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

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2022 Interim Inspection Report

Inspection

15 November 2022

About the AFRC

The Accounting and Financial Reporting Council 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 https://www.afrc.org.hk.

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Foreword

I am pleased to share with the public our 2022 Interim Inspection Report, which includes information on findings from inspections of public interest entity (**PIE**) engagements and systems of quality control of PIE auditors in the middle of our 2022 inspection year. The report contains a description of the most significant deficiencies in the PIE engagements and firm-wide systems of quality control that we inspected to date, key reminders for 2022 year end audits, potential areas of inspection focus in 2023 and actions we expect auditors, directors and audit committees to take ahead of the coming busy season for audit. This report also provides information on our review of the remediation plans submitted by the PIE auditors subject to our 2021 inspection and updates on our approach to regulating practice units under the further reform of the accounting profession.

2022 interim inspection results

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

To date, we have only completed a small proportion of planned PIE engagement inspections of Category A firms, and more information is needed to evaluate the overall performance of these firms in the current year's inspection. We will share the full-year inspection results of all firms subject to our 2022 Inspection in the 2022 Annual Inspection Report to be issued in the first half of 2023.

So far, the results of our current year inspections of PIE engagements completed by the Category B and C firms are disappointing. We continued to identify previously reported significant deficiencies in many of these audits. These deficiencies relate to (i) lack of adequate exercise of professional skeptisicm; (ii) insufficient evaluation of management's application of accounting standards for revenue recognition and expected credit loss; and (iii) insufficient testing of journal entries and other adjustments. It was even more disappointing to identify instances where the auditors violated the auditor independence rules under the Code of Ethics for Professional Accountants. Auditors should take robust and immediate action to address these findings ahead of the 2022 year end audits.

With respect to our inspections of the systems of quality control, the common deficiencies identified from the Category B and C firms inspected to date are consistent with those disclosed in our previous inspection reports. In the current year, we also determined client and engagement acceptance and continuance as an area requiring immediate attention and improvement. An effective system of quality control drives consistent, high-quality audits, while deficiencies in the system may impact engagement audit quality. Firms should consider our findings when establishing their new systems of quality management (**SoQM**) under the new and revised quality management standards (the **new QMSs**), which will be effective next month.

Our expectations of directors and audit committees

Directors are responsible for the preparation of financial statements that give a true and fair view of the state of affairs of an entity. They should ensure that entities have applied appropriate accounting policies that comply with the requirements of applicable accounting standards and that the information and assumptions management used in determining significant accounting judgements and estimates are relevant and reasonable. Directors should also exercise sufficient oversight over management to ensure that management provide auditors with all information and explanations that may be relevant to the audits in a timely manner and be open and receptive to challenges the auditors raise.

Audit committees are the cornerstone of the governance process and play a crucial role in safeguarding the quality of the financial statements and the audit of the financial statements. Audit committees should ensure that the entities have robust internal controls and competent resources to prepare high-quality financial information. They should also thoroughly understand the business rationale of significant unusual or highly complex transactions and how their companies have been impacted by the recent drastic economic and market changes. It is crucial for the audit committees to maintain close and effective dialogue with their auditors, and monitor and assist them, where necessary, to resolve significant matters arising from the audits with management. Of equal importance, they should also ensure that the auditors have access to the information they need. We also expect audit committees to challenge their auditors on whether and how the common deficiencies described in this and our previous inspection reports have been addressed.

Updates on 2021 inspections

All firms we inspected in 2021 performed a root causes analysis (**RCA**) of the deficiencies identified in our inspections of their audits and systems of quality control and have submitted plans to remediate those deficiencies. We highlight in this report the good practices we observed from our review of these remediation plans. We encourage all firms to adopt these good practices to enhance their RCA and remediation processes which will be mandated under the new QMSs.

Further reform

From 1 October 2022, the AFRC assumed the power to conduct inspections of all practice units. We will adopt the principle of proportionality and a risk-based approach, and progressively implement our inspections of practice units that are not PIE auditors.

We will continue to direct our inspection function in a manner that is practical and fair to our regulatees without compromising the public interest.

