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

afrc.org.hk

2023 Annual Inspection Report

11 July 2024

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, and promotes the healthy development of the accounting profession.

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

Foreword

Our role as the independent regulator

1. Adherence to laws, regulations, and ethical practices is of paramount importance in today's dynamic and competitive business landscape. Businesses that operate with integrity not only foster trust among stakeholders but also lay a solid foundation for sustainable growth.

2. As an independent regulator of the accounting profession, our role is crucial in ensuring that audit firms maintain and uphold professional standards, thus promoting the credibility and transparency of financial reporting.

Firm's commitment to quality

3. Setting the right tone at the top is the primary duty of firm leadership. We strongly encourage leaders of audit firms to establish a culture of continuous improvement that emphasizes and rewards quality audits.

4. This is vital for the long-term development of the accounting profession. Such a culture will strengthen public trust in the quality of financial reporting in Hong Kong as a competitive international financial centre (**IFC**).

5. Since our first inspection in 2020, through publications and constant dialogue, we have advocated the importance of firm leadership in upholding audit quality. We have provided guidance and reminders to audit firms on (i) fostering a culture of accountability; (ii) strengthening policies and procedures for client acceptance and continuance; (iii) improving audit execution; and (iv) implementing mechanisms for effective resource management. We have also increased the public transparency of our inspection approach and methodology to ensure that firms and their engagement teams understand them.

6. We encourage firms to take advantage of our inspection findings and recommendations to proactively address areas that require improvement and to allocate resources more effectively, thus improving the quality of their audit work.

Expanded scope of inspection

7. In our 2023 inspections, we inspected a total of 33 firms (2022: 26), including 20 out of 45 public interest entity (**PIE**) auditors (2022: 26 out of 44) and 13 out of 2,792 non-public interest entity (**non-PIE**) auditors (2022: nil), which reflected our principle of proportionality. Among these 33 firms, we inspected 98 (2022: 61) engagements, comprising of 56 PIE engagements (2022: 55) and 42 non-PIE engagements (2022: 6).

8. Among the non-PIE audits, we inspected a total of 42 non-PIE engagements (2022: 6), of which 17 audits (2022: 6) were completed by PIE auditors and 25 audits (2022: nil) were completed by non-PIE auditors, reflecting a significant expansion in our inspection efforts. The expanded inspection scope included 22 audits of licensed corporations registered with the Securities and Futures Commission (**SFC**), which carried more public interest.

9. Following the further reform in 2022, our regulatory powers were expanded to inspections of firm's compliance with the Guidelines on Anti-Money Laundering (**AML**) and Counter-Terrorist Financing (**CTF**) for professional accountants as set out in Chapter F of the Code of Ethics for Professional Accountants (**CoE**) issued by the Hong Kong Institute of Certified Public Accountants (**HKICPA**) (**AML Guidelines**).

10. For the first time in 2023, we inspected 42 practice units, including the aforesaid 33 practice units, for their compliance with the AML/CTF requirements.

11. To ensure compliance with the new quality management standards (**QMS**), all firms were required to design and implement a system of quality management (**SQM**) by 15 December 2022, followed by a mandatory evaluation within one year. In response, we introduced an inspection approach which was tailored to evaluate the implementation of SQM across firms of different categories.

12. An effective SQM is about creating a comprehensive system that enables and supports engagement teams in consistently delivering quality audits. Our observations indicate a clear correlation between SQM and the execution of quality audits. Firms that invest in a robust SQM that supports the consistent execution of quality audits tend to have fewer significant findings.

13. The overall inspection results were mixed in 2023, both across different categories of firms and within the same category of firms.

Inspection findings of Category A firms

14. The Category A firms (collectively audited 89% of the PIE audit market by market capitalization and 62% by number of PIE engagements), showed some improvements in their audit quality. However, such improvements were not seen across all firms in that category. This suggests that the leaders of those firms which did not show notable improvements need to put in efforts to establish a stronger culture of quality in their firms.

15. There is a welcoming sign that most Category A firms have taken the guidance and reminders provided through our publications and stakeholder engagement activities seriously for enhancing audit quality.

Inspection findings of Category B and C firms

16. Category B and C firms (collectively audited 3.3% of the PIE audit market by market capitalization and 33% by number of PIE engagements) are normally subject to at least one inspection every three years. Accordingly, the inspection results, and the overall audit quality ratings, may not be directly comparable across years.

17. Irrespective of which specific firms we inspected within categories B and C, we observed that audit quality ratings of the inspected engagements were mostly below a satisfactory level, although, one Category B firm and one Category C firm, both of which were subject to a previous inspection, showed slight improvements compared to their last results.

18. Our inspection findings suggest that most firms we inspected in these categories did not act on our previous findings, recommendations, guidance or reminders (though three of them were not subject to our previous inspections). While our 2023 findings in these categories are largely consistent with those in previous years, we are concerned that these issues are widespread within each category, rather than simply isolated incidents within specific firms. We urge firms in these categories to improve their audit quality by proactively referencing our previous publications and acting on them.

19. The inspection results for the three Category B firms that were subject to our specific scope inspection were unacceptable. The proactive approach we introduced this year is to address our concerns about the competence and capabilities of these three specific Category B firms, which had taken on a significant number of PIE engagements that were either sizeable or had significant unresolved matters identified by the outgoing auditors.

Follow-up of inspections

20. In 2023, we adjusted the number of engagement inspections per firm to reflect our reward and reinforcement approach. Where firms have made significant improvements in their inspection results, we have reduced the total number of engagement inspections in recognition of their progress. This is to encourage them to maintain their commitment to improving audit quality. For firms whose previous inspection results were consistently unsatisfactory, we have increased the total number of engagement inspections.

21. While acknowledging the importance of recognition of improvements, we also hold firms accountable for their actions and the quality of their work. This combined approach aims to reinforce the importance of making continuous improvement in audit quality and the delivery of quality audits.

22. Though instances of non-compliance and misconduct, such as failure to complete necessary corrective actions, breaches of independence requirements, or potential misconduct by professional accountants, have been referred to our Investigation and Compliance Department (**INC Department**) for appropriate follow up action, we urge leadership to communicate the right messages internally. We also expect their full cooperation with our inspections and that they leverage our inspection findings for their own good.

23. We encountered certain non-compliance with our regulatory requirements during our 2023 inspection. Therefore, we would like to highlight the importance of firms' full cooperation with the AFRC. Any delays in fulfilling specified timelines for completing remediations, a failure to produce information and documents for the AFRC to exercise its regulatory function of inspection, or a failure to self-report matters of regulatory concerns not only highlights a non-compliance attitude and a poor culture within a firm but may result in possible disciplinary action.

Looking ahead

24. Hong Kong needs to stay vigilant and responsive to the economic challenges and business opportunities ahead. Therefore, it is essential that the accounting profession delivers high-quality audits.

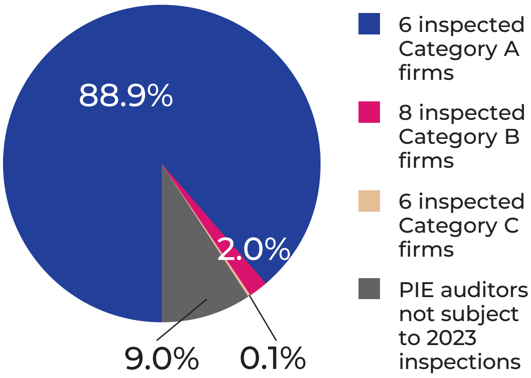
25. To support consistent delivery of high-quality audits, firms, especially small to mid-sized ones, need to pay immediate attention to the growing importance of technology. With the increasing reliance on digital systems and data analytics by the business communities, auditors must keep abreast of technological advancements and embrace them. This will ensure the effectiveness and enhance the efficiency of their audit practices, as well as improve the overall quality of audit outcomes.

26. Furthermore, we strongly encourage accounting professionals to actively develop and enhance their skillsets and competencies to seize opportunities for the profession. In today's fast-paced and dynamic business environment, accountants need to be adaptable and possess a diverse range of skills. As environmental, social, and governance factors continue to gain prominence, there is a growing need for accountants to understand and communicate sustainability performance and its impact on business decisions and financial reporting.

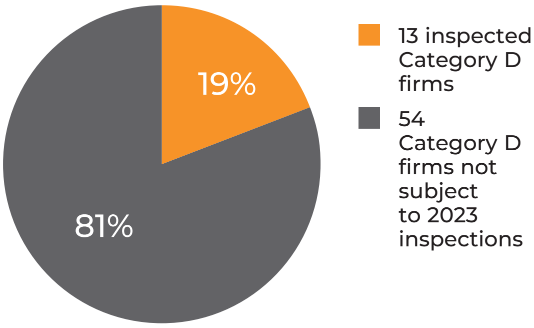
27. The Hong Kong SAR Government issued a vision statement in March 2024, that described an "aim to be among the first jurisdictions to align the local sustainability disclosure requirements with the International Sustainability Standards Board's reporting standards." As part of the vision, the Government and financial regulators, including the AFRC, will promote sustainability assurance to enable credible implementation and facilitate the use of technological solutions to enhance efficiency, reduce costs, and enable comparability and interoperability of disclosures. Accounting professionals can position themselves at the forefront of industry trends and contribute to the market's sustainable development by investing in technology and proactively developing sustainability reporting skills.

Highlights of 2023 Inspection

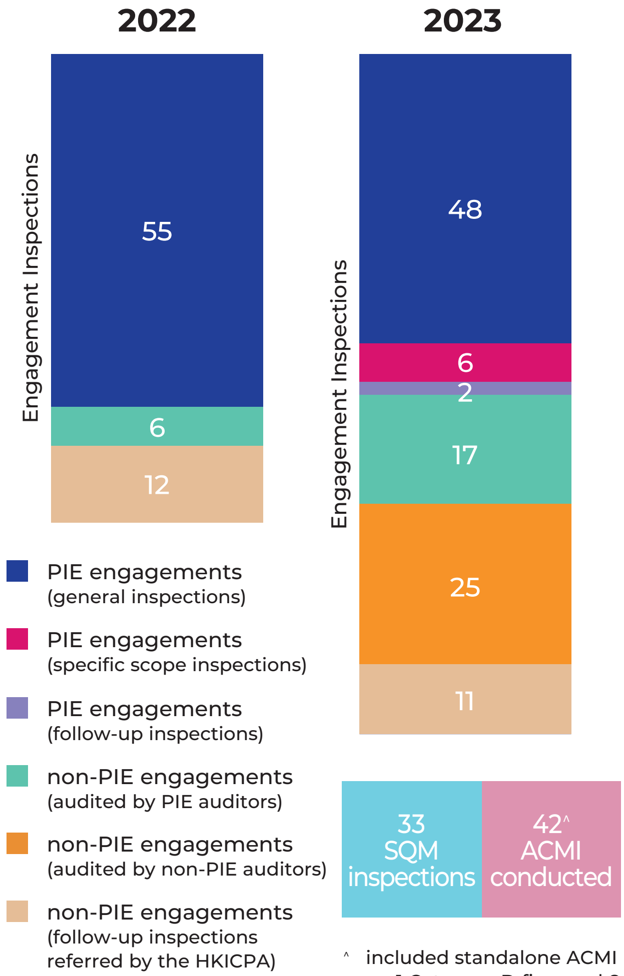
Market share of Category A to C firms* (By market cap of listed entities as at 31 December 2022)



Inspections of Category D firms* (By number of practice units as at 31 December 2022)

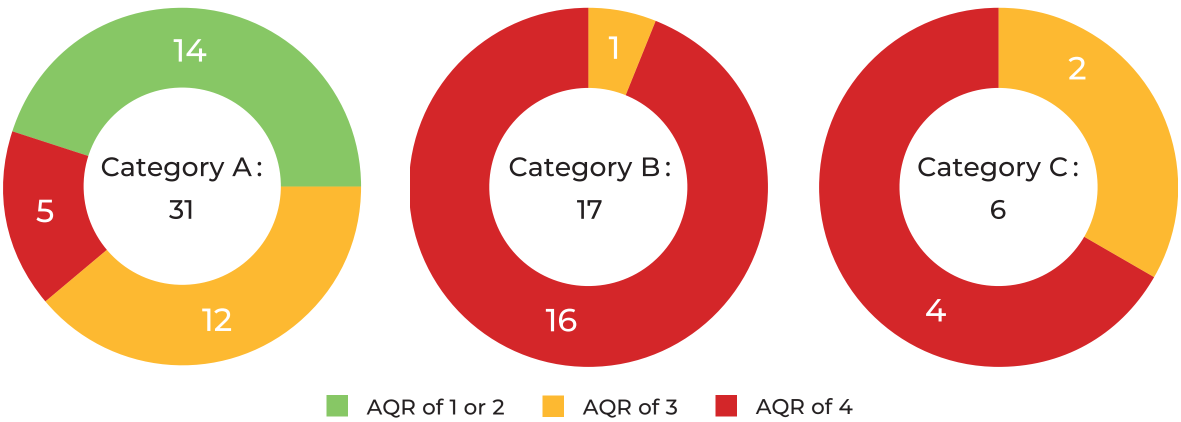


Number of engagement inspections, SQM inspections and ACMI



^ included standalone ACMI on 1 Category D firm and 8 Category E firms

Audit quality ratings (AQR)# (By category of audit firms and number of PIE engagements inspected)



(PIE engagements under follow-up inspections were not rated and not included in the above figures)

(Further details regarding AQR can be found in section 1.III)

* 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. Category D firms are non-PIE practice units that completed more than 20 non-listed entity audits with more public interest elements and/or more than 500 non-listed entity audits. Other practice units not in categories A to D are categorized as Category E firms.

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 PIE engagements we inspected.

Table of contents

Table of contents

Section 1
Overview of 2023 Inspections

I. Our mission and objective

1. Inspections play a vital role in fulfilling the AFRC's mission to safeguard the interests of investors and other stakeholders who rely on financial reporting.

2. By sharing our observations and insights from our inspections, we hope to foster a collaborative culture of promoting and recognizing the importance of audit quality with the regulated market.

3. This should create a ripple effect that ultimately improves financial reporting quality, safeguards public interest, and maintains public confidence in the Hong Kong capital markets.

II. Purpose of this report

4. We aim to provide firms with an overview of our inspection findings. We have also included leading practices and common findings we found in firms' SQM. Firms can act on our inspection insights to improve audit quality.

5. We present our observations and insights from the AML/CTF compliance monitoring inspections (**ACMI**) so that firms can take appropriate action to ensure compliance with the existing legal requirements on AML/CTF. We remind firm leaders of their statutory duty under the AML/CTF Ordinance (**AMLO**) to report money laundering (**ML**) and terrorist financing (**TF**) activities.

6. Lastly, we share our 2024 inspection approach and areas of focus. By providing guidance to firms on how we expect them to perform quality audits, we expect appropriate responses across the regulated market will lead to an overall improvement in audit quality.

III. Our approach

7. Following the further reform implemented in 2022, all practice units, including non-PIE auditors, are now subject to the AFRC's inspection. We continued to adopt a risk-based approach and apply the principle of proportionality when selecting firms and their engagements for inspection. To increase the robustness of our inspections, we have also incorporated an element of randomization when selecting firms and engagements for inspection.

Dedicating our resources through the risk-based approach and the principle of proportionality

8. As 2023 is the first full year after the further reform, in which all practice units are subject to our inspection, our inspection covered practice units and engagements of both PIE auditors (20 firms, 56 PIE engagements, and 17 non-PIE engagements) and non-PIE auditors (13 firms and 25 non-PIE engagements).

9. We inspected a total of 33 firms (2022: 26) and 98 engagements (2022: 61), comprising both PIE engagements and non-PIE engagements. We focused most of our resources on the PIE auditors, representing 73 or 74% (2022: 55 or 90%) of the total engagement inspections. We inspected 25 non-PIE engagements (2022: 6) completed by non-PIE auditors, representing 26% (2022: 10%) of the total engagement inspections. For the first time in 2023, a total of 42 practice units were subject to ACMI.

10. Our inspection efforts have expanded significantly in 2023, with the number of firms and the number of engagement inspections increased by 27% and 61% respectively. Despite the substantial expansion in our inspection work, we were able to maintain a high level of effectiveness by leveraging on our experiences in the first inspection cycle and implementing efficiencies within our inspection processes.

11. Given the overriding public interest associated with PIE engagements, we continued to prioritize our resources in the inspections of PIE auditors and PIE engagements. This approach enables us to effectively discharge our statutory duties by dedicating our resources to potential issues that may have a greater impact on the public.

12. In 2023, we have taken a **combination of approaches** as outlined in (a) and (b) below (as a "cocktail" approach) to further promote audit quality, building on the findings from the first inspection cycle (2020-2022) and the evolving landscape of the audit market.

    a. *Reinforcement approach*

        i. For firms that have demonstrated substantial improvement and a strong commitment to audit quality over the years, we have reduced the total number of engagements selected for inspection. This approach not only allows us to focus our resources on firms with greater audit quality concerns, but it also serves as a recognition of and positive response to the firms' dedication to continuous quality improvement.

        ii. Conversely, for firms whose previous inspection results were consistently unsatisfactory, we have increased the total number of engagements selected for inspection. This approach is designed to encourage firms and their leadership to focus their efforts on creating the right culture to achieve significant improvements in their audit quality.

    b. *Pro-active approach*

    Concurrently, we have adopted a proactive approach to closely monitor emerging risks in the audit market and to perform thematic or specific scope inspections on relevant firms. This includes closely scrutinizing changes of auditors, especially late-stage changes. This proactive approach allows us to positively intervene in the trajectory of an audit's quality and to protect the public interest at the outset.

Our dual role as the regulator and promoter of the accounting profession

13. Since the first auditor regulatory reform in 2019, we have become the independent auditor regulator for Hong Kong and have consistently advocated the importance of effective auditor regulation for upholding the audit quality of the accounting profession.

14. Following the further reform in 2022, the AFRC was tasked with promoting the development of the accounting profession.

15. It is obvious that the complementary achievement of these two roles, i.e., being a regulator and a promoter of the profession, is conducive to the development of the accounting profession. However, achieving the optimal balance between regulation and development is not straightforward, unless it is considered within the context of protecting the public interest and supporting Hong Kong's status as an IFC.

16. Our ongoing inspection process has been instrumental in enhancing our role as a regulator of the accounting profession. We are glad to see signs of proactive audit quality initiatives, particularly among the larger firms that audit the majority of PIEs. Yet, there remains room for improvement across the accounting profession as a whole. We recognize that continued and sustained efforts will be necessary to facilitate more substantial and widespread improvements moving forward.

17. Over the past four years, we have issued a wide range of inspection publications and engaged various key stakeholders. These efforts aim at nurturing professional development both within firms and across the entire accounting profession.

18. Our publications, ranging from inspection findings and recommendations to guidance and reminders, have provided auditors with valuable direction and insights. By taking advantage of these publications, firms are expected to enhance their audit quality.

19. Through our stakeholder engagement initiatives, we have fostered collaboration and knowledge-sharing, thereby creating opportunities for auditors to learn from each other, address audit quality issues, and tackle industry challenges.

20. We also actively promote the importance of good corporate governance in supporting the development of the accounting profession and the protection of the public interest.

Our inspection publications and stakeholder engagement initiatives

Inspection Reports

- 2022 Annual Inspection Report (July 2023)
- 2023 Inspection Insights (November 2023)

Audit Focus

- Audit Planning (July 2023)
- Year-end audit reminders (December 2023)

Inspection Questionnaires

- Two phases (September 2023 and January 2024)

Briefing session on the 2022 Annual Inspection Report

- To urge quality control system responsible persons of the registered PIE auditors to duly discharge their responsibilities in enhancing audit quality[1] (September 2023)

Explanatory video on the inspection of non-PIE practice units

- Overview of our inspection approach and firm's preparation for an upcoming inspection[2] (November 2023)

[1] Briefing session with PIE auditors: 2022 Annual Inspection Report, 22 September 2023
[2] Inspection of Non-PIE Practice Units, November 2023

Audit Quality Rating (AQR) and its importance

21. We use AQR to measure both the number and severity of findings we identify during the engagement inspections. It provides an overall assessment of the quality of a PIE audit completed by a firm.

22. Chart 1 provides an elaboration on the AQR.

23. In line with our peer regulators, we apply the AQR to PIE engagements being inspected.

24. By publishing the AQR, we hope to help the public understand the audit quality of the PIE audits we have inspected.

25. We urge preparers and users of audited financial statements to leverage the published AQR when making decisions. It has been our unwavering desire to encourage the firms we have inspected to share our inspection findings with the audit committees and those responsible for the corporate governance of the PIEs. We have also reminded members of audit committees of their right to request a copy of our inspection report when their auditors have been inspected by us.

26. In 2024, we will seek an understanding of whether or not the regulated market has been acting on our advice to promote this good governance practice of communicating the AFRC's inspection findings. Auditors should be aware that we will closely monitor their adherence to this guidance in the coming year.

27 This continuous reinforcement emphasizes the importance we place on encouraging this transparency, as it not only promotes accountability but also empowers audit committees to oversee the quality of their auditors. Ultimately, this transparency aims to bolster audit quality across the profession, ensuring the reliability of financial reporting.

Chart 1 Elaboration of AQR[3] in our engagement inspections

1 – Good 2 – Limited improvements required	3 – Improvements required	4 – Significant improvements required
One or more areas requiring improvements of limited significance were identified. An engagement will be rated 1 when no finding warranting inclusion in the inspection report was identified.	One or more key findings requiring more substantive improvements were identified.	One or more key findings were identified, which raised significant concerns as to the sufficiency or quality of audit evidence, the appropriateness of the key audit judgements, or the auditor's compliance with ethical requirements for professional accountants.

[3] 1 represents the highest score and 4 represents the lowest score for audit quality in the engagements we inspected.

IV. Inspection results of PIE auditors

28. Our 2023 engagement inspections comprise two approaches:

a. **A general approach** which evaluates the audit quality of completed PIE engagements, with an inspection of key risk areas specific to the selected engagements.

b. **A specific scope approach** that targets identified concerns of both the market and the AFRC. This allows us to conduct more in-depth inspections of key risk areas specific to the firms and ensures a thorough assessment of the firms' quality risks in performing engagements.

Table 1 Number of PIE engagements inspected by categories of firms and their AQR

	2022					2023				
	Total number of firms inspected	Number of PIE engagements inspected				Total number of firms inspected	Number of PIE engagements inspected			
		Total	AQR of 1 or 2	AQR of 3	AQR of 4		Total	AQR of 1 or 2	AQR of 3	AQR of 4
Category A	6	33	18	13	2	6	31	14	12	5
Category B	11	15	1	7	7	5	11	0	1	10
Category C	9	7	1	2	4	6	6	0	2	4
General inspections	**26**	**55**	**20**	**22**	**13**	**17**	**48**	**14**	**15**	**19**
Specific scope inspections – Category B	**0**	**0**	**0**	**0**	**0**	**3**	**6**	**0**	**0**	**6**
All PIE auditors	**26**	**55**	**20**	**22**	**13**	**20**	**54**	**14**	**15**	**25**

Caveat – how to use AQR for different categories of firms

Each Category A firm is inspected annually, while Category B and C firms are inspected at least once in every three years. Therefore, there is a caveat when one compares inspection results across categories and years.

For Category A firms, inspection results are same-firm-specific, allowing for meaningful comparisons of their performance over time.

In contrast, for Category B and C firms, inspection results reflect a sample of different firms each year. Consequently, the results for these categories may not be directly comparable across years, as they do not refer to the same firms.

Our selection of engagements does not necessarily constitute a representative sample of the firm's total population of audits. Furthermore, our risk-based approach of selecting engagements for inspection may have directed us to high-risk engagements. Therefore, the inspection results of these engagements may not be representative and cannot be generalized to the population.

Category A firms

29. Category A firms capture a significant majority of the market share, accounting for 62% of the number of listed entity audits, 89% of the market capitalization of listed entities in Hong Kong, and 76% of the audit fees paid by these listed entities in 2022[4]. Given their dominant position, we expect them to take a leading role in spearheading and upholding audit quality.

30. During our inspection, we found that these firms generally demonstrated a strong commitment to investing in human resources and technology, despite economic and resource challenges, and they have taken proactive steps to improve their SQM and audit processes.

6 Category A firms annually inspected

Audit approximately
1,603
listed entities or
89%
of listed entities by market cap

All Category A firms are subject to our annual inspection

AQR of 1 or 2:
14 PIE engagements

AQR of 3:
12 PIE engagements

AQR of 4:
5 PIE engagements

Table 2 Number of PIE engagements inspected by Category A firms and their AQR

		2022				2023			
		Number of PIE engagements inspected							
Category A firms	Total number of listed entities (by auditor appointments) as at 31 December 2022	Total	AQR of 1 or 2	AQR of 3	AQR of 4	Total	AQR of 1 or 2	AQR of 3	AQR of 4
BDO	199	5	1	2	2	6	2	3	1
Deloitte	258	5	4	1	0	4	2	0	2
EY	397	6	5	1	0	4	3	1	0
HLB	102	5	0	5	0	5	0	4	1
KPMG	232	5	3	2	0	5	2	2	1
PwC	415	7	5	2	0	7	5	2	0
Total	**1,603**	**33**	**18**	**13**	**2**	**31**	**14**	**12**	**5**

[4]Report on the Analysis of the Public Interest Entity Audit Market in Hong Kong, March 2024

(i) General inspections

31. During our inspection of Category A firms, we inspected a total of 31 PIE engagements (2022: 33). Of these engagements, 14 (or 45%) have an AQR of 1 or 2 (2022: 18 or 55%).

Most Category A firms have been taking proactive steps to enhance audit practices

32. Our inspections have found that Category A firms as a whole have demonstrated a consistent dedication to enhancing audit quality. Most firms have progressively and consistently implemented initiatives for improving audit quality, actively addressed our previous inspection findings, and remediated deficiencies identified within their SQM.

33. To ensure the sustainability of these initiatives, firm leadership, particularly Chairpersons and Managing Partners, must continue to provide guidance, prioritize audit quality to ensure the firms' financial and operational priorities do not undermine their commitment to quality, and consistently evaluate the effectiveness of their actions.

Reinforcement approach

34. As explained in section 1 paragraph 12, and building on the findings from the first inspection cycle (2020-2022), we have modified the number of engagements we selected for inspection in 2023.

35. In 2023, we increased the number of engagement inspection for one Category A firm because of its unsatisfactory inspection results in the first inspection cycle. Notably, for that Category A firm, we found an overall improvement in its audit quality compared to 2022, with an increase in the proportion of audits assessed as good or satisfactory (AQR of 1 or 2), and a decrease in the proportion of audits assessed as significant improvements required (AQR of 4).

36. We must emphasize that our reinforcement approach can only be effective if firm leadership sets a clear commitment to quality at the top and induces a positive change in firm culture.

Unsatisfactory results and public expectations

37. For those Category A firms that showed inconsistent quality improvement during our first inspection cycle, we continue to monitor their corrective actions closely, with a specific focus on their implementation of remediation plans.

38. Under the AFRC regime, where effective oversight and development of the accounting profession are both important, it is essential for the Category A firms to possess skills and ability commensurate with public expectations. These firms must demonstrate a steadfast commitment to improving audit quality in the upcoming years. By closely monitoring and holding firms accountable, our objective is to foster continuous improvement in audit quality across all Category A firms.

Collective efforts to enhance culture focused on compliance

39. Since 2020, we have been providing firms and their audit clients with our inspection findings, as well as guidance and reminders to promote continuous improvement. Our efforts are designed to encourage firms to make improvements to their audit practices and quality controls.

40. When firms embrace a mindset of compliance and act on our recommendations, it allows them to enhance their audit practices. We have seen the investments and efforts made by the firm leadership of most Category A firms and the positive effects reflected in audit quality when firms heed our advocacy and make consistent efforts to improve their audit quality. The commitment from the top will help ensure a continuous firm-wide focus on quality improvement and drive positive changes in audit quality across the firms and the accounting profession, which includes the following:

    a. Cultivating a culture prioritizing quality
    b. Ensuring accountability for quality
    c. Enhancing a proactive compliance approach
    d. Managing resources proactively
    e. Continuously improving audit practices
    f. Strengthening file assembly process
    g. Closely monitoring partner workload and performance

41. **Integrity** is of paramount importance to **audit quality**. It is vitally important for firm leaders to cultivate a **culture of quality and integrity**, and we have seen the leadership of most Category A firms consistently emphasizing the importance of delivering quality audits. This lays the foundation for firms to deliver quality audits consistently in the future.

42. Fostering **accountability** between firm leadership and professional staff creates a sense of shared responsibility and aligned values focused on quality work, all of which are conducive to enhancing audit performance. Based on our inspection findings, all Category A firms have implemented a quality-based recognition and accountability framework in their performance evaluation systems. However, to ensure the effectiveness of these systems, firms should not only punish poor audit performance but also reward good audit performance.

43. Firm leadership should nurture a **culture of compliance**. This includes the **timely self-reporting of any critical matters** that may have relevance to the firms' SQM to the AFRC. A compliance-oriented mindset will foster a positive attitude towards regulatory compliance with the AFRC.

44. Two Category A firms have proactively communicated matters of concern to the AFRC, reflecting their strong commitment to compliance and their desire to promptly resolve any potential regulatory issues. These are specifically related to late auditor resignations as outlined in the Guidance Notes on Change of Auditors.

45 By encouraging firms to self-report significant deficiencies identified in their SQM and any unresolved matters related to late auditor resignations in a timely manner, we can prompt audit firms to address these issues more proactively, therefore improving audit quality.

46. Generally, most Category A firms have been responsive to our expectations on specific areas of audit execution and have taken steps to change their quality controls and training materials accordingly.

47. A compliance-oriented approach showcases the dedication of firm leadership to earning the trust of their regulator and the benefits they see in the connection between a compliance mindset and audit quality.

48. We observed that the leadership of one specific Category A firm demonstrated a strong commitment to actively monitoring its client portfolio and ensuring the availability of sufficient resources. This **proactive resource management approach** plays a crucial role in preventing resource constraints that could potentially undermine the quality of audit work.

49. We note that some firms have actively developed audit milestone programmes to facilitate **early planning** and have **reinforced procedures for client acceptance and continuance**. These measures are aimed at improving communication and evaluation of unresolved audit issues prior to the auditor appointment or resignation. We encourage the leadership of these firms to closely monitor whether their new measures are effectively implemented in driving continuous quality improvement.

50. We have observed a strong commitment by some firms to strengthen their systems of quality control/management, beyond the minimum regulatory requirements. Specifically, firms have **enhanced file assembly and retrieval procedures**. For example, two Category A firms have tightened policies to complete file assembly within seven to 14 days after the date of the auditor's report, well ahead of the standard 60-day requirement.

51. By tightening their internal policies which ensure audit documentation is completed before the date of the auditor's report, and limit modifications, which are administrative in nature, to the audit file to only within the first 7 to 14 days, this approach, exceeding mere compliance, highlights the firm leadership's recognition of the critical importance of audit documentation integrity.

52. We have also noted that leadership of some firms has adopted a risk-based approach in **monitoring the performance and workload** of engagement teams, particularly for partners who received unsatisfactory internal or external inspection results. In response, these firms have implemented heightened oversight and provided additional coaching and support to the partners deemed to be at higher quality risk.

53. In 2023, all the Category A firms have taken proactive measures to enhance guidance and standardized working paper templates in response to our inspection findings. These measures aim at achieving consistency in the execution of audits.

54. However, we have yet to observe consistent improvements in the audit quality of certain Category A firms across years. We have identified the following three factors that may affect the extent of improvement in the delivery of quality audits.

    a. Complexity of an audit

        i. Conducting audits, especially complex ones, in a dynamic economic environment presents challenges that can impact audit quality.

        ii. The complexity of the environment is characterized by heightened risks such as increased business volatility, changes in accounting policies, risks of financial misstatements, and fraud risks.

        iii. The lack of stability and predictability in the global economy can also hinder the identification and evaluation of risks, potentially leading to gaps in audit procedures and a reduced level of assurance, thereby impairing audit quality.

        iv. All these risks create challenges for auditors to accurately evaluate the reliability of financial statements. To address these challenges, firm leadership must foster a high level of professional skepticism and enhance the robustness of quality management processes, especially by strengthening the industry knowledge of engagement teams.

        v. This will help ensure audits are conducted with the utmost professional skepticism to effectively address heightened risks.

b. Financial objectives overriding audit quality

i. Audit quality must not be compromised by financial objectives. Keeping engagement partners and their teams motivated by and accountable for audit quality relies on leadership's determination to embed a continued emphasis on audit quality into its culture, practices, and reward system.

ii. Without clearly defined quality-oriented performance targets to achieve, partners may encounter difficulties in making decisions as to how to allocate their time and resources without compromising the overall quality of audits. Firm leadership plays a vital role in this situation and should establish clear and transparent audit quality targets.

iii. This will enable partners to align their efforts towards consistently delivering high-quality audits without fear of losing their audit clients to other firms or compromising audit quality.

c. Continuous improvement

i. There may be a time lag between the inspection results we found in 2023 and the initiatives taken by firms in addressing our previous findings. However, every step forward taken by firms to improve audit quality pays dividends in the future.

ii. Some Category A firms have undertaken audit quality initiatives based on our previous inspection findings. However, the engagements which had a financial year-end of 30 June 2022 or before, as selected under our risk-based approach, did not reflect the initiatives that the firms had implemented in 2023.

iii. Despite these factors, firm leadership should prioritize the implementation of initiatives which aim to address the common findings we have identified in our inspections of their peers.

55. To prevent findings from recurring in the future, firm leadership has a responsibility to ensure that their remediation plans are properly designed and effectively implemented. To ensure effective implementation, some Category A firms have designated remediation coaching teams to oversee the design and execution of the plans. This arrangement helps to maintain a focus on identifying the root cause of deficiencies and drive accountability for the effective execution of the remediation initiatives.

(ii) Follow-up inspections

56. In our 2023 inspection, we selected two engagements that were previously inspected for which significant findings were identified. The purpose of these follow-up inspections is twofold. First, it allows us to evaluate the remedial action taken by the firms and assess how well they have rectified the previously identified findings. Second, it is intended to encourage leadership of firms to take timely remediation action.

57. The results of our follow-up inspections of these two PIE engagements suggested that the two Category A firms have implemented effective remedial actions to address the issues previously identified. The two firms have also enhanced their audit procedures by improving the firm's augmented working paper templates.

Category B and C firms

Table 3 Number of PIE engagements inspected of selected Category B firms and their AQR

		2023			
		No. of PIE engagements inspected			
Category B firms	Total no. of listed entities (by auditor appointments) as at 31 December 2022	Total	AQR of 1 or 2	AQR of 3	AQR of 4
5 firms under general inspections	231	11	0	1	10
3 firms under specific scope inspections	131	6	0	0	6
Total	**362**	**17**	**0**	**1**	**16**

20 Category C firms non-annually inspected

Audit approximately **74** listed entities or **0.1%** of listed entities by market cap

6 Category C firms selected for 2023 inspection

Audit approximately **30** listed entities or **0.02%** of listed entities by market cap

AQR of 1 or 2: 0 PIE engagement

AQR of 3: 2 PIE engagements

AQR of 4: 4 PIE engagements

Table 4 Number of PIE engagements inspected of selected Category C firms and their AQR

		2023			
		Number of PIE engagements inspected			
Category C firms	Total number of listed entities (by auditor appointments) as at 31 December 2022	Total	AQR of 1 or 2	AQR of 3	AQR of 4
6 firms under general inspections	30	6	0	2	4

58. In 2023, we inspected eight Category B firms and 17 of their engagements. We also inspected six Category C firms and six of their engagements. Table 5 is presented without disclosing the identity of a particular firm. However, it enables the public to better understand the distribution of the AQR by engagement across the Category B and C firms we inspected.

Table 5 AQR of each inspected engagement for each Category B or C firms subject to 2023 inspection

	Category B and C firms subject to 2023 inspection													
Inspected engagement	B1	B2	B3	B4	B5	B6	B7	B8	C1	C2	C3	C4	C5	C6
#1	4													
#2	4													
#3	4													
#4		4												
#5		4												
#6			3											
#7			4											
#8				4										
#9				4										
#10					4									
#11					4									
#12						4								
#13						4								
#14							4							
#15							4							
#16								4						
#17								4						
#18									3					
#19										4				
#20											3			
#21												4		
#22													4	
#23														4

Note: Firms B1 to B5 and C1 to C6 were under general inspections. Firms B6 to B8 were under specific scope inspections.

(i) General inspections

59. Adopting the risk-based approach and the principle of proportionality, our general inspections covered five Category B and six Category C firms and 17 PIE engagements completed by these firms (2022: 22).

60. Of these 17 engagements inspected, 82% (or 14) had an AQR of 4 (2022: 50% or 11). The higher rate of deficiencies this year indicates that the Category B and C firms fell below the public expectation for PIE audits. They need to make a significant effort to reach a satisfactory level of audit quality.

Repeated unacceptable inspection results of five firms showed that their firm leadership lacked quality management mindsets and did not benefit from our previous inspections

61. We expect firms to take benefit from our inspection and take appropriate actions to improve their audit quality.

62. When comparing the 2023 inspection results of the Category B and C firms inspected with their previous records, we noted that most of them (B1, B2, B4, C2 and C4) made no improvement. The deficiency rate of recurring findings as set out in Table 9 of Section 3.III was unacceptable. This strongly suggests that their root cause analysis (**RCA**) and the remediation plans formulated in previous years did not effectively address the actual underlying problems, the planned remediation actions were not implemented properly or there were other issues in their systems of quality control/management.

63. Firm B2 was previously inspected in 2021. In 2022, we issued a requirement letter under section 21H(b) of the AFRCO, which required the firm to take corrective action (such as the development of new working paper templates, guidelines, and training courses) within specified timeframes, ranging from three to seven weeks from the date of the requirement letter, as agreed upon by the firm. However, the firm did not fully comply with our requirement, which was a serious matter. As a result, the AFRC subsequently took enforcement action, which led to a reprimand and pecuniary penalty against the firm and its leader for its non-compliance with the regulatory requirements.

64. We expect all firm leadership to strictly adhere to our regulatory deadlines and fully cooperate with the AFRC. Non-compliance with regulatory requirements and failure to meet deadlines will not be tolerated, as they undermine the effectiveness of regulatory oversight. The AFRC is committed to taking appropriate and proportionate enforcement action to ensure regulatees fulfill their obligations.

65. The AFRC reminds firm leadership to dedicate sufficient effort and resources towards evaluating the adequacy and effectiveness of their remediation plans in addressing significant deficiencies. It is crucial that firms take prompt follow-up action if their action plans are not appropriately designed or effectively implemented within the specified timelines. This approach will enable firms to prevent the recurrence of such deficiencies in the future.

66. We emphasize the importance of firms taking full ownership of their compliance responsibilities. Firms must thoroughly assess their remediation plans to ensure they robustly address the root causes of the identified deficiencies. Merely developing action plans is not enough. Firms must also closely monitor the implementation of these plans and make necessary adjustments to ensure their effectiveness.

67. By prioritizing the evaluation and implementation of effective remediation measures, firms can demonstrate their commitment to maintaining a higher standard of compliance and quality. The AFRC expects firm leadership to dedicate the necessary attention and resources to this critical task, as it is essential for upholding the integrity of the financial reporting ecosystem.

Firms subject to first-time inspections have a pressing need to foster a compliance culture

68. Adhering to our risk-focused approach, we selected one Category B firm (B5) and two Category C firms (C5 and C6) for first-time inspections. These firms (B5, C5 and C6) completed their first PIE audits in 2023.

69. Our inspections of firm C5 and firm C6 revealed significant instances of non-compliance with CoE and QMS. The most serious concerns identified were at firm C5, where we found the engagement teams had altered the archived audit working papers and the engagement directors and managers had backdated the engagements inspected.

70. Alteration of archived audit working papers and backdating of the signoff dates are egregious breaches of the CoE for professional accountants. These actions undermine the integrity and reliability of the audit process, which is essential for maintaining public trust in the financial reporting quality in Hong Kong. Such practices are unacceptable and the AFRC will take necessary follow up action.

71. Our inspection of firm C6 found that it did not develop and implement SQM. Specifically, C6 had not performed any risk assessment procedures as part of its SQM implementation, despite our continuous effort and repeated publications[5] emphasizing the importance of SQM to the accounting profession. This suggests that the leadership of this firm did not exhibit a compliant attitude in adhering to the QMS.

72. For firm B5, the inspection results of two PIE engagements indicated that the engagement partners did not appropriately direct, supervise and review the work of their engagement teams. Hence, firm B5's SQM did not ensure the integrity and reliability of the audit process. This deficiency may be largely attributed to two factors:

    a. The limited experience of the two engagement partners, whose years of experience serving in that role for non-PIE engagements were one and four years, respectively.

    b. The complexity and higher risk profile of the firm's PIE engagements, which differed significantly from the non-PIE engagements the partners had primarily overseen in the past.

[5] New and revised quality management standards - Survey on implementation progress by PIE Auditors, 31 March 2022
New and revised quality management standards follow-up survey on the implementation progress by public interest entity auditors, 10 November 2022
Inspection Insights, 30 November 2023
Audit Focus: 2023 Financial Year-end Audits Reminders, 22 December 2023

73. The AFRC is concerned that the engagement partners' lack of sufficient experience in leading complex and high-risk PIE audits has undermined the firm's ability to effectively oversee and manage the quality of their PIE engagements.

74. These significant non-compliances and engagement findings identified during our inspections have suggested an urgent need for the leadership of these firms to foster a culture centered on quality and integrity. They must emphasize these as core values and recognize the importance of quality management as a key driver of the firm's success.

75. The introduction of first-time inspections presents a valuable opportunity for firms to critically evaluate their existing policies, procedures, and internal controls. Firms, newly entered or planning to enter the PIE audit market, should view these inspections as a catalyst for proactively strengthening their compliance frameworks, rather than merely reacting to identified deficiencies.

76. By fostering a compliance culture, firms can:

    a. Empower their employees to prioritize adherence to regulations and standards.

    b. Promote ownership and accountability for compliance responsibilities at all levels.

    c. Encourage open communication and collaboration with the AFRC to address any concerns or issues.

    d. Implement effective training and continuous learning programmes to enhance compliance awareness and capabilities.

    e. Continuously monitor and improve their compliance processes to stay ahead of regulatory requirements, thereby upholding audit quality.

Mixed outcomes for firm's quality improvement efforts

77. We have seen mixed outcomes from firms' quality improvement efforts. Some firms that leveraged our previous findings and implemented tailored RCA-driven remediation plans have demonstrated notable enhancements. However, other firms, particularly those with ineffective leadership, have continued to perform poorly with significant deficiencies, highlighting the need for more consistent and effective quality management measures across the profession.

78. There was some improvement in the AQR of firm B3 (2023: 3) and firm C1 (2023: 3) compared with their previous rating (B3: 4; C1: 4). Even though there is still great room for improvement, we commended firms for taking benefit of our findings and followed our guidance to develop a remediation plan to respond to our inspection findings through its RCA. For example, they have taken corrective action such as increasing the level of qualified staff, standardizing audit methodology in group audits and risk assessments, and providing additional training and guidance to staff.

79. For firm C3, it maintained an AQR of 3 compared with its previous results. As per our requirement last year, the firm took measures to remediate its previous deficiencies in its system of quality control and benefited from an improved SQM this year. We are pleased to find from our 2023 inspection that the firm did not have recurring firm-wide deficiencies.

80. Though there is no one size fit all solution to quality improvement, RCA and remediation plans are time-tested and effective tools for firms to strive for improvement in audit quality. We encourage firm leadership and their engagement teams to continuously review our advocacy on effective RCA[6] and implement tailored solutions to address their specific quality challenges.

[6] An External Auditor's Guide to Performing Root Cause Analysis, 17 June 2022

Leadership of Category B and C firms must demonstrate improvement in their PIE audit quality

81. The AFRC has yet to observe an acceptable level of audit quality across the Category B and C firms that we have inspected. We have identified the following three critical actions that firm leadership must take immediately.

    a. They must **strengthen their commitment** to effectively implement corrective actions. They should conduct robust RCAs to thoroughly identify and address the underlying causes of those deficiencies uncovered during the AFRC's inspections.

    b. They should only accept PIE engagements when **audit fee is commensurate with the audit risk** they undertake. This would allow firms to allocate sufficient resources to ensure the delivery of quality audits. Inadequate resources and budget constraints may have compromised firm's ability to maintain the desired level of audit quality. Firm leadership must not impose unreasonable budget constraints that could undermine their ability to perform quality audits and meet the public's expectation of audit quality.

    c. They should assign **partners or directors who have sufficient experience and expertise** in dealing with the complex auditing and accounting issues of high-risk PIE engagements. Without properly assigning engagements to partners with relevant experience, the quality of the audits may have been compromised, particularly if the work is assigned to newly admitted partners or directors with limited experience in handling engagements with greater audit risks.

82. In summary, the AFRC emphasizes that the quality of PIE audits is of paramount importance. We will hold all audit firms, regardless of their size or market position, to the same high standards. Maintaining consistent audit quality across the accounting profession is crucial for protecting the public interest and preserving the integrity of Hong Kong as an IFC.

(ii) Specific scope inspections on three Category B firms

For three Category B firms where their PIE engagements were sizeable or had significant unresolved matters identified by outgoing auditors, we have taken a proactive approach to address our concerns regarding their competence and capabilities.

The objective and approach of the specific scope inspections

83. The objective of specific scope inspections is to address significant audit quality risks and other matters in firms that have grown rapidly in the past few years and in which we have already identified audit quality issues, or in firms that we have assessed as being at a much higher risk of not being able to deliver a quality audit.

84. A specific scope inspection may include the following:

    a. In-depth inspections of completed audits of selected Hong Kong-listed entities.

    b. Comprehensive inspection of selected components of a firm's SQM.

    c. On-site assessment of a firm's remediation action when significant concerns have arisen about its efforts to effectively address identified audit quality control deficiencies.

85. By conducting these specific scope inspections, we aim to address potential quality concerns before they escalate and pose broader risks to the integrity of the capital markets. This proactive approach allows us to work closely with firms to address emerging challenges and ensure the consistent delivery of quality audits that meet the public expectation.

86. In 2023, three Category B firms were selected for specific scope inspections due to their unsatisfactory past inspection results and a lack of commitment to improving audit quality commensurate with their rapid growth in the number of PIE audits.

Significant findings identified

87. Our inspection results indicate that the audit quality of the six PIE engagements we inspected was **unacceptable**. There were significant concerns as to the sufficiency or quality of audit evidence obtained by these auditors for their conclusions. Examples of significant findings identified were:

    a. The engagement team did not evaluate whether it was reasonable for a PIE to estimate the useful lives of certain material intangible assets to be shorter than their licence periods by a few years. These assets were fully amortized before the PIE obtained all their expected future economic benefits.

    b. A PIE acquired material know-how for its new business. The business was at an early stage of development and only had a few customers. However, the assumptions adopted by the management in estimating the recoverable amount of the cash-generating unit to which the asset was related were very aggressive. For instance, sales were forecast to increase by four times in just a year and six times in five years compared to the actual sales. Other than inquiry of management and reviewing a business proposal prepared by management for a prospective client, the engagement team did not perform any other procedures on these significant assumptions.

    c. A PIE had committed to purchasing certain products at pre-determined prices and had made certain down payment. Product prices slumped before the products were delivered to the PIE by the end of the reporting period. The PIE recorded a provision for the estimated losses on the purchase contracts under HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which was equivalent to the down payments made. However, the auditor did not critically assess whether the PIE was obliged to pay any compensation or penalties if it did not honour these contracts. Any additional provisions for compensation or penalties would be material to the PIE's consolidated financial statements as a whole.

d. The engagement team did not perform sufficient procedures to test revenue.

Our inspections identified a number of significant findings as follows.

i. In one audit, the auditor primarily used audit confirmations to verify over 80% of the company's revenue from major construction contracts, rather than examining the underlying transactions in detail. In two audits, the confirmation procedures themselves were inadequate – the auditors did not properly verify the authenticity of the confirming parties or ensure appropriate controls over the entire confirmation process. Additionally, the auditors did not perform alternative procedures for instances where there were no responses to the confirmation requests.

This over-reliance on and ineffective controls over the confirmation process raises significant concerns about the occurrence and accuracy of the reported revenue from contracts with customers.

ii. The auditor's underlying working papers were found to be inadequate in supporting the specific audit procedures they represented as having been performed to address the key audit matters related to revenue recognition, as disclosed in the independent auditor's report.

This raises significant concerns that the auditor's report may have misled the public regarding the actual audit procedures that were carried out.

iii. The audit working papers contained information which did not agree with those related to revenue disclosed in the PIE's audited financial statements.

These inconsistencies between the audited financial statements and the audit documentation raise serious concerns about the reliability and integrity of the information being provided to the public.

88. We also have specific concerns from our findings that the engagement team of one PIE engagement did not identify and properly evaluate the objectivity of its appointed valuation expert. The valuation expert was involved in the review of expected credit losses of certain material financial assets of the PIE. At the same time, he also provided the PIE with valuation services regarding property, plant and equipment. This calls into serious question about the reliability and objectivity of the conclusions made by the auditor's expert regarding the valuation of specific account balances in the audited financial statements due to potential conflict of interests.

Our follow-up actions

89. Engagements with unacceptable audit quality will be referred to our INC Department for further action. Due to the persistent unsatisfactory inspection results, we will closely monitor whether appropriate remediation actions have been implemented by these firms and continuously assess their state of audit quality through more frequent inspections.

Possible causes of deficiencies of specific Category B firms

90. We have identified three key factors that may have contributed to this substandard audit work. These factors include:

    a. Inappropriate leadership that is overly focused on financial priorities, at the expense of upholding audit quality

        i. These firms exhibited a lack of thorough risk assessment in evaluating the complexity and risk profile of prospective PIE audit engagements before accepting them. This was particularly concerning for PIEs with unresolved audit matters from prior years, where the firms did not adequately consider the increased audit effort required. Our inspection revealed that, on average, 25% (with one firm having an even higher proportion of 44%) of the newly accepted PIE audit clients across the three specific Category B firms had significant unresolved matters reported by their outgoing auditors in 2022.

ii. The audit fees were agreed at levels that were not commensurate with resources generally required for delivering quality audits. This fee-driven approach hindered the firms' ability to allocate sufficient time, personnel, and expertise to properly execute the audits. We observed that, on average, 60% of the new auditor appointments were accepted with a reduction of the audit fee by these three Category B firms. In extreme cases, these reductions were more than 50% of the annual audit fees received by the outgoing auditors.

b. Lack of skeptical minds to challenge their clients when performing audits

i. The engagement partners and other engagement team members exhibited a lack of professional skepticism and failed to robustly challenge management's assertions and assumptions whenever necessary. A skeptical mindset is essential for auditors to identify and scrutinize potentially unreasonable assumptions or estimates made by management, which can have a material impact on the financial statements. The absence of this critical mindset undermined the firms' ability to uncover hidden risks and irregularities.

ii. The engagement teams exhibited an over-reliance on the information and representations provided by their audit clients, and lack of sufficient testing to verify the accuracy and completeness of such information. Effective audits require a balanced approach of obtaining and evaluating multiple sources of evidence to form independent conclusions.

c. Lack of monitoring of partner workload

i. These firms did not adequately monitor partner workloads, resulting in potential issues such as insufficient allocation of resources or insufficient supervision and direction by engagement partners for higher-risk audit engagements. One of these firms had accepted a number of sizable and complex PIE audits (an eight-fold increase in terms of the market capitalization of their listed entity audit clients) with only a small number increase in the engagement partners. Additionally, certain engagement partners at these three Category B firms were handling excessive workloads, having each completed between 15 to 17 PIE audits within a 15-month period. Some of the PIE audit clients handled by these partners involved complex audit matters and had large market capitalizations.

ii. The firms lacked robust partner supervision and sufficient reviews of the work performed by audit teams, particularly in areas involving significant management judgments and estimations.

91. Our findings underscore the critical importance of auditors maintaining an appropriate level of professional skepticism throughout the engagement and not blindly accepting management's explanations or the information provided by audit clients. Failure to do so can lead to significant audit deficiencies and a breakdown in the fundamental role of the audit function to provide independent assurance.

V. Inspection results of non-PIE auditors

92. Following further reforms in 2022, our inspection scope has been expanded to include non-PIE audits. In 2022, the focus was on inspecting non-PIE audits carried out by the Category A firms. In 2023, the scope was expanded further to include firms in Category B to D firms.

93. In 2023, a total of 42 non-PIE engagements were inspected (2022: 6). 17 of these were selected from PIE auditors (2022: 6), and 25 were selected from non-PIE auditors (2022: nil).

94. According to our 2023 questionnaires, there are 2,792 Category D and E firms in total. Adopting the principle of proportionality, the inspection focused on the Category D firms, which are firms that have more than 20 non-listed entity audits with more public interest elements and/or 500 non-listed entity audits. 13 Category D firms were subject to inspections in 2023 (2022: nil), with non-PIE audit clients ranging from 510 to 3,000.

95. In 2022, we completed 12 follow-up inspections of non-PIE practice units referred by the HKICPA under the transitional arrangements. Eight non-PIE practice units continued to undergo our follow-up inspections on 11 non-PIE engagements in 2023.

96. As this was our first year of inspecting non-PIE practice units, our primary focus was on obtaining an understanding on the overall state of quality of work performed by these auditors. Therefore, we did not assign any AQR to their engagements.

97. Additional information on the inspection findings and insights for non-PIE auditors can be found in sections 2.III and 4.II.

Section 2
Inspections of Systems of Quality Management

Firms that demonstrate a continued commitment to audit quality have better-developed SQM and are more effective in driving continuous improvements in the overall quality of their audit engagements.

In contrast, firms that exhibit many significant findings in their SQM or have failed to show any improvement in audit quality over time, are reflecting a failure by their leadership to foster a strong culture of audit quality throughout the organization.

I. Importance of SQM to audit quality and our inspection approach

1. SQM serves as a foundation for firms and creates a system that enables engagement teams to consistently perform quality audits. An effective SQM helps to achieve greater consistency and reliability in the delivery of quality audits.

2. Our 2023 inspection approach for SQM is risk-based with a focus on the firm-wide specific quality risk.

3. This is our first year of conducting inspections of firms' SQM following the implementation of QMS requirements, which took effect on 15 December 2022, our primary focus of the inspections has been on evaluating:

   a. The firms' establishment of appropriate quality objectives.

   b. The identification and assessment of relevant quality risks.

   c. The design and implementation of the effective responses to address those quality risks.

4. This inspection approach aims at:

   a. Effectively addressing the unique quality management challenges faced by firms of different sizes while maintaining a comprehensive oversight of the audit ecosystem.

   b. Effectively allocating our resources and attention to areas of the greatest concern.

Inspections of Category A firms' SQM

5. For the six Category A firms, we focused on evaluating the robustness of their risk assessment processes including the design of the responses to address quality risks identified for each component of the SQM. In 2024 and 2025, our inspection approach will be risk-focused and cyclical. This will be supported by in-depth review of particular aspects of the Category A firms' SQM.

6. By adopting this risk-based and thematic approach, we want to ensure that the firm's SQM remains agile, relevant, and effective in driving continuous improvements in audit quality across the firms.

Inspections of Category B and C firms' SQM

7. For the 11 Category B and C firms subject to the 2023 general inspection, we focused on the key quality risks that were more relevant to the firm's specific facts and circumstances for each SQM component. In these selected focus areas, we have evaluated:

   a. The design and implementation of the firms' responses to address the key quality risks.

   b. The design of the firms' monitoring and remediation process.

Inspection of Category D firms' SQM

8. For the 13 Category D firms subject to the 2023 inspection, we focused on:

   a. The evaluation of the robustness and effectiveness of their risk assessment process.

   b. Key responses that were considered necessary to support the performance of quality audits consistently.

Our approach to SQM inspection

9. As we embarked on the second inspection cycle, we have enhanced our mechanism in assessing the significance of each SQM finding. This involves a more comprehensive assessment that considers the nature, severity and pervasiveness of the non-compliance.

10. By taking a more holistic and nuanced approach to assessing the significance of a SQM finding, we aim to provide firms with clearer and more actionable feedback.

11. As a result of this enhanced approach, firms that we have inspected can more effectively prioritize and focus their corrective actions on the more significant SQM findings. This ensures that firms are promptly addressing the most critical issues and vulnerabilities within their SQM.

12. We urge leadership of all firms to leverage our approach when addressing the SQM findings. Firms are encouraged to adopt a collaborative mindset in working with the AFRC to strengthen their SQM and foster a culture of continuous improvement.

II. Key findings – PIE auditors

Category A firms

13. The table below shows the number of Category A firms where our 2023 inspection identified findings related to specific SQM components. Notably, two Category A firms had significant findings in their engagement performance. Further details are set out in Annex 2.

Table 6 Number of Category A firms to which identified findings related to components of HKSQM 1

Eight components of HKSQM 1	Number of Category A firms to which identified findings related to			
	Other findings	Less significant findings	Significant findings	Total
Risk assessment process	0	2	0	**2**
Governance & leadership	1	2	N/A*	**3**
Relevant ethical requirements	2	2	N/A*	**4**
Acceptance and continuance	3	N/A*	N/A*	**3**
Engagement performance	2	2	2	**6**
Resources	N/A*	2	N/A*	**2**
Information and communication	1	2	N/A*	**3**
Monitoring & remediation	3	N/A*	1	**4**

* Our 2023 SQM inspection primarily focused on evaluating the risk assessment processes of these firms under the HKSQM 1. N/A means no findings were identified within the scope of our SQM inspection. Further details of our SQM inspection approach of the Category A firms can be found in paragraphs 5 and 6 of section 2.

Robust risk assessment process at specific Category A firms

14. Most Category A firms have implemented and tailored their risk assessment processes within their SQM. These firms have allocated dedicated resources and utilized support from their international networks to enhance their risk assessment capabilities.

15. During our first year of inspection of SQM, we did not identify any significant findings in the risk assessment processes of the Category A firms.

16. However, we did observe some variations in the approaches and levels of detail adopted by the Category A firms in identifying and assessing their quality risks. For example, one firm has comprehensively evaluated the degree to which an identified quality risk may adversely affect the achievement of each quality objective. The firm then designed targeted responses to mitigate those risks.

17. This leading practice of risk based, tailored SQM implementation can serve as a valuable learning opportunity for other firms. By observing how more well established Category A firms are identifying and addressing their specific quality risks, other firms can enhance their own SQM policies and procedures to drive continuous improvement in audit quality.

Enhancing client acceptance and continuance procedures

18. Our Guidance Notes on Change of Auditors outlines our expectations on firms surrounding the change of auditors. All firms should have implemented effective policies and procedures for the acceptance and continuance of client relationships and specific engagements with reference to our guidance notes.

19. During our engagement inspections, we only identified other findings related to the acceptance and continuance of client relationships and engagements within some Category A firms.

20. Firms across all categories should persist in designing and implementing a robust SQM that enable a comprehensive client acceptance and continuance assessment. Firms should also ensure the client continuance evaluation is robustly performed to support their proposals for seeking reappointment during the annual general meetings of their PIE audit clients. A comprehensive client continuance evaluation should involve a careful consideration of the audit fee proposal to ensure the firms are allocating sufficient resources to deliver quality audits.

Category B and C firms

21. The table below shows the number of Category B and C firms where our 2023 inspection identified findings related to specific SQM components. Significantly, of the 11 Category B and C firms that were subject to our general inspections, significant findings were found, particularly in the SQM components of governance and leadership, relevant ethical requirements, engagement performance, and monitoring and remediation. Further details are set out in Annex 2.

Table 7 Number of Category B and C firms to which identified findings related to components of HKSQM 1

Eight components of HKSQM 1	Number of Category B and C firms to which identified findings related to			
	Other findings	Less significant findings	Significant findings	Total
Risk assessment process	1	5	1	**7**
Governance & leadership	0	3	4	**7**
Relevant ethical requirements	0	4	5	**9**
Acceptance and continuance	0	5	0	**5**
Engagement performance	0	5	5	**10**
Resources	1	1	3	**5**
Information and communication	2	5	0	**7**
Monitoring & remediation	0	9	2	**11**

The risk assessment process at most Category B and C firms was too generic

22. We found most of the Category B and C firms' risk assessment processes are too generic without considering their firm-specific circumstances.

23. Over 60% of the Category B firms and over 80% of the Category C firms subject to the 2023 inspection established their risk assessment process, policies and procedures for their SQM based on the quality management manual template issued by the HKICPA in September 2022 (**HKICPA QMS Manual**).

24. We have noticed that:

    a. Firm C6 did not perform any risk assessment process under the new QMS.

    b. Five other Category B and C firms made only limited modifications to the HKICPA QMS Manual. These firms did not properly identify all the quality risks specific to their firms or were unable to explain why certain quality risks were relevant to them and how their policies and procedures could address those risks.

Importance of leadership in driving a compliance culture

25. Our inspection findings that related to the governance & leadership component of the SQM had indicated recurring instances of significant or less significant non-compliance within the quality management/control systems of seven firms. The presence of recurring quality control or management issues suggest a lack of appropriate "tone at the top" set by senior leadership, including Chairpersons and Managing Partners, