team members to identify susceptibility to risks of material misstatement including due to fraud. Be involved in the design of procedures responsive to the significant risks and higher risks of material misstatement identified.

ii. Provide timely and proactive direction and supervision of key engagement team members to stay aware of significant matters arising during the audit, and be involved in addressing them.

iii. Conduct timely reviews of the work of the engagement teams to ensure that sufficient appropriate audit evidence has been obtained and that the evidence supports the conclusions reached before the date of the auditor's report.

c. Lack of professional skepticism and questioning mindset

Firms did not reinforce the importance of professional skepticism by providing internal training and providing real-time coaching to less experienced staff. As a result, the engagement teams placed excessive reliance on management's representations and did not properly exercise professional skepticism throughout the audit to challenge management about the accounting estimates which were significant and highly judgmental, including the following:

i. Reasonableness of significant assumptions used by management in the cash flow projections for asset impairment assessments and/or going concern assessments, or valuation of assets or financial assets at fair value measurement.

ii. Reasonableness and appropriateness of the method for making such accounting estimates.

iii. Relevance, completeness and accuracy of the input data used in the cash flow projections or valuations.

Without proper exercise of professional skepticism, the engagement teams failed to identify potential material misstatements resulting from management biases.

d. Lack of knowledge and experience

In certain engagements, complex audit areas which involved significant judgments such as asset impairment assessments were assigned to junior engagement team members who did not possess the appropriate knowledge, skills and experience to perform the relevant audit procedures. In addition, the engagement partners and more experienced team members did not adequately direct and supervise the engagement teams and review their work.

e. Insufficient training and guidance

Firms did not provide sufficient training in accounting knowledge and auditing skills in relation to areas which required significant judgment such as ECL, impairment assessments and going concern assessments.

In addition, firms did not provide adequate guidance on the nature and extent of audit procedures which should be performed, but only required audit staff to complete the checklists that set out brief descriptions of the required audit procedures. Some audit staff misunderstood that completing the checklists was sufficient to support audit conclusions.

f. Ineffective project management on the reporting timeline

Where management did not provide the information required by auditors in a timely manner, engagement teams did not communicate such delay with the directors and audit committees and re-negotiate the reporting timeline. This resulted in increased pressure on the engagement team members to complete the audit work within an unreasonably limited timeframe, compromising the audit quality.

Factors contributing to an improved audit quality of certain PIE auditors

During the 2020–22 Cycle, we have continuously emphasised the importance of upholding audit quality in our publications and webinars. We have communicated our common findings with firms on a timely basis. We have reviewed RCAs and remediation plans holistically. In addition, we have issued guidance and open letters, aiming to uphold high standards of professional conduct and protect the public interest.

We noted that certain Category A firms and firms we re-inspected in 2022 have established initiatives and taken positive action to improve audit quality. We have noted improvements in audit quality, and in some key areas of common findings including the exercise of professional skepticism, sufficiency of audit documentation and the auditor's responses to KAM. Factors which we observed to have contributed to the improved audit quality include:

a. Firm leadership demonstrating a commitment to audit quality

Firm leaders took initiatives to deliver strong and frequent messages that priority was to be given to audit quality rather than business growth, including:

i. Linking partner remuneration to audit quality, by which unsatisfactory results in internal quality reviews and external inspections would result in a poor performance rating and significant reduction in performance bonuses.

ii. Organising regular meetings with audit partners to reiterate that audit quality could not be compromised and obtaining feedback to assess the culture and quality at the individual engagement level.

iii. Introducing quality control programmes to promote accountability at the manager level, in which one or two engagements led by each manager were subject to review and top scoring managers were rewarded with additional performance bonuses.

b. Early and comprehensive planning and robust risk assessment and audit plans

Firms encouraged earlier audit planning and partner involvement to identify accounting and auditing issues, including:

i. Introducing audit quality milestones to set the timeline for key audit planning procedures and monitoring the status of audit planning for each engagement. Failure to meet the timeline would impact the performance rating of engagement team members.

ii. Organising meetings of engagement partners with the firms' leaders regularly to provide updates on the significant matters identified for high-risk engagements and involving the technical department in consultation at an early stage of audit.

iii. Establishing real-time coaching programmes in which experienced reviewers who were not involved in the engagements reviewed the working papers at various stages of the audit to coach the engagement team members on complex accounting and auditing issues.

c. Continuous focus on enhancing competence and capabilities

Firms devoted effort to continuously increase the resources provided to audit staff to prevent adverse findings from re-occurring, including:

i. Timely reminders to audit staff of key focus areas and lessons learnt from internal and external inspections by issuing a series of inspection alerts and showing audit quality pop-up messages on staff's laptops.

ii. Enhancing audit working paper templates with additional guidance and illustrative examples for areas which are complex or highly judgmental, such as asset impairment and ECL assessments, to explain the nature and extent of audit procedures required.

iii. Providing training and periodic audit reminders to staff to reiterate the importance of exercising professional skepticism throughout the audit.

iv. Requiring engagement teams to hold debriefing meetings and develop an action plan to improve effectiveness and efficiency in the coming audit.

d. Assignment of partners and staff with appropriate experience and knowledge

Firms implemented information systems that contained the background information on audited entities and engagements, qualifications and accreditation required by engagement team members for each audit engagement; and professional qualifications, industry experience and capabilities of the audit personnel to ensure that appropriate audit personnel with the necessary competence and capabilities are assigned to relevant audit engagements.

3.3 Non-public interest entity engagement inspections

Introduction

3.3.1 Since 1 October 2022, our regulatory power has extended to auditors of all entities in Hong Kong.

3.3.2 In our 2022 inspections, our risk-based selections of non-PIE engagements focused on SFC licensed corporations. We inspected 6 regulated non-PIE engagements of Category A firms in the fourth quarter of 2022. The engagements inspected were those of entities that had financial year-ends in the period between 30 September 2021 and 31 March 2022 (inclusive).

3.3.3 We also conducted 12 follow-up inspections on cases transferred to us by the HKICPA under the transitional arrangements.

3.3.4 We are drawing attention to the findings identified from the inspection of regulated audits and other non-PIE audits to alert practice units to avoid the same deficiencies from reoccurring in future audits.

Our Inspection approach

3.3.5 Our non-PIE engagement inspections cover the quality of the audit work performed in the areas we selected for review, the sufficiency and appropriateness of the audit evidence obtained, and the appropriateness of the key audit judgments made by the engagement teams. We also inspected the work performed by the engagement teams to support the conclusion reached on the entity's compliance with the SFC requirements in the compliance reports.

3.3.6 We adopt the same inspection methodology for PIE and non-PIE engagement inspections. For each inspection, we issue a private report to the practice units and such report sets out the scope of our inspection and any findings identified from the engagement inspections.

Deficiencies in audit and compliance work

3.3.7 Auditors of licensed corporations are required to perform sufficient work to support their conclusions in the compliance reports and their opinions in the auditors' reports. The evidence that we have gained through our inspections indicates that not all auditors of licensed corporations are thoroughly conversant with the guidance and recommended procedures set out in PN 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries.* Given the public interest in regulated clients, it is important for auditors of licensed corporations to acquire and maintain adequate technical competence before carrying out audit work on the licensed corporations.

3.3.8 In 2022, 6 of the 24 deficiencies (or 25%) we identified in the six regulated non-PIE engagement inspections of Category A firms were significant in nature. The significant deficiencies arising from our non-PIE engagement inspections included:

a. Lack of evaluation and consideration of whether provisions for ECL were required for the undrawn margin loan commitments under HKFRS 9 *Financial Instruments*.

b. Insufficient procedures to ascertain whether the licensed corporations had sent the standing authority renewal notices to all its applicable customers within one week after expiry dates of the standing authorities as required by Section 8(4) of the Securities and Futures (Client Money) Rules and Section 4(4) of the Securities and Futures (Client Securities) Rules.

c. Failure to test the accuracy and completeness of the client monthly statements issued by the licensed corporations, which were used by the engagement teams as evidence in substantive testing.

d. Lack of professional skepticism exercised in evaluating the audit implications of ongoing SFC investigations against representatives of the licensed corporations.

Other deficiencies in non-PIE engagements inspected e.g., those relating to journal entry testing, and documentation of audit work, were common to those identified in the PIE engagement inspections as set out in Section 3.2.

3.3.9 Considering the nature and significance of the deficiencies identified, we referred two non-PIE engagements inspected under Category A firms for consideration of initiation of a possible disciplinary sanction.

Follow-up inspections on cases transferred by the HKICPA

3.3.10 In the follow-up inspection cases transferred by the HKICPA, we identified that certain practice units had not performed audit procedures to adequately address the requirements of auditing standards. This includes cases where insufficient work was performed to identify risks of material misstatement pertaining to specific assertions or to design and perform appropriate audit procedures responsive to assessed audit risks. The areas of common deficiency include:

a. Ineffective reviews performed by the engagement partners or directors.

b. Failure to assess the appropriateness of accounting policies adopted by the non-PIE e.g., revenue recognition.

c. Failure to design and perform sufficient appropriate audit procedures to test the completeness of journal entries, and to identify and test journal entries with fraudulent characteristics.

d. Insufficient evidence to support the recoverability of accounts and other receivables.

Our expectations

3.3.11 In light of the above deficiencies noted, we emphasise that practice units should obtain a thorough understanding of the client's business and environment in order to appropriately identify and assess risks of material misstatement, develop an appropriate audit plan, and design and perform appropriate audit procedures.

3.3.12 Before taking up regulated client engagements, practice units should ensure that their engagement teams are familiar with the relevant laws, regulations, and audit guides, including practice notes issued by the HKICPA. Mapping the compliance work and procedures undertaken with the requirements of relevant practice notes (e.g., PN820 (Revised) for audits of SFC licensed corporations) would ensure the completeness of compliance work by practice units.

Section 4
Results from our inspections of systems of quality control

4.1 Introduction

4.1.1 An effective SQC supports the maintenance of high-quality audits. It is therefore important for firms to establish strong quality control not only at the engagement level but also at the firm-wide level. We inspect a firm's SQC to determine if it meets the requirements of Hong Kong Standard on Quality Control 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or other Assurance or Related Services Engagements* (**HKSQC 1**) and other relevant standards.

The results of the 2020-22 Cycle show that firms with adequate quality control policies and procedures in place were directly correlated with the audit quality in their engagement inspections.

4.1.2 In 2022, we focused on the SQC policies and procedures regarding acceptance and continuance and engagement performance for all Category A firms (**Thematic Review**) while we inspected all six elements of the SQCs of Category B and C firms that were inspected for the first time in 2022 (**Full Review**).

4.1.3 The SQCs are more effectively implemented in four of the Category A firms than in the other two Category A firms. There is also an opportunity for firms from other categories to learn from understanding the good practices we have observed in the better governed SQCs. In contrast, we found significant deficiencies in relation to the engagement performance element of the SQCs of the two Category A firms with audit quality ratings that have shown no substantial improvement during the 2020-22 Cycle. We have summarised our key findings and also good practices of some Category A firms' SQCs in Section 4.2.

4.1.4 In 2022, we inspected 14 Category B and C firms' SQCs (2021: 11 and 2020: 12). Our inspection results showed that the common areas requiring improvement identified across these firms are broadly consistent with those disclosed in our 2020 and 2021 Inspection Reports.

In 2022, we identified acceptance and continuance of client relationships and specific engagements as an area requiring immediate attention and improvement, noting that the number of Category B and C firms with deficiencies had increased substantially to 71% in 2022 from 33% in 2020.

For the first time, we also identified instances where the violation of independence rules undermined the auditor's independence and objectivity. Further details are set out in Section 4.3.

4.1.5 We are paying close attention to the risks to audit quality arising from late changes of auditors given that we have observed a negative association of Late Appointments with audit quality. We highlight our related observations and special considerations on the procedures of acceptance and continuance of client relationships and specific engagements in Section 4.4.

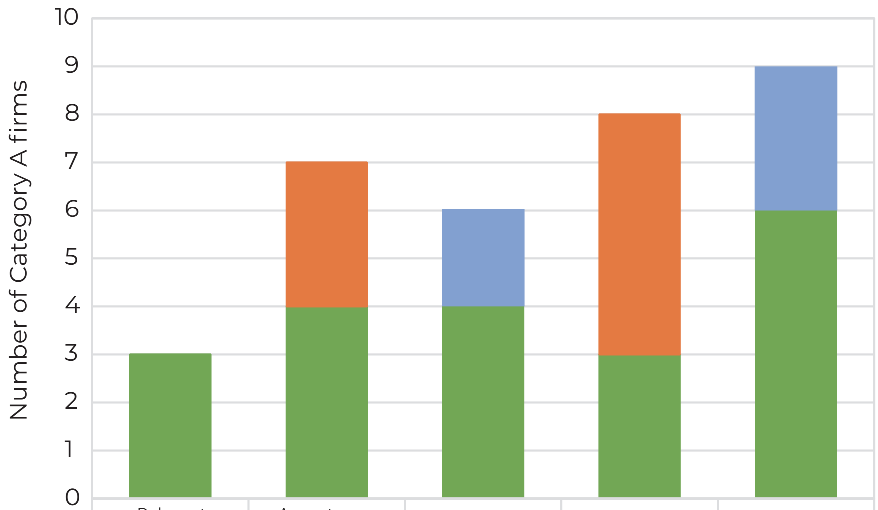
4.1.6 Practice units are reminded to take immediate action to enhance their SoQM, in order to address our concerns and to fulfil the requirements of the QMSs which have been effective since 15 December 2022.

4.2 Results of the thematic review on Category A firms

4.2.1 The table below sets out the areas that we covered during the 2020–22 Cycle:

SQC elements	2020	2021	2022
Leadership Responsibilities	✓		
Relevant Ethical Requirements	✓		
Acceptance and Continuance of Client Relationships and Specific Engagements	✓		✓
Human Resources	✓	✓	
Engagement Performance	✓		✓
Monitoring	✓	✓	

Figure 5 Comparison of the number of Category A firms that had SQC deficiencies over the 2020-22 Cycle



	Relevant ethical requirement	Acceptance and continuance	Human resources	Engagement performance	Monitoring
2022	N/A	3	N/A	5	N/A
2021	N/A	N/A	2	N/A	3
2020	3	4	4	3	6

a. Engagement performance

Deficiencies in "Engagement Performance" were identified in five of six Category A firms. In three of the Category A firms, there were areas for improvement as set out below:

i. Insufficient documentation on evaluating work of auditor's internal expert.

ii. Insufficient group audit documentation.

iii. Delay of assembly of final engagement files when comparing to the firm's internal file assembly policies.

iv. Inadequate supervision and review on the assembly of final engagement files.

v. Insufficient understanding of when audit work papers should be signed off and dated as evidence of work performed or reviewed.

vi. Inappropriate timing of charging hours in timesheet records.

In the other two Category A firms, we identified deficiencies relating to the firms' work to address KAM and significant risk areas in most or even all engagements selected under the 2022 inspection. The engagement partners and EQRs did not conduct a quality review to ensure that sufficient and appropriate audit evidence was obtained to support the audit opinion on each set of the financial statements inspected, in accordance with paragraphs 17 and 20 of HKSA 220 *Quality Control for an Audit of Financial Statements*.

The deficiencies above revealed that the policies and procedures relating to the review responsibilities of the engagement partners and EQRs were not implemented effectively. This is unacceptable and we have urged these two firms to take robust and immediate action, including but not limited to:

i. Understanding the root causes of the deficiencies;

ii. Developing an appropriate plan of action to remediate the deficiencies; and

iii. Taking appropriate follow-up action on the recurring deficiencies.

b. Acceptance and continuance of client relationships and specific engagements

Deficiencies were identified in three of six Category A firms. In two of the Category A firms, the identified deficiencies were not significant in nature but there were areas for improvement as below:

i. Late approval from the firm's leadership before acceptance of a new client relationship.

ii. Insufficient approval from the firm's leadership for a special instance where an audit client was re-accepted 6 months after the firm's resignation as an auditor of that client.

We identified significant deficiencies in one Category A firm that did not require its engagement teams to critically assess whether it is competence and possesses the necessary capabilities, including time and resources, commensurate with the size, nature and complexity of the business operations of a new or an existing client when considering acceptance or continuance of a PIE client relationship and a specific PIE engagement.

4.2.2 Despite the deficiencies identified above, we have seen good practices in the 2022 inspection. We share these good practices with interested parties, including auditors, such that they can consider these when performing audits. Examples of good practices include:

Good practices observed in 2022 inspection

a. Using information technology systems in the assignment of engagement teams to achieve a better human resource allocation amongst audit engagements which require different skillsets and knowledge.

b. Implementing an "audit quality milestones programme" to mandate the completion of certain activities by specified dates to facilitate engagement teams to identify and respond to key issues in the early stage of the audit and avoid last-minute surprises during the audit peak season.

c. Implementing additional monitoring controls to address the escalated financial risks of specific business sectors, e.g., the mainland China property development sector, by re-assessing the risk profile of the audit clients by reviewing and analysing the audit clients' latest financial and liquidity positions.

d. Decreasing the archive date of the assembled audit file for PIE engagements to 14 days to better safeguard the integrity of the audit documentation as well as promote more timely preparation and review of audit documentation.

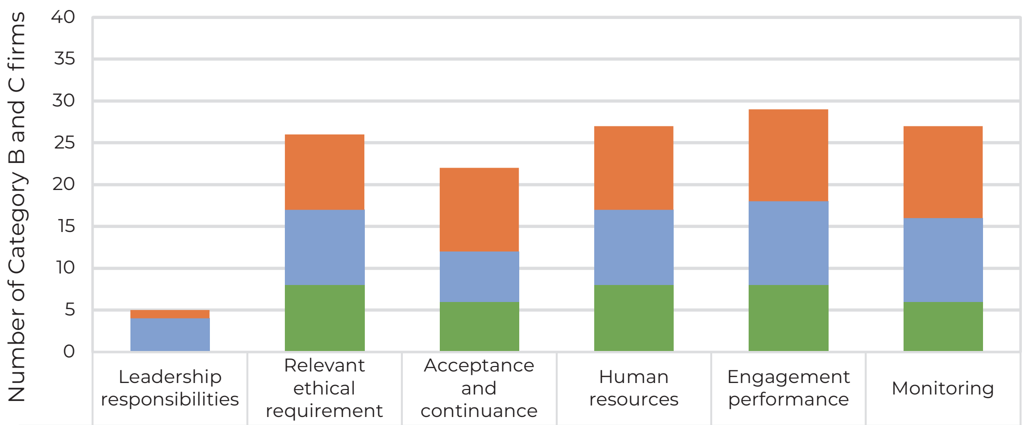
e. Setting the right tone from the top by involving top management, SQC responsible person(s), and engagement partners throughout the inspection processes.

4.3 Results of the full review on Category B and C firms

Overview

In 2022 inspections, we carried out full reviews of all the policies and procedures of the SQC on 14 (2021: 11 and 2020: 12) Category B and C firms. In respect of the re-inspected five Category B firms and one Category C firm, we inspected the changes in their firm-wide policies and procedures since their first inspections.

Figure 6. Comparison of the number of Category B and C firms that had SQC deficiencies over the 2020-22 Cycle



	Leadership responsibilities	Relevant ethical requirement	Acceptance and continuance	Human resources	Engagement performance	Monitoring
2022	1	9	10	10	11	11
2021	4	9	6	9	10	10
2020	0	8	6	8	8	6

The following table summarises the common deficiencies identified during the 2020–22 Cycle. As the **Category B and C firms subject to our inspections were not the same for each year,** the statistics below are **not directly comparable over the years.**

Common deficiencies of Quality Control Findings (QCF)

	Key areas of deficiencies by six elements of HKSQC 1	Number of firms under full review to which deficiencies related to			
		2020	2021	2022	Overall
	Total number of Category B and C firms inspected	12	11	14	**37**
QCF1	**Relevant ethical requirements**				
a.	Lack of effective controls over personal confirmations of independence	7 (58%)	8 (73%)	5 (36%)	**20 (54%)**
b.	Lack of effective controls over maintenance of "family trees" of audit clients	0 (0%)	5 (45%)	7 (50%)	**12 (32%)**
c.	Lack of robust independence assessment concerning the provision of non-assurance services to audit clients	6 (50%)	5 (45%)	6 (43%)	**17 (46%)**
QCF2	**Acceptance and continuance of client relationships and specific engagements**				
a.	Insufficient quality control procedures over client and engagement acceptance and continuance	4 (33%)	6 (55%)	10 (71%)	**20 (54%)**
QCF3	**Human resources**				
a.	Insufficient internal trainings and/or insufficient monitoring of external trainings attended by professional staff	5 (42%)	8 (73%)	9 (64%)	**22 (59%)**
b.	Insufficient consideration of audit quality as part of the performance evaluation of audit partners and staff, partner admission and staff promotion	8 (67%)	6 (55%)	8 (57%)	**22 (59%)**
QCF4	**Engagement performance**				
a.	No or insufficient control to avoid unauthorised alteration or loss of archived hardcopy engagement documentation	3 (25%)	7 (64%)	10 (71%)	**20 (54%)**
b.	Ineffective reviews by engagement partners or EQRs	6 (50%)	5 (45%)	5 (36%)	**16 (43%)**
QCF5	**Monitoring**				
a.	Discrepancies between the internal and external inspection results	2 (17%)	7 (64%)	7 (50%)	**16 (43%)**
b.	Evaluation and remediation of identified deficiencies: no (or superficial) RCA and/or remediation plan	3 (25%)	8 (73%)	5 (36%)	**16 (43%)**

QCF1 — Relevant ethical requirements

a. Lack of effective controls over personal confirmations of independence

i. Firms did not maintain a complete list of entities related to their listed entity audit clients to ensure that their professional staff complied with the applicable independence requirements.

ii. Firms did not establish monitoring procedures to verify the accuracy and completeness of the information contained in the personal confirmations of independence.

Our expectations
✓ Strengthen policies and procedures regarding the accuracy and completeness of the register for listed entity audit clients and related entities.
✓ Monitor the independence compliance of professional staff and immediate and close family members by measures such as periodic random checking.
✓ Establish monitoring procedures to verify the accuracy and completeness of the information contained in the compliance confirmations to ensure that their professional staff complied with all the relevant ethical requirements.

b. Lack of effective controls over maintenance of "family trees" of audit clients

i. Firms did not establish policies and procedures to identify all the related entities of PIE audit clients, over which the PIE audit clients had direct or indirect control, for evaluating the independence of the firms from the PIE audit clients.

ii. Firms did not implement effective controls to ensure the information in the "family trees" for each PIE audit client is complete.

iii. Given the above, threats to independence were created as the professional staff of the firms did not have complete information for evaluating their independence from the PIE audit clients.

Our expectations
✓ Conduct a robust review of their policies and procedures to ensure that they maintain complete "family trees" of their audit clients and comply with the relevant requirements of the Code of Ethics for Professional Accountants (**CoE**).

c. Lack of robust independence assessment in relation to the provision of non-assurance services to audit clients

i. Firms did not establish policies and procedures to require the engagement teams to determine whether non-assurance services provided by them and/or their network firms to an audit client might threaten independence before providing such services.

ii. Firms' independence assessment did not provide sufficient details to support how the threats to independence were assessed and whether relevant safeguards were applied in accordance with the CoE.

Our expectations
✓ Evaluate the appropriateness of (i) providing non-assurance services to their audit clients and (ii) the proposed safeguards, if any, to address threats to independence.

d. Emerging issues in auditor independence identified in the 2022 inspection

For the first time during the 2020-22 Cycle, we identified instances where the auditors violated the auditor independence rules under the CoE. In 2022, we identified the following three circumstances which impaired auditor's independence.

i. A network firm of a PIE auditor provided internal control review services to certain material subsidiaries of a listed entity, resulting in a self-interest and self-review threat.

ii. A group engagement team prepared the financial statements of a material subsidiary of a listed entity, which created a self-review threat.

iii. An audit firm failed to identify the self-interest or intimidation threat because the audit fee from a PIE audit client had exceeded 15% of the total fees received by the PIE auditor for more than two consecutive years. As such, the audit firm did not disclose such fee dependence to the Audit Committee of the PIE audit client nor did it evaluate what safeguards should be in place to reduce such a threat.

We urge all practice units to comply with the CoE to identify threats to independence, evaluate the threats identified and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level to ensure that there is no breach of independence requirements.

QCF3 — Human resources

a. Insufficient internal training and/or insufficient monitoring of external training attended by professional staff

i. Firms did not establish policies and procedures to identify the training needs of each grade of professional staff nor require them to attend training in relation to professional auditing and accounting standards updates.

ii. Firms did not have policies and procedures to ensure that their professional staff developed and maintained their professional competence by providing sufficient internal training or relevant external training from professional bodies or training institutes, in order to comply with relevant requirements as set out in Statement 1.500 *Continuing Professional Development*.

Our expectations	
✓	Understand the training needs of different levels of professional staff and provide adequate and continuous training for them.
✓	Monitor and assist professional staff to attain and maintain the necessary competence and capabilities in conducting audits.

b. Insufficient consideration of audit quality as part of the performance evaluation of audit partners and staff, partner admission and staff promotion

i. There was insufficient consideration of audit quality as part of the performance evaluation of audit partners and staff, partner admission and staff promotion.

ii. Firms did not reward high-quality work nor penalise low-quality work, in order to promote audit quality in their work culture.

Our expectations	
✓	Incorporate audit quality as part of the performance evaluation for audit partners and staff, partner admission and promotion processes.

QCF4 — Engagement performance

a. No or insufficient control to avoid unauthorised alteration or loss of archived hardcopy engagement documentation

Firms did not have sufficient controls in place to avoid unauthorised alteration or loss of audit documentation after they are archived. Integrity of audit engagement files could not be assured as the access to archived audit files was not appropriately restricted and there was a lack of monitoring by the firms over such access.

Our expectations	
✓	Establish policies and procedures to maintain integrity and manage accessibility and retrievability of archived hardcopy engagement documentation.
✓	Restrict system access to prevent unauthorised modification to audit engagement files after the date of the auditor's report and date of file assembly.

b. Ineffective reviews by engagement partners or engagement quality reviewers

Most of the engagements we inspected for the Category B and C firms were assessed as 3 or 4. This indicated that the engagement partners and the EQRs did not conduct an effective review to safeguard the quality of the audits.

Our expectations	
✓	Both engagement partners and EQRs should devote sufficient time and resources to carry out effective quality reviews from the planning stage to the completion and reporting stage of an audit.

QCF5 — Monitoring

a. Discrepancies between internal and external inspection results

Firms' internal monitoring programmes did not identify the deficiencies identified by us in relation to the audit firm's implementation of quality control policies and procedures and/or audit engagements.

Our expectations	
✓	Establish comprehensive monitoring programmes and checklists to enhance the effectiveness of the monitoring process.
✓	Sufficient guidance and training should be provided to the personnel of the internal monitoring programmes to ensure they are competent to carry out an effective monitoring.

b. Evaluation and remediation of identified deficiencies

Firms did not establish policies and procedures to (i) evaluate the effect of deficiencies identified from their internal monitoring process nor (ii) develop a remediation plan to address those deficiencies. As such, the firms did not (i) identify the underlying causes of audit quality deficiencies effectively and promptly; nor (ii) determine the correct actions to prevent the deficiencies from recurring in the future.

Our expectations
✓ Perform a robust RCA review to identify the underlying causes of audit quality deficiencies and formulate a plan of action to remediate those deficiencies effectively by designating a remediation coach with appropriate knowledge and experience. Further details on our RCA reviews are set out in Section 5.2.

4.4 Special considerations on acceptance and continuance procedures (QCF2)

PIE auditors must recognise that they act in the public interest, and they should only accept client relationships and/or engagements when they have the appropriate competence and capabilities to carry out a quality audit. Firms should ensure that the assessment for client and engagement acceptance and continuance process is robust and continuous.

Consideration of late appointment of auditors

In our *open letter issued on 27 October 2022* (***2022 Open Letter***) and our *follow-up open letter on 11 January 2023* (***2023 Open Letter***), we expressed concerns about the issues regarding late changes in auditor appointments or resignations.

We observed that there had been an improvement in the quality of disclosures in the listed entities' announcements (such as having more details about the facts and circumstances leading to an auditor's resignation) since we expressed our concerns in the open letters.

However, we still remain concerned about the consequences arising from late changes of auditors given that we observed that audit quality was generally lower when an auditor was appointed late, i.e., 13 of 15 (or 87%) initial audit engagements with Late Appointments, were rated as 3 or 4.

We identified the following major deficiencies in the firms' client acceptance and continuance procedures during our inspections, including the specific scope inspection on a Category B firm as mentioned in Section 2.2.24.

a. Insufficient assessment of the professional competence to deliver a quality audit

In respect of the Category B firm that was subject to the specific scope inspection, we observed that 90% of its new client appointments with a 2021 December year-end were led by engagement partners with track records of poor-quality ratings in our inspections or subject to reprimands issued by the HKICPA in the past years.

When assigning engagement partners and EQRs to these engagements, particularly those relating to late changes of auditors, the firm could not demonstrate that it had assessed:

i. Whether they have the necessary competence and capability to carry out a quality audit; and

ii. Whether additional engagement quality review procedures were required.

b. Insufficient understanding of the significant unresolved matters identified by the outgoing auditors

We identified that certain Category B and C firms, including the Category B firm that was subject to our specific scope inspection, did not obtain a sufficient understanding of the nature and significance of the unresolved matters raised by the outgoing auditors nor critically assess whether those matters might indicate the existence of management integrity issues before accepting the appointment as the auditor of a new client.

c. Insufficient resources to plan and conduct a proper audit

We identified a number of instances where listed entities and their outgoing auditors failed to agree a timeline or process to resolve outstanding audit issues. Subsequently, incoming auditors were appointed within a short period and were able to issue audit opinions on the financial statements of these listed entities within a few months of their appointment.

In respect of the Category B firm that was subject to the specific scope inspection, we observed:

i. There was no information about how the budgeted hours for each engagement team was determined with reference to the planned scope of audit; and

ii. There was no evaluation about the overall workload of each engagement team member (including the audit directors) given that the time budgets only provided information about the incremental workload of each engagement team member when the firm accepted the new engagements.

In light of the above issues, we highlighted the following actions which should be immediately taken by the incoming auditors.

a. Robust assessment of the firm's competence and capabilities, including time and resources, to perform a quality audit

i. Accept or continue client relationships and engagements only when the engagement teams and component auditors are competent and possess the necessary capabilities to perform the audits, including sufficient industry knowledge and experience, time and resources.

ii. Regularly review the firms' client and engagement portfolio by considering the industry, nature and risk of their clients and engagements, and critically evaluate the competence, capabilities and capacity of their audit partners and staff in continuing to serve them.

iii. Decline to accept or withdraw from the client relationship and engagement if they do not have the necessary expertise and resources to handle and address the risks from the significant unresolved matters of the listed entities.

iv. Perform sufficient procedures to identify and consider the events or circumstances that cast doubt on the integrity of the owners, board members or management of a prospective client.

b. Thorough understanding of the nature and significance of the unresolved audit matters identified by the outgoing auditor and an evaluation of the corresponding audit implications before accepting an appointment

i. Take all reasonable steps to identify relevant facts and circumstances before making acceptance decisions. In particular, obtain an understanding of those matters that gave rise to the resignation by the outgoing auditor or the modified report issued on the prior year financial statements; and sufficiently assess whether those matters raise concern over management's integrity or creates a limitation on the scope of work.

ii. When there are unresolved audit matters, perform additional procedures such as reviewing correspondence between the outgoing auditors and management/audit committees of the listed entities; and the correspondence between the PIE and the regulators; and corroborate responses from the listed entities through specific enquiries with the outgoing auditors, and request access to audit working papers of the outgoing auditors.

c. Maintaining professional skepticism

Maintain a “questioning mind” when performing client and engagement acceptance procedures, especially when the resignations are said to have been triggered by a disagreement over audit fees, corporate governance considerations, or when the resignation was requested by the listed entity.

On the other hand, we also expect the following actions to be taken by the outgoing auditors:

a. Auditors should proactively discuss with audit committees any disagreements with management encountered during the audits and seek their assistance in resolving any such matters with management.

b. Auditors should always endeavour to complete the audit rather than attempt to avoid the responsibility of adversely reporting on the financial statements by resigning.

c. In the event that auditors decide not to continue with the engagement, outgoing auditors should set out in the letter of resignation the precise circumstances leading to the resignation, including the nature and significance of all disagreements with management and unresolved audit issues, as well as the results of the communication with audit committees.

d. Auditors should always maintain an open dialogue with incoming auditors on the unresolved audit matters and any unusual circumstances leading to their resignation, by considering making the relevant audit work papers and correspondence available to the incoming auditors, in addition to referring to a letter of professional clearance.

4.5 Other observations during inspection process

Cooperation during the inspection process is of vital importance as it maximizes the effectiveness and efficiency of our inspection work, which in turn enhances audit quality. Generally, firms were cooperative with our inspectors during the inspection process. We identified good practices among Category A firms:

a. Involvement of top management personnel and SQC responsible person(s) throughout the meetings with our inspectors to ensure the inspections were conducted efficiently and effectively.

b. Responsive to providing access to, and the ability to copy, any record or information in the possession, custody, or control of such firm or person, and to provide information by oral interviews, written responses, or otherwise, within our set timeframe.

c. Acknowledgment and commitment of top management personnel to make continuous improvements on their SQCs, policies and processes to respond to our findings in our exit meetings.

Audit firms' leadership must set the right tone at the top through their consistent action and communications to demonstrate their commitment to audit quality. However, we encountered instances among certain practice units that hindered the inspection process as below.

a. Engagement teams did not include all relevant work papers in the final set of audit documentation that was required to be assembled. Engagement teams are required to complete the file assembly not more than 60 days after the date of the auditor's report as required by HKSA 230 *Audit Documentation.*

b. Engagement partners and/or EQRs did not attend the meetings to address the significant matters/queries raised by inspectors and were unable to demonstrate they had carried out a proper review of the engagements and had sufficient knowledge of the engagements.

c. Engagement partners failed to provide documents and/or explanations when responding to our information requests and queries during inspection process.

d. Firms requested extensions of time to respond to our written queries or inspection reports without any reasonable cause.

e. Firms' uncooperative behaviors, such as not providing or delay in providing relevant documents, providing incomplete or inaccurate information to our inspectors.

The powers of an inspector are set out in Sections 20ZZC and 21C of the AFRCO. We expect all practice units and every associated person of the practice units to cooperate fully with our inspectors in the performance of our inspections.

Section 5
Updates from previous inspections

5.1 Review of remediation plans and our follow-up actions

5.1.1 Upon completion of our inspections, practice units are required to submit their plans to remediate the findings identified from our inspections of the SQC and selected engagements (**Remediation Plans**).

5.1.2 After our inspections, we will evaluate the Remediation Plans submitted by the firms, and may decide to take any follow-up action pursuant to Sections 21H and 20ZZE of the AFRCO, as set out in Section 1.5 of Annex 1 to this report.

Review of 2020–2021 Remediation Plans

5.1.3 We reviewed the Remediation Plans submitted by all 17 PIE auditors (2020: 18 PIE auditors) inspected in 2021 and provided feedback on their Remediation Plans. Through our reviews of their Remediation Plans, they were able to learn how to strengthen their policies and procedures at the firm level to improve audit quality.

Effectiveness of Remediation Plans

5.1.4 Most firms were responsive and proactive in improving their audit quality by rectifying the deficiencies identified in our inspections. The corrective actions included but were not limited to the following:

a. Enhancing independence quality controls and safeguards to address the potential threats to independence.

b. Delivering additional audit alerts and reminders regarding the importance of effective supervision and review as well as professional skepticism.

c. Designing and enhancing guidance and templates to address the findings we identified.

d. Providing relevant training by incorporating our inspection findings into their training programmes.

Failure to formulate appropriate Remediation Plans

5.1.5 Amongst the 17 firms who submitted Remediation Plans in response to our inspection findings of 2021, requirement letters (**Requirement Letter**) were issued to four of them due to the following:

a. Failure to undertake appropriate remedial action to address the deficiencies identified; and/or

b. Insufficient information submitted to assess the appropriateness of the design of the planned remediation action; and/or

c. Failure to demonstrate their capabilities to execute their Remediation Plans.

5.1.6 The purpose of the Requirement Letter is to require the practice units to take specific action in their proposed Remediation Plans or other specific action determined by us. Practice units are required to provide a monitoring report to us every three months with supporting documents demonstrating the implementation progress of those actions specified in the Requirement Letter until they are completed.

Failure to implement Remediation Plans effectively

5.1.7 Based on our assessment, it is disappointing to note that those firms without substantial improvement in the 2020–22 Cycle had not effectively implemented robust action at the firm level according to the Remediation Plans, thus resulted in recurring issues and unsatisfactory inspection results.

Recurring issues not fully addressed	
a.	Audit procedures were not performed according to the audit working paper templates that were modified to address our findings.
b.	Ineffective workload monitoring on the basis that the number of qualified staff available for the number of PIE engagements remained low.
c.	Insufficient monitoring of audit partner rotation of significant subsidiaries of PIE audit clients.
d.	Ineffective monitoring process on the basis that significant findings were identified in our inspections of engagements rated as “compliant” in the firm’s internal monitoring programmes.
e.	Incomplete “family trees” of its PIE audit clients including their unlisted related entities, such as associates, joint ventures, non-controlling shareholders, etc.

Follow-up actions against firms which did not effectively implement Remediation Plans

5.1.8 We emphasise the importance of performing real-time reviews on the remediation plans to ensure that they can address the identified deficiencies, and assigning a designated person to confirm that the remedial actions are effectively implemented. Practice units must respond with actions to prevent deficiencies from recurring in future audits.

5.1.9 We will increase the frequency of inspection of those firms which did not effectively implement their remediation actions to address the deficiencies identified in our previous inspections. If the firms failed to comply with the requirements imposed under section 21H(b) of the AFRCO, we may refer the matter for disciplinary consideration.

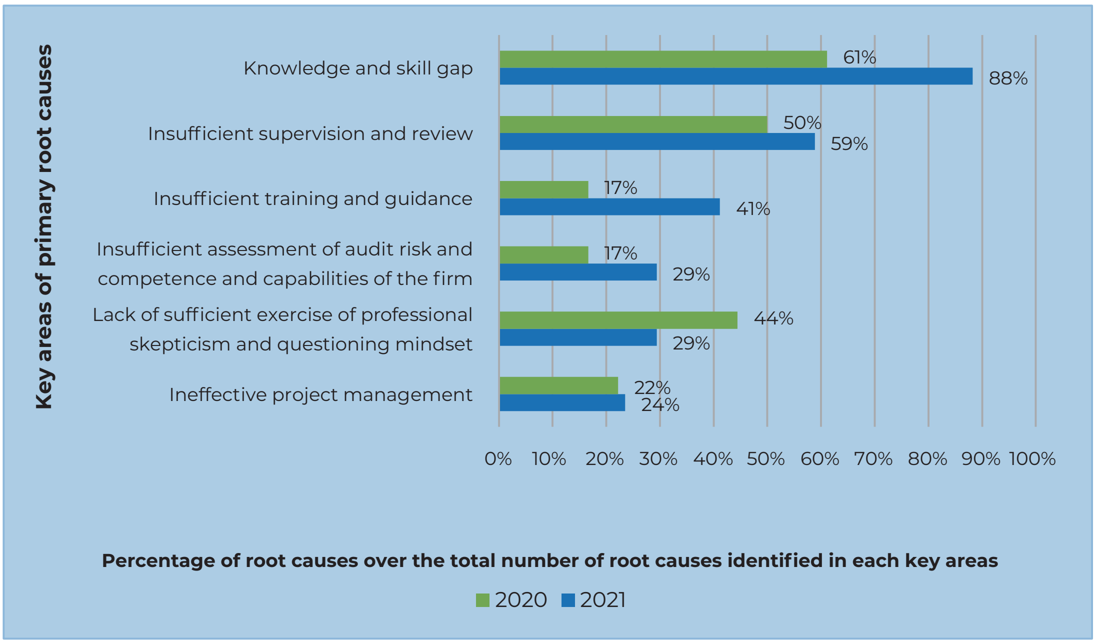
5.2 Root cause analysis

Root causes identified by the firms

5.2.1 While we are still in the process of reviewing the Remediation Plans for the 2022 inspections, the common root causes identified by the firms are broadly consistent with those of 2021 and 2020 (**Figure 7**).

Knowledge and skill gaps of audit staff and/or partners have been identified as the most common root cause.

Figure 7. Primary root causes identified by the firms in 2021 and 2020



Common deficiencies identified in poorly performed root cause analysis

5.2.2 From our review of poorly performed RCAs, we identified that firms:

a. May not have properly identified the underlying root causes for their significant deficiencies.

For example, insufficient documentation was identified as a root cause simply based on the engagement team's oral representation. However, the firms did not consider the reasons why insufficient documentation occurred, which may be due to insufficient supervision and review, insufficient knowledge and skills of individuals, and the level of professional skepticism exercised by the engagement teams.

b. Did not tailor or design specific measures or corrective actions to address the identified deficiencies.

For example, providing training was proposed as the only remedial action to address all the deficiencies identified without considering other possible causes, such as insufficient time to plan and conduct the audit or lack of competence and capable resources.

c. Did not propose appropriate remedial action for the deficiencies identified.

For example, a resources issue was identified as a root cause without proposing specific and appropriate action to resolve it. Possible actions to address the resources issue include revisiting the client and engagement portfolio at the firm level and monitoring the staff-to-engagement ratio.

Good practices observed for an effective root cause analysis

5.2.3 A comprehensive and effective RCA should be specifically tailored to meet the nature and circumstances of the firm including a thorough understanding of the structure of the firm, nature and industry of the firm's audit clients, and relevant requirements of laws and regulations governing the firms.

5.2.4 Practice units should adopt the good practices we observed from our review of the Remediation Plans to enhance their RCAs and remediation processes, which will be part of the monitoring process under the QMSs.

Good practices observed	
a.	Adopting the ***External Auditor's Guide to Performing Root Cause Analysis*** issued by AFRC in performing the RCA.
b.	Providing guidance and training to those who conduct RCA.
c.	Assigning a designated person with an appropriate level of authority and experience to provide coaching to the engagement team that will formulate the Remediation Plans and perform RCA independently.
d.	Involving all relevant engagement team members, including internal specialists and EQRs, in the process of identifying the root cause(s) of identified deficiencies and determining remedial action.
e.	Considering a wide range of remedial actions to address the identified deficiencies, including but not limited to establishing guidance on better project management and reassessing the resource and workload allocation.
f.	Communicating the results of RCA, including good practices observed from engagement teams who delivered good quality audits, to all audit partners and staff.
g.	Implementing remedial actions to address the root causes identified before the commencement of the next audit cycle so that necessary actions were taken in time to prevent the deficiencies from reoccurring.

Section 6
Looking ahead

6.1 Introduction

6.1.1 Based on our experience and findings in the 2020–22 Cycle, we will continue enhancing our inspection approach in the second inspection cycle (**2023–25 Cycle**) and to expand our potential areas of inspection focus in 2023.

6.1.2 We set out below our actions and measures to uphold the quality of audit engagements performed by the practice units, our expectations of what constitutes a quality audit, and hence our expectations of the respective duty of auditors, company directors and their audit committees.

6.2 Inspection approach for 2023–25 Cycle

6.2.1 There are a total number of 1,957 registered practice units and 5,152 holders of practising certificates as of 30 June 2023. We continue to take a proportionate and risk-based approach to regulate the practice units, and further refine our regulatory approach in response to the changing environment and market behaviour surrounding the accounting and auditing industry.

PIE engagements

6.2.2 In order to uphold audit quality to protect public interest, we continue to take proactive measures and actions (Section 6.3) in response to the situations where (a) there are an increasing number of late changes of PIE auditors due to unresolved audit matters, (b) practice units act as the principal auditors but significant parts of the Hong Kong listed entity audit are performed by other auditors located in jurisdictions outside Hong Kong, and (c) practice units with significant quality deficiencies with no substantial improvement in audit quality ratings over the 2020–2022 Cycle.

International Ethics Standards Board for Accountants (IESBA) definition on PIE and its implications

6.2.3 The IESBA has revised its definition of PIE, which will be effective for audits of financial statements for periods beginning on or after 15 December 2024. The revision aims to protect public interest by specifying a broader list of categories of entities as PIEs to reflect the significance of their financial well-being on stakeholders. The HKICPA also has an initiative to support the IESBA's overarching objective to refine the definition of PIE.

6.2.4 Our inspection programme continues to be risk-based using the proportionality approach and focused primarily on the practice units performing audits in the public interest. We expect to increase our inspection proportionately to cope with a widening group of PIE audits in order to protect the public interest.

Non-PIE engagements

6.2.5 In the 2023–25 Cycle, we will inspect non-PIE engagements performed by Category A firms annually, Category B and C firms and other large practice units at least once in every three-year inspection cycle while other smaller practice units are to be selected for inspection through both a risk-based and random approach.

6.2.6 In 2023-24, we will conduct the remaining 10 follow-up inspections on cases referred to the AFRC by the HKICPA under the transitional arrangements.

6.2.7 In order to discharge our regulatory duties, we plan to engage with non-PIE practice units in August 2023 and ensure that they understand our inspection regime, inspection approach and process.

6.2.8 We will also launch an inspection questionnaire in July 2023 to collect up-to-date information from practice units to facilitate the determination of inspection priority and frequency for non-PIE practice units and also for anti-money laundering (**AML**) and counter-terrorist financing (**CTF**) compliance monitoring inspections (**ACMI**).

Anti-money laundering and counter-terrorist financing compliance monitoring inspections

6.2.9 ACMI will be covered in the 2023 inspection of all practice units. The purpose of ACMI is to ascertain whether the practice units have observed, maintained or applied the Guidelines on AML and CTF for professional accountants as set out in Chapter F of the Code of Ethics (Professional Accountants) issued by HKICPA (**AML Guidelines**). A risk-based approach will be adopted, such that practice units having a large client portfolio and/or providing specified services set out in paragraphs 600.2.1 and 600.2.2 of the AML Guidelines will be selected and subject to more comprehensive reviews.

6.2.10 To comply with the requirements of the AML Guidelines, practice units are expected to have adequate policies, procedures and controls in place in order to minimise any risk of involvement in money-laundering or terrorist financing.

Areas of inspection focus in 2023

6.2.11 The inspection focus in 2023 will relate primarily to the significant deficiencies we identified from our inspection findings in the 2020–2022 Cycle (Sections 3 and 4), and to how practice units address audit risks arising from the changes in economic and market conditions and revised standards and guidelines, which include:

a. Risk assessment process of the newly implemented SoQM;

b. AML/CTF compliance; and

c. Enhanced procedures for identifying and assessing the risk of material misstatement as required by HKSA 315 (Revised 2019) (2022) *Identifying and Assessing the Risks of Material Misstatement*.

Our Powers

6.2.12 Under Sections 37CA, 37D and 37E of the AFRCO respectively, we may take disciplinary action against professional persons who have committed CPA misconduct or PIE auditors and registered responsible persons of a registered PIE auditor who have committed misconduct under Section 37AA, 37A and 37B of the AFRCO, respectively.

The AFRC may impose sanctions including a public/private reprimand, suspension or revocation of registration, removal of name from the list of registered responsible persons permanently or for a period of time, cancellation/non-issuance of a practising certificate and/or payment of a pecuniary penalty provided under the AFRCO.

6.3 Our measures and actions to uphold the audit quality in the 2023–25 Cycle

Monitoring practice units with late changes in appointments or resignations

6.3.1 Late changes in auditors' appointments or resignations will remain as one of our main focuses given our general concerns on its impact to audit quality.

6.3.2 We will continue to monitor changes in auditors closely and will not hesitate to take proactive and appropriate follow-up action, such as:

a. Enquiring of outgoing auditors about their reasons for late resignations and the obstacles to resolving unresolved audit matters leading to their resignations;

b. Conducting interviews with incoming auditors to ensure they understand their obligation to uphold audit quality;

c. Assessing whether incoming auditors have adequate manpower, resources, and experience to take on those late engagements and have developed robust audit plans to address any unresolved matters (see our *Guidelines for Effective Committee — Selection, Appointment, and Reappointment of Auditors* published in December 2021 and our Oct 2022 and Jan 2023 Open Letters);

d. Conducting specific scope inspections on practice units with a tendency to accept higher-risk engagements in respect of its client or engagement acceptance procedures;

e. Extending our scope of inspections to inspect the engagements related to Late Appointments; and

f. Referring potential misconduct by practice units identified in the course of our inspection function for consideration of a disciplinary sanction.

6.3.3 We will continue to collaborate with the SFC and the Stock Exchange of Hong Kong to monitor any potential malpractices in market.

Cross-border regulatory collaboration

6.3.4 We have observed that some PIE auditors in Hong Kong engage mainland China auditors to conduct a substantial part of the audits of the Hong Kong listed entities for which the PIE auditor is the appointed auditor. We have identified risks to audit quality arising from such arrangements. Such risks include the risk that the subcontractor firms do not have the competence and capabilities necessary to perform the audit work on the listed entity. AFRC will look closely at the compliance with auditing standards applicable to the work of component auditors.

6.3.5 We will continue to maintain close collaboration with the SEB through regular knowledge sharing, information exchange and cooperation on matters of mutual interest.

Monitoring practice units with significant quality issues

6.3.6 Based on the results of inspections in our 2020–22 Cycle, the inspection results of two Category A firms and most Category B and C firms show that the audit quality ratings of their engagements are unsatisfactory. In the case of the two Category A firms, there has been no substantive improvement in their audit quality ratings during the 2020–22 Cycle. Immediate and more robust action must be taken by these firms to improve the quality of their audits.

6.3.7 We have communicated our concerns about their poor audit quality results in our past inspections with the firms' leaders and have asked these firms to take robust remedial action to improve audit quality as a matter of urgency.

6.3.8 In order to monitor audit quality in the market, we will increase our frequency of inspection of practice units which had poor quality ratings without substantial improvement during the 2020–22 Cycle.

6.4 Our expectations of a good quality audit

6.4.1 Practice units should consider the following three key aspects of the audit process to perform a quality audit. The list below does not attempt to cover all areas of an audit that must be undertaken, but instead focuses on the areas where quality audits stand out.

Client acceptance and planning	
a.	Assess the firm's competence and resources before new client and engagement acceptance.
b.	Understand the impact of changes in the market and economy on the client's operations and perform robust risk assessment and audit planning.
c.	Consider the risk of fraud carefully, being alert to the possibility of unusual transactions, discuss and document the vulnerability of the entity to fraud.
d.	Identify the significant components, plan properly the group audit approach and communicate that clearly to the component auditors when performing large group audits.
e.	Independence is always the cornerstone of auditing and must not be compromised.

Execution	
a.	Direct the engagement team to perform work with sufficient supervision and monitoring by the engagement partners and EQRs.
b.	Demonstrate appropriate supervision and oversight by the group engagement teams, such as by challenging the reasonableness of key judgments made or the sufficiency and appropriateness of audit procedures performed by the component auditors.
c.	Exercise professional skepticism throughout the entire audit and incorporate an element of unpredictability in the determination of audit scoping or type of audit procedures to be performed.
d.	Involve relevant audit specialists or experts in the audit teams to ensure there is sufficient and appropriate expertise to perform procedures in response to risks.
e.	Pay attention to the key common findings set out in Section 3 and Section 4 and take further steps to enhance the practice units' policies and procedures to address those deficiencies.

Completion and reporting	
a.	Look-back and reassess the level of work performed against the audit plan and ensure that sufficient and appropriate audit evidence has been obtained in support of the conclusions and judgements drawn by the auditors.
b.	Communicate significant matters or other matters of interest to the client management and audit committees in a timely manner.

Special considerations on group audits involving the work of component auditors

6.4.2 In many cases, a business comprises several legal entities (which may be located in other jurisdictions and audited by other component auditors), whose results are consolidated into a single set of consolidated financial statements of the group.

6.4.3 Practice units should carefully consider the recently revised auditing standard for group audits, HKSA 600 (Revised 2022) *Special Considerations — Audits of Group Financial Statements (Including Work of Component Auditors) and Conforming and Consequential Amendments to Other Hong Kong Standards Arising from HKSA 600 (Revised)*, which will be effective for audits of group financial statements for periods beginning on or after 15 December 2023.

Group engagement partners should ensure that the following key matters are addressed when performing a group audit:

a. Take responsibility for the nature, timing and extent of direction and supervision of component auditors and the review of their work.

b. Take steps to understand and determine whether component auditors possess the appropriate competence and capabilities, including sufficient time and resources, to perform the required or assigned audit procedures and are able to meet the relevant applicable ethical requirements.

c. Incorporate unpredictability in selecting components, determining the type of work to be performed and the extent to which the group auditor is involved in the component auditors' work to increase the likelihood of identifying a material misstatement of the group financial statements due to fraud.

d. Communicate to the audit committees the planned responsibilities of other auditors that will perform audit procedures in the audit, and the basis for determining that the firms could serve as the principal auditors if significant parts of the audit were performed by other auditors.

6.5 Emphasis of the roles and our expectations for auditors, directors of listed entities and their audit committees

6.5.1 Auditors play a pivotal role in safeguarding the public interest by performing quality audits. While directors have a primary role in understanding and approving key areas of judgement and estimation applied in preparing the financial statements, audit committees also play a crucial role in safeguarding the quality of the financial statements and the audit of the financial statements. As highlighted in Section 4.3 of our *2022 Interim Inspection Report*, our expectations for auditors, directors and audit committees also include the below.

Our expectations for auditors

6.5.2 Culture is key to success in achieving and maintaining audit quality and should continue to be an area of focus by the leadership and engagement partners of the practice units. Audit quality, professional skepticism, professionalism, integrity and ethics all contribute to a firm's reputation and public confidence in the financial reporting system of Hong Kong.

6.5.3 Firm leadership, partners, managers, and staff all have important roles in contributing to a culture focused on audit quality. Key considerations included:

a. Give strong messages to partners and staff that audit quality is always the top priority of the firms and must not be compromised. Firms should continuously issue audit alerts and reminders on audit quality.

b. Be accountable for quality audits, and always endeavour to complete the audit rather than attempt to avoid the responsibility of adversely reporting on the financial statements by resigning.

c. Assign appropriate engagement partners and staff with the relevant experience and expertise for higher risk or more complex audits by setting qualification requirements when assigning work.

d. Provide genuine support when engagement partners and staff identify unusual or abnormal transactions in their audits by involving risk management leaders and top management personnel on contentious issues.

e. Communicate with regulators when there are any issues in relation to i) malpractice of top management or engagement partners and staff and ii) potential fraud and non-compliance with laws and regulations of their audit clients by submitting a whistleblowing report to the AFRC.

Our expectations for directors of listed entities and their audit committees

6.5.4 Company directors, audit committees and management all have roles in supporting quality audits. Among other matters, directors and audit committees should:

a. Ensure that financial information is prepared with quality and all relevant information provided to auditors is accurate, complete, and readily available for audit on a timely basis.

   Directors and audit committees should assess whether the finance department of their company has a suitably qualified chief finance officer/director and others in the key roles of financial reporting.

b. Evaluate the competence and capabilities of their auditors by inquiring whether audits of their company have been subject to our inspections, discussing the deficiencies identified in our inspections and challenging how they have properly addressed these matters in the coming audit.

   We strongly encourage the directors and audit committees to request a copy of the engagement inspection report of their company and evaluate the audit quality of their auditors.

c. Maintain two-way communications with the auditors on any key audit risk areas (including complex accounting treatments, significant accounting estimates or judgements, complex business transactions near to the financial year ends, and/or significant issues arising from the business processes and internal controls).

   The audit committee should discuss any major issues that arose during the course of the audit, and ask the auditors to explain how they addressed those risks, review key accounting judgements of management and auditors, and evaluate any material corrected and uncorrected misstatements identified in the audit.

d. Assess the commitment of the auditors to audit quality and ensure that they have sufficient resources to address the deficiencies identified by the regulators, or to resolve the audit matters identified by the outgoing auditors upon resignation, if relevant.

e. Review the level of resources the auditors have devoted to the audits, including the partner involvement and the relevant experience and competence of the engagement teams, the need for the use of an auditor’s expert, the appropriate use of other component auditors in the audit and the timeframe to complete the audit as well.

f. Assess the auditor's professional skepticism applied in challenging accounting treatments and estimates made by management and ensure independence of the auditors before engaging them to perform any non-audit services.

g. Manage the process of appointing or removing an auditor and the determination of audit fees. In particular, they should ensure that the auditors are provided with sufficient information and have a reasonable timeframe in which to complete the audit, rather than attempt to avoid any modification to the opinion in the auditor's report by limiting the auditors' scope of work or requesting the auditors to resign.

Audit fees should not be the only consideration in the selection, appointment and reappointment of auditors. Directors and audit committees should consider our published guidelines, survey and research in a) *2021 Guidelines for Effective Audit Committees — Selection, Appointment and Reappointment of Auditors,* b) *2023 Survey Report on the Implementation of Guidelines for Effective Audit Committees — Selection, Appointment and Reappointment of Auditors* and c) *Audit fees paid by listed companies in Hong Kong in 2020/2021*. They should ensure that audit fees are set at a reasonable level that supports the audit work required in delivering quality audits.

Annex 1
Overview of our inspection methodology

1.1 Introduction

1.1.1 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, the consequence of inspection findings and the oversight process of our inspection work.

1.2 Our inspection methodology

Inspection of PIE Auditors with respect to PIE engagements

1.2.1 Under Part 3A of the AFRCO, we are empowered to carry out inspections in relation to PIE engagements completed by PIE auditors on or after 1 October 2019 for the purpose of ascertaining whether the PIE auditors have complied with, or likely to be able to comply with (a) a provision of the AFRCO; or (b) applicable professional standards as set out below at 1.3.4.

1.2.2 The PIE 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 Limited, except listed corporations whose listed securities do not include shares or stocks.

1.2.3 Category A firms are selected for inspection annually and Category B and C firms are selected for inspection at least once every three years. Practice units may be subject to follow-up inspections if there are any specific concerns over the quality of their audits.

Inspection of Practice Units with respect to engagements other than PIE engagements (non-PIE engagements)

1.2.4 Since 1 October 2022, our regulatory power has further expanded to cover inspections of practice units with respect to engagements other than PIE engagements. Under Part 3AA Division 2 of the AFRCO, the AFRC is empowered to carry out inspections in relation to a practice unit for the purpose of determining whether it has (a) observed, maintained or applied professional standard(s) under the Professional Accountants Ordinance and (b) complied with the AML Guidelines.

1.2.5 All practice units that undertake engagements other than PIE engagements are subject to inspections. A registered PIE auditor is also a practice unit and is therefore subject to our inspection powers under both Parts 3A and 3AA of AFRCO. However, it should be noted that the AFRC has separate powers of inspection under Part 3A of the AFRCO in relation to “PIE engagements”.

1.2.6 Category D firms are firms which have more than 20 engagements having more public interest elements and/or more than 500 non-PIE engagements. These are selected for inspection at least once every three years. Other practice units not in Categories A to D are categorized as Category E firms and they are selected for inspection in lesser frequency than Category D firms, using sampling approaches, with risk-based overlays.

Principles of an inspection

1.2.7 The objectives of an inspection are to monitor and promote audit quality. We adopt a risk-based approach for selecting firms for an inspection. Before the commencement of a three-year inspection cycle, we collect data about the firms to assist us in preparing the three-year inspection plan. The frequency of inspections will primarily be determined based on the following factors:

a. Whether the firm is a PIE auditor;

b. Size of the firm — based on the number of audit clients; and

c. Types and extent of engagements that are considered to have more public interest elements.

1.2.8 Our methodology for selecting engagements and the areas of our inspection focus in each engagement are weighted towards engagements and areas we consider having a higher risk to audit quality. The risk factors include but are not limited to the following:

a. The nature or principal activities and size of the entity;

b. The level of public interest, such as audits of listed entities with larger market capitalization, capital market transaction engagements such as initial public offerings, and entities in regulated industries;

c. Late changes in auditor appointments and/or that the auditor's report was issued shortly after the appointment;

d. Considerations related to the engagement partners or EQRs, including prior inspection results; and

e. Areas that present audit challenges and significant audit risks.

1.2.9 We also incorporate an element of unpredictability during the selection process, such as randomly selecting additional firm(s) from certain categories of practice units to ensure all firms have a chance of selection.

1.2.10 In addition, we exchange information with our INC Department and take into consideration complaints or referrals received by them and the results of their financial statements review programme in our engagement selection processes.

1.2.11 Prior to the commencement of an inspection, the firm is required to provide required documents including a full list of engagements that have been completed during the inspection period as specified in the notification letter.

1.2.12 We maintain a database of all entities listed in Hong Kong. The database is updated continuously and comprises information on the listed entity's business, 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.

1.2.13 We identify the presence of audit quality risk factors in engagements from the information we maintain and have received from the practice units. A weighting is applied to these risk factors to determine the final list of engagements to inspect.

1.2.14 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 practice units and the engagements to be inspected.

1.2.15 When we receive or identify information about potential concerns relating to the SQC of a practice unit, we may conduct a specific scope inspection on it. Findings identified during the specific scope inspection will be included in the inspection reports for that practice unit.

1.3 How we conduct our inspections

1.3.1 An inspection covers evaluation of the firm's SQC under HKSQC 1 and completed engagement(s). The upcoming inspection also covers an inspection of the practice units' compliance with the AML Guidelines.

1.3.2 An inspection of the SQC covers how the firm designs, implements, and operates its SQC in accordance with HKSQC 1. The design of the firm's SQC, in particular the complexity and formality of the system, will vary according to the nature and circumstances of the firms and the engagements performed by the firms.

1.3.3 An inspection of the SQC is carried out principally through discussions with the firm's SQC responsible person and/or any individual assigned operational responsibility for the practice unit's SQC, review of the documentation maintained by the auditor and testing the firm's compliance with relevant requirements.

1.3.4 An engagement inspection is performed to assess the firm's compliance with applicable professional standards of the engagements inspected. For PIE Engagements, professional standards refer to applicable auditing, assurance and ethical standards issued by the HKICPA and international bodies such as the International Auditing and Assurance Standards Board and IESBA or specified under the Listing Rules, or comparable standards allowed by the SFC or the Stock Exchange of Hong Kong Limited. For non-PIE engagements, professional standards refer to any statement of professional ethics, or standard of accounting, auditing or assurance practices, issued or specified under the Professional Accountants Ordinance.

1.3.5 An engagement inspection is conducted through review of the documentation maintained by the firm and discussions with the engagement team. 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.

1.4 Evaluation of engagement quality and firm-wide systems of quality control

1.4.1 A finding relating to the SQC represents a significant deficiency relating to the firm's policies and procedures in complying with or applying HKSQC 1. In addition, we also consider whether any common engagement findings identified in more than one inspected engagement, indicate systematic issues at the SQC. These are required to be addressed at a firm-wide level.

1.4.2 An observation represents a deficiency that does not amount to a finding but should be drawn to the attention of the practice unit. Observations are discussed with the firm at the final stage of inspection and are not included in the inspection report. We may also identify areas of improvement and provide insights to improve the overall SQC in our inspection report.

1.4.3 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.

1.4.4 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.

1.4.5 The SQC of a firm and non-PIE engagements inspected are not rated in the 2020–22 Cycle. However, we will be looking at the possibility of rating the SoQM in the next cycle. Individual PIE engagements which are selected for inspection are rated for audit quality based on their inspection findings. There are four ratings of audit quality that will be assigned to each individual engagement (not applicable to assurance engagements). The four ratings of audit quality applicable to PIE engagements inspected 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

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

1.4.7 The quality rating for each PIE engagement and the deficiencies identified in a firm's SQC 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 Deputy Head of Inspection as delegated by the Head of Inspection, for quality and the appropriateness of the deficiencies identified and ratings assigned to engagements.

1.4.8 During the course of our inspection, we hold frequent meetings with the engagement teams and the practice units 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.

1.4.9 At the conclusion of each inspection, we issue a draft inspection report, which sets out the findings from our SQC and engagement inspections, our audit quality ratings and key rating drivers for each PIE engagement inspected and any good practice observations, to the individual firms inspected to provide them with a reasonable opportunity to be heard in respect of the matters set out in the report.

1.4.10 When all written representations have been received or the deadline for making representations has otherwise passed, the inspector will consider any representations from the firm which have been submitted and may modify the draft inspection report in the light of such representations before finalizing it.

1.4.11 The auditor is required to perform a RCA of the deficiencies identified in our inspections and develop and execute a plan to remediate those inspection findings. 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 conclusion where needed.

We evaluate the proposed remediation plan for implementing the remedial actions within a timeframe with the auditor. We may also inspect and evaluate the additional work performed and evidence obtained by the firm to remediate significant findings on both the SQCs and engagements and test the effectiveness of these remedial actions.

1.5 Consequences of inspection

1.5.1 We may, having regard to an inspection report in relation to a practice unit or a PIE auditor, take a range of follow-up actions under Sections 20ZZE and 21H of the AFRCO, respectively, including:

a. Requiring the unit or the PIE 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 unit or the PIE 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 unit or the PIE auditor has committed a misconduct; and

e. Having regard to an inspection report in relation to a PIE engagement, taking any other follow-up action that is considered appropriate.

1.5.2 We determine appropriate follow-up actions to be taken against engagements rated as 3 or 4. Where possible misconduct as defined under the AFRCO is identified, the case may be referred for possible disciplinary action.

1.5.3 Where our inspections identify potential material misstatements in the financial statements and/or indications of fraud committed by a listed entity, or where we identify a SFC licensed corporation that breached relevant laws and regulations under the Securities and Futures Ordinance, we will also share the relevant information with the SFC for its consideration of appropriate follow-up action.

1.6 Oversight

1.6.1 Our inspection processes are subject to an appropriate level of oversight by the Inspection Committee and the Process Review Panel (**PRP**).

1.6.2 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 SQC.

1.6.3 The Inspection Committee also undertakes an ex-post review of a sample of completed inspections, the aim of which is to ensure that we maintain objectivity and consistency in its inspection process, properly use its regulatory powers, and provide recommendations on how the Inspection Department might enhance their practices and procedures.

1.6.4 The PRP for the AFRC 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 are handled consistently and in accordance with internal procedures and guidelines.

Annex 2
Glossary

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

ACMI	AML/CTF Compliance Monitoring Inspection
AFRC	Accounting and Financial Reporting Council
AFRCO	Accounting and Financial Reporting Council Ordinance
AML	Anti-money laundering
AML Guidelines	Guidelines on AML and CTF for professional accountants as set out in Chapter F of the Code of Ethics (Professional Accountants) issued by HKICPA
AAQR	Average audit quality rating
CoE	Code of Ethics for Professional Accountants
COVID-19	Coronavirus disease 2019
CTF	Counter-terrorist financing
ECL	Expected credit losses
EQRs	Engagement quality reviewers
HKFRS	Hong Kong Financial Reporting Standard
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSA	Hong Kong Standard on Auditing
HKSQC 1	Hong Kong Standard on Quality Control 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or other Assurance or Related Services Engagements*

QMSs	New and revised quality management standards, namely, Hong Kong Standard on Quality Management 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements and Conforming Amendments to HKSAs and Related Material Arising from the Quality Management Projects*, Hong Kong Standard on Quality Management 2 *Engagement Quality Reviews* and Hong Kong Standard on Auditing 220 (Revised) *Quality Management for an Audit of Financial Statements* and the equivalent international standards issued by the International Auditing and Assurance Standards Board
IESBA	International Ethics Standards Board for Accountants
INC Department	Investigation and Compliance Department
KAM	Key Audit Matters
PIE	Public interest entity
PRP	Process Review Panel
RCA	Root cause analysis
SEB	Supervision and Evaluation Bureau of the Ministry of Finance of the People's Republic of China
SFC	Securities and Futures Commission
SQC	Systems of quality control
SoQM	Systems of quality management

Contacts

If you have any enquires or comments, please feel free to contact us.

Accounting and Financial Reporting Council
10/F, Two Taikoo Place, 979 King's Road, Quarry Bay
Hong Kong

T (852) 2810 6321
F (852) 2810 6320
E general@afrc.org.hk
www.afrc.org.hk