Janey Lai
Head of Inspection

Table of contents

Section 1
Introduction

1.1 Purpose of this report

1.1.1 The purpose of this interim report is to:

a. Provide timely disclosure of the significant findings from our inspections to date so that PIE auditors can learn from the market-wide findings and take immediate action to improve the effectiveness of their systems of quality control and prevent them from occurring in their future audits (section 2).

b. Provide information on our review of the remediation plans submitted by firms subject to our 2021 Inspection (section 3).

c. Provide key reminders for the 2022 year end audits so that PIE auditors can take them into consideration when they plan and perform their audits to improve the audit quality (section 4.2).

d. Set out the respective roles and responsibilities of auditors, directors and audit committees of listed entities in upholding audit quality and our expectations of them ahead of the imminent busy season for audit (section 4.3).

e. Highlight areas for which we may place greater emphasis in our 2023 Inspections (sections 4.4 and 4.5).

f. Provide an update on our approach in regulating practice units under the further reform of the accounting profession (section 4.6).

1.1.2 Our inspections focus on how PIE auditors performed PIE engagements and the effectiveness of their systems of quality control, to determine whether the applicable professional standards and legal and regulatory requirements have been complied with. Our inspection methodology and approach are consistent with that in the prior year[1].

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[1] Details of our inspection methodology and approach are set out in Annex 1 of the *2021 Annual Inspection Report.*

Section 2
2022 interim inspections

2.1 Results from our inspections of PIE engagements to date

Introduction

2.1.1 As of the end of September 2022, we have completed 20 PIE engagement inspections (September 2021: 23). These included inspections of 4, 10 and 6 engagements completed by Category A, B and C firms[2], respectively. The PIE engagements we inspected related to listed entity audits for the financial years ended between 30 June 2019 and 31 March 2022.

2.1.2 To date, we have only completed a small proportion of planned PIE engagement inspections of Category A firms for our 2022 Inspection, and more information is needed to evaluate the overall performance of these firms in the current year's inspection. We will share the results of our 2022 Inspection in the 2022 Annual Inspection Report which will be issued in the first half of 2023. Like our prior year's Annual Inspection Reports, the 2022 Annual Inspection Report will also include an analysis of the number of inspection findings in key areas by their significance and by the category of audit firms.

2.1.3 So far, the results of our current year inspections of PIE engagements completed by the Category B and C firms are disappointing. We continued to identify previously reported significant deficiencies in many of these audits. These deficiencies relate to areas including (i) lack of adequate exercise of professional skepticism; (ii) insufficient evaluation of management's application of accounting standards for revenue recognition and expected credit loss; and (iii) insufficient testing of journal entries and other adjustments. It was even more disappointing to find that two PIE auditors had violated the auditor independence rules under the Code of Ethics for Professional Accountants issued by the Hong Kong Institute of Certified Public Accountants (**HKICPA**).

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[2] Category A, B, and C firms complete more than 100, between 10 and 100, and at least one but less than 10 PIE audits annually, respectively. We inspect Category A firms annually and Category B and C firms at least once in a three-year inspection cycle.

2.1.4 We set out in sections 2.1.7 to 2.1.10 examples of most significant findings across the engagements inspected to date.

2.1.5 We inspected different Category B and C firms in 2021 and 2022 Inspections. Therefore, the inspection results of the current year should not be directly compared with the results of last year. In addition, our inspections included some audits being carried out in earlier years (i.e., entities with financial years ended between 30 June 2019 and 31 December 2020). Firms that had not been previously inspected by us might have taken actions to improve their audit quality in the later years of audit in addressing the market-wide deficiencies reported in our previous publications. However, the possible improvement in audit quality might not have been reflected in our inspection results.

2.1.6 We noted that audit quality is generally lower when the auditor is appointed late. The situation was even worse when the available resources and relevant experience of the incoming auditors were disproportionate to the size of the listed entities and the complexities of the audits. In certain instances, we noted that these firms had limited or even no experience in performing audits of larger size entities and/or relevant industries. PIE auditors have to recognise that they act in the public interest, and they should not accept client relationships and/or engagements whenever they are knowingly not competent and capable of rendering quality audit services.

Examples of most significant findings

2.1.7 Lack of adequate exercise of professional scepticism:

a. Insufficient evaluation and challenge of key management assumptions and judgements used in the going concern and asset impairment assessments, for example, significant revenue growth, substantial cost reductions, discount rate and the identification of cash-generating unit(s).

b. Insufficient evaluation of the feasibility of management plans to deal with the principal events or conditions that give rise to significant doubt on the entity's ability to continue as going concern and the adequacy of relevant disclosures.

c. Inadequate basis for issuing a disclaimer of opinion relating to an entity's ability to continue as a going concern.

2.1.8 Insufficient evaluation of management's application of accounting standards for revenue recognition and expected credit loss:

a. Insufficient evaluation of revenue recognition, including the timing of revenue recognition, principal versus agent analysis, identification of separate performance obligations, and provision of warranty.

b. Insufficient understanding of the entity's transaction flows and internal control.

c. Insufficient evaluation of the appropriateness of management's rebuttal of the presumption that default would occur when a financial asset was 90 days past due.

d. Insufficient evaluation of the appropriateness of grouping of the financial assets by credit quality and the reasonableness of key assumptions adopted by management in estimating the expected credit loss, for example, how the historical loss rates were adjusted to reflect the current conditions and estimate of future economic conditions.

2.1.9 Insufficient testing of journal entries and other adjustments:

a. Insufficient audit procedures to ensure the completeness of journal entries.

b. Fraud risk factors were not entity specific for identifying journal entries that contained fraudulent characteristics for testing.

c. Insufficient basis in applying a monetary threshold for journal entries testing.

2.1.10 Violation of auditor independence rule under the Code of Ethics for Professional Accountants issued by the HKICPA:

a. A network firm of a PIE auditor provided internal control review services to certain material subsidiaries of a listed entity.

b. A group engagement team prepared the financial statements of a material subsidiary of a listed entity.

2.2 Results from our inspections of systems of quality control (SQC) to date

Introduction

2.2.1 We continued to inspect all six SQC elements for each Category B and C firm subject to our current year's inspection. With respect to the Category A firms, the focus of our current year SQC inspection was related to the policies and procedures of Client and Engagement Acceptance and Continuance and Engagement Performance. The primary objective of the focus review is to identify common areas for improvements and good practices across the Category A firms.

2.2.2 As of the end of September 2022, we have inspected 12 Category B and C firms' SQC (September 2021: 11). Our inspection results show that the common areas requiring improvement identified across these firms are broadly consistent with those disclosed in our 2020 and 2021 Inspection Reports. Areas requiring improvements relate to (i) promoting an internal culture of quality; (ii) independence; (iii) internal monitoring; (iv) training; and (v) integrity, accessibility, or retrievability of engagement documentation[3]. In the current year, we also identified client and engagement acceptance and continuance as an area requiring immediate attention and improvement, details of which are set out in sections 2.2.3 to 2.2.7.

Client and engagement acceptance and continuance

2.2.3 Firms are required to establish policies and procedures to reasonably assure that they will only accept or continue client relationships and engagements when they (i) are competent and capable, including time and resources, to perform the engagement; (ii) can comply with relevant ethical requirements; and (iii) have considered the integrity of the client.

Areas requiring improvement

2.2.4 We identified deficiencies in the client and engagement acceptance and continuance processes in around two-thirds of the firms inspected to date. Examples of common deficiencies include:

a. Insufficient assessment of the firm's competence and capabilities to perform a quality audit before accepting an appointment.

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

c. Did not obtain and read the letter of resignation or termination from the outgoing auditor of the listed entity to assess the audit impact of the circumstances leading to their resignation or termination before accepting an appointment.

d. Insufficient guidance in determining the risk associated with a new or continuing client relationship and engagement.

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[3] Details of the recurrent findings are included in section 4.2 of the *2021 Annual Inspection Report*.

Our recommendations

2.2.5 Firms should strengthen their quality control procedures around client and engagement acceptance and continuance to identify entities that present a higher inherent risk. Firms should decline or withdraw from any client relationship and engagement if they do not have the necessary expertise and resources to handle and address the risk.

2.2.6 Firms should only accept or continue client relationships and engagements when the engagement teams (i) are competent and possess the necessary capabilities to perform the audits, including appropriate skills, sufficient industry knowledge and experience, time and resources; (ii) have sufficiently understood and evaluated the audit implications of the circumstances leading to the outgoing auditors' resignations; and (iii) have critically assessed management integrity. These considerations should be sufficiently documented.

2.2.7 Firms should regularly review their client and engagement portfolio by considering the industry, nature and risk of their client and engagement portfolio. They should also critically evaluate the competence, capabilities and capacity of their audit partners and staff in continuing to serve them.

2.3 Our responses

2.3.1 We have referred and will continue to refer inspected PIE engagements in which the audit quality significantly fell short of the standard we expect to our Investigation and Compliance Department for its consideration of initiating an enquiry and/or investigation.

2.3.2 We will complete our first three-year inspection cycle by March 2023. By then, all PIE audit firms will have been inspected at least once. We expect all PIE auditors to have acted according to their remediation plans to address our findings on inspections of engagements and SQC. We will assess the effectiveness of their remediation actions in the next inspection.

2.3.3 To further uphold the level of quality in the accounting profession and therefore safeguard the public interest, we will not hesitate to take necessary follow-up actions on firms which require significant improvements in the quality of their engagements inspected or have not taken action to improve audit quality, including but not limited to (i) conducting further inspections; (ii) initiating an investigation of the audit firms; (iii) imposing conditions on the registration of audit firms as PIE auditors; and (iv) referring the engagements/audit firms for possible disciplinary actions.

Section 3
Updates from 2021 inspections

3.1 Review of the remediation plans for the 2021 inspection year

3.1.1 Root cause analysis (**RCA**) is a powerful process that enables firms to identify the underlying causes of audit quality deficiencies effectively and systematically and to determine the corrective actions to prevent them from recurring in future audits.

3.1.2 We required all 17 PIE auditors we inspected in 2021 to perform RCA and submit a plan to remediate deficiencies identified from our inspections of systems of quality control and PIE engagements. We have reviewed the proposed remediation plans and will assess the effectiveness of these plans in the subsequent inspection.

3.1.3 Common root causes identified by the firms include:

a. Insufficient involvement and inadequate supervision and review by engagement manager and partner.

b. Insufficient documentation of the nature and details of supporting evidence examined and the basis of conclusions.

c. Lack of required technical knowledge and experience of the engagement team in carrying out the audit.

d. Over-reliance on management's representations and a lack of sufficient challenge over management's estimates, including the method, data and assumptions used in making the accounting estimates.

e. Ineffective project management where audits of complex or highly judgemental areas were assigned to and performed by junior team members who did not possess the appropriate knowledge and skills.

f. Insufficient firm training or guidance in relation to audits of key risk areas.

g. Ineffective audit planning and risk assessment for identifying key risk areas, leading to insufficient and inappropriate audit procedures to address those risks.

h. Lack of evaluation concerning the sufficiency and capability of the firm's personnel in accepting or continuing a client relationship.

Areas requiring improvement

3.1.4 The performance of RCA is not a box-ticking exercise but an evaluation process to understand the factors that caused the deficiencies and to establish appropriate and effective remediation actions. However, the RCAs performed by around one-third firms we had inspected in 2021 were insufficiently rigorous, leading to inappropriate or poorly designed action plans to remediate the identified deficiencies. In such cases, we required firms to revise and re-submit their remediation plans.

3.1.5 Examples of poorly performed RCAs and remediation plans include:

a. Placing undue reliance on the engagement team's oral representation to conclude that lack of audit documentation was the only root cause without obtaining further evidence to verify whether the audit work had been performed. In the case where work had been performed, there was no understanding of the underlying reasons for not documenting the audit work despite substantial time and effort being spent on the key audit procedures.

b. Training was proposed as the only remediation 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 competent and capable resources.

c. No specific and appropriate action was proposed to resolve a resources issue even though it was identified as a root cause. Possible actions to address the resources issue might include revisiting the client and engagement portfolio at the firm level and monitoring the staff-to-engagement ratio.

Good practices observed

3.1.6 We highlight below the good practices we observed from our review of the remediation plans submitted by the PIE auditors. Firms should adopt these practices to enhance their RCA and remediation processes which will be mandated under new QMSs.

3.1.7 Examples of good practices observed:

a. Adopting the *External Auditor's Guide to Performing Root Cause Analysis* that we issued in June 2022 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 perform RCA.

d. Involving all relevant engagement team members, including internal specialists and EQC reviewers, in the process of identifying the root cause(s) of identified deficiencies and determining the remediation actions.

e. Considering a wide range of remediation actions to address the identified deficiencies, including but not limited to providing training, developing/enhancing the firm's policies and procedures, standard forms and templates, establishing guidance on better project management and re-assessing 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 the audit partners and staff.

g. Implementing the remediation actions to address the root causes identified before the commencement of the next audit cycle so that necessary action could be taken in time to prevent the deficiencies from recurring.

Section 4
Our expectations

4.1 Introduction

4.1.1 This section sets out key reminders for 2022 year end audits, our expectations of auditors, directors and audit committees of the listed entities ahead of the next audit cycle, potential areas of inspection focus in 2023, as well as an update on our approach in regulating practice units under the further reform of the accounting profession.

4.2 Key reminders for 2022 year end audits

4.2.1 Concerning the common deficiencies identified from inspections to date, we urge the auditors to consider, inter alia, the following matters as they plan and perform the 2022 year end audits.

Assess the firm's competence and capability to perform quality audits

4.2.2 Firms should perform a holistic review and properly manage the growth and complexity of their client and engagement portfolio. They should critically assess their ability to perform a quality audit when accepting or continuing a client relationship and engagement. More specifically, they should consider whether (i) they have the appropriate level of skills, time and resources commensurate with the size and structure of the clients and the nature and complexity of their business operations; (ii) they possess sufficient knowledge and experience of the relevant industries; and (iii) the reporting timeframe and proposed audit fee allow them to devote sufficient resources to perform a quality audit.

Understand the client's business and conduct a robust risk assessment

4.2.3 Auditors should commence the audit planning as early as practicable and obtain an in-depth understanding of their audit clients and their businesses. They should plan and design appropriate audit procedures responsive to the assessed risk with sufficient and timely involvement of senior members of the engagement team. Auditors should be mindful not to simply follow last year's audit procedures which may not be sufficient and appropriate to address the assessed risks of the current year's audit.

4.2.4 Auditors should remain alert to the impact of changes in the economic environment and market conditions on their clients' businesses and what emerging risks they face. Auditors should from time to time re-assess the audit risks and revise the audit strategy as appropriate when there is a significant change in the entities' operations or the surrounding business environment during the audit, or when any contradictory or disconfirming audit evidence is identified.

Heighten professional skepticism and challenge status quo

4.2.5 Auditors should meet with management to discuss and challenge their key estimates and significant assumptions and discuss alternative scenarios. It is important that auditors remain skeptical to critically evaluate all available audit evidence, including contradictory evidence, to corroborate management's representations and be alert to disconfirming information, such as information that is out of the ordinary given the current macro-economic environment. Auditors should also perform a retrospective review of management judgements and assumptions reflected in the financial statements of the prior periods.

4.2.6 Auditors should critically assess the reliability and relevance of the information used by management in forming their estimates.

4.2.7 Auditors should engage internal or external experts for areas that require specific industry knowledge or involve complex techniques in determining the estimates, such as valuations of certain types of assets or estimations of expected credit losses for certain financial assets.

4.2.8 Auditors should maintain a questioning mind in evaluating the business rationale for unusual transactions and the associated risk of fraud.

Going concern assessment

4.2.9 Auditors should critically evaluate what events or conditions, individually or collectively, that might cast significant doubt on the entity's ability to continue as a going concern with reference to the entity's funding and liquidity position and the current economic conditions and obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists through performing additional audit procedures.

4.2.10 HKAS 1 (Revised) *Presentation of Financial Statements* requires management to consider all available information about the future, that is, at least twelve months from the end of reporting period, in assessing whether the going concern assumption is appropriate. Auditors should request management to extend the assessment period over twelve months where necessary.

4.2.11 Auditors should critically evaluate whether the going concern assessment plans for future actions formulated by management are feasible. Auditors should also ensure that the entity adequately discloses such information in the financial statements.

Review of component auditors' work

4.2.12 Group auditors take full responsibility for the audit of the group financial statements and are responsible for the direction, supervision and performance of the group audit engagement. They should:

a. Evaluate critically whether component auditors comply with the relevant professional standards and regulatory requirements applicable to the group audits, in terms of quality control policies and procedures, audit methodologies and professional competence.

b. Communicate clearly with component auditors about their respective responsibilities and the group auditors' expectations, in terms of relevant ethical requirements, the scope of work of component auditors and the reporting requirements.

c. Supervise the component auditors throughout the audit and perform additional audit procedures on the financial information of the components where necessary.

d. Evaluate critically the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence on which to base the group audit opinion.

Using the work of an auditor's expert

4.2.13 Auditors should agree with the auditor's expert on the scope and timing of its work before the commencement of work. Auditors should critically evaluate the accuracy and completeness of the source data, relevance and reasonableness of assumptions and methods used by the auditor's expert and ensure that the caveats made by and observations identified by the auditor's expert are properly evaluated and addressed.

Involvement of engagement partners and EQC reviewers

4.2.14 Engagement partners and EQC reviewers should be sufficiently involved at the early stage of the audit to identify key accounting and auditing issues. This allows sufficient time for management and the engagement team to address the critical audit matters well before the year end date and to alleviate the pressure on the resources during the audit peak season.

4.2.15 Engagement partners should communicate with and supervise the engagement team on a timely basis throughout the audit and review audit documentation at appropriate stages of the audit.

4.2.16 Firms should only assign individuals with sufficient and appropriate experience, knowledge, authority, and capacity as EQC reviewers. EQC reviewers should critically challenge the significant judgements made and the conclusions reached by the engagement team in a timely manner, and their involvement should be adequately evidenced and documented.

Audit documentation

4.2.17 Audit documentation should be prepared on a timely basis to facilitate the effective review and evaluation of audit evidence obtained and conclusions reached in forming the audit opinion.

4.2.18 Audit documentation should provide sufficient details of the purpose of the audit test, nature, timing and extent of the audit procedures performed, the results of the audit procedures performed, the audit evidence obtained, the significant professional judgements applied, and the conclusions (including the basis for the conclusion) reached.

Maintain close dialogue with management and audit committees

4.2.19 Auditors should maintain close and effective dialogue with management throughout the audit to ensure significant accounting and auditing matters are immediately communicated and addressed by management. Examples of significant accounting matters include going concern and asset impairment assessments, possible impact on the key accounting estimates arising from changes in economic conditions and interest rate hikes, and appropriateness of the use of going concern basis in the preparation of the financial statements.

4.2.20 Auditors should communicate with management about the quality of information required from management and agree on a reasonable reporting timeframe. Auditors should report to the audit committees when the quality of the entities' financial function and the information provided for the audits do not meet their standards or when the proposed reporting timeframes do not allow sufficient time for them to conduct a quality audit.

4.2.21 Auditors should communicate with management and audit committees on a timely basis when additional information and/or time may be required for resolving significant matters and/or unexpected matters arise during the audit. Auditors should proactively work with management to resolve such matters.

4.3 Our expectations of auditors, directors and audit committees ahead of the next audit cycle

Actions by auditors

4.3.1 Auditors play a pivotal role in safeguarding the public interest by performing quality audits. As mentioned in our *open letter* issued on 27 October 2022, auditors should proactively discuss with the audit committees any contentious audit issues and seek their assistance to resolve any such issues with management. They should always endeavour to complete the audit rather than attempt to avoid the responsibility of adversely reporting on the financial statements by resigning. Auditors should properly plan the resources they need for their existing client and engagement portfolio and critically assess their competence and capabilities to perform a quality audit before accepting any new client relationship and engagement.

4.3.2 Auditors should fully address the common deficiencies described in this and our previous reports and take immediate and robust action to strengthen their policies and procedures and prevent them from recurring in their future audits. Auditors should consider the identified deficiencies when establishing the new SoQM under the new QMSs, which will be effective on 15 December 2022. Auditors should also consider the key reminders as set out in section 4.2 of this report as they plan and perform the upcoming year end audits.

Actions by directors

4.3.3 Directors have a primary role in understanding and approving key areas of judgement and estimation applied in preparing the financial statements. They should challenge management as to the relevance and appropriateness of the information and assumptions used in determining significant accounting judgements and estimates.

4.3.4 Directors have a fiduciary duty to ensure that financial statements are prepared in accordance with the applicable financial reporting standards, and that appropriate accounting policies have been applied and supported by reasonable accounting judgements and estimates.

4.3.5 Directors should ensure that management provide auditors with the information requested in connection with the audit on a timely basis and that the listed entity has adequate resources and competent staff.

Actions by audit committees

4.3.6 Audit committees are the cornerstone of the governance process and play a crucial role in safeguarding the quality of the financial statements and the audit of the financial statements. Audit committees should ensure that the entities have robust internal controls and that sufficient and capable resources are employed to support quality financial reporting. They should also thoroughly understand the business rationale of significant unusual or highly complex transactions and how their companies have been impacted by the recent drastic economic and market changes.

4.3.7 Audit committees should maintain effective dialogue with their auditors, monitor how their auditors resolve the significant matters arising from the audits and challenge their auditors as to whether and how they have addressed and considered the common deficiencies and key reminders highlighted in this report. Audit committees should also ensure that their auditors have access to the information they need and that the reporting timeframes and proposed audit fee are reasonable to allow them to devote sufficient time and resources to conduct a quality audit. The *Guideline for Effective Audit Committees – Selection, Appointment and Re-appointment of Auditors* that we issued in December 2021 could be used as a reference when engaging in discussions with the auditors.

4.4 Potential areas of engagement inspection focus in 2023

4.4.1 Potential areas of inspection focus in 2023 will primarily relate to the significant deficiencies identified from our inspections to date and how auditors address the audit risks arising from the current year's significant changes in economic and market conditions, which include:

a. Adequate exercise of professional skepticism

   How the engagement team has applied professional scepticism in evaluating the reasonableness of management's key estimates and significant assumptions in areas such as going concern and asset impairment assessments in light of the current market conditions and future economic outlook, for example, the impact of the interest rate hikes in determining the discount rate for the asset impairment test.

b. Revenue recognition and expected credit loss

   Given the prevalence of deficiencies identified in our inspections to date, the auditor's evaluation of the entity's application of accounting standards for revenue recognition and expected credit loss will continue to be a key area of inspection focus.

c. Execution of group audits

COVID-19 might have changed the approach in which the group auditors supervise and review the work of the component auditors; for example, the group auditors might only perform remote reviews instead of on-site reviews of the component auditors' audit working papers. Our 2023 inspection will focus on how the group engagement team has obtained an understanding of the component auditor, communicated the group and component materiality, significant audit risks and reporting requirements, and evaluated the sufficiency and appropriateness of the audit evidence obtained by the component auditors.

d. Revised auditing standards for identifying and assessing the risk of material misstatement

The HKSA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*, which became effective for audits of annual financial statements beginning on or after 15 December 2021, established more robust requirements and detailed guidance to drive auditors to perform consistent and effective risk assessment processes. Audit firms are expected to review their audit methodology to ensure compliance and provide guidance and training to engagement teams. Our 2023 inspection will focus on how the engagement team has assessed the inherent and control risks separately and designed and performed appropriate audit procedures to address those risks.

4.5 Inspection of systems of quality management (SoQM) in 2023

4.5.1 As highlighted in section 6.2 of our 2021 Annual Inspection Report, firms are required to have their new system of quality management designed and implemented by 15 December 2022. On 10 November 2022, we published the results of our *follow-up survey* with respect to the readiness of PIE auditors for the New QMSs. The results of the survey highlighted the status of implementation and the key challenges encountered by different categories of firms, as well as good practices and reminders for firms at the final stage of the implementation journey.

4.5.2 In 2023, we will inspect the selected PIE auditors' SoQM to determine if they meet the requirements of the new QMSs and other relevant standards. Our inspection focus will be placed on how the PIE auditors have established their quality objectives, identified and assessed the risks to meet those objectives, and designed and implemented their responses to address such risks.

4.6 Further reform

4.6.1 From 1 October 2022, the Inspection Department assumed the power to conduct inspections of all practice units. This adds to our existing inspection functions in relation to PIE audits completed by PIE auditors. We will adopt the principle of proportionality and a risk-based approach, and progressively implement our inspections of practice units that are not PIE auditors.

4.6.2 We will focus our initial efforts in relation to these practice units on dialogue and understanding of their scope of practice and the challenges they face and the risks of harm to the public interest in relation to their performance of audits and assurance engagements and develop a comprehensive programme to ensure that these practice units are effectively inspected to protect the public interest.

4.6.3 We will start the practice unit inspections by conducting inspections of non-PIE engagements of Category A firms and gradually expand it to other practice units. The Inspection Department will also establish a new database by collecting information from the practice units, such as their policies and procedures and the number and nature of non-PIE engagements to determine the priority and frequency of inspections in future. In the meantime, we will also conduct follow-up visits on cases referred to the AFRC by the HKICPA under the transitional arrangements agreed with the HKICPA.

4.6.4 The *Policy Statements and Outlines of the Inspection Processes for all Practice Units* (including compliance with the anti-money laundering and counterterrorist financing requirements) provides further details about our regulatory principles and processes with respect to the inspection of practice units.

4.6.5 We will continue to direct our inspection function in a manner that is practical and fair to our regulatees without compromising the public interest.

Contacts

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

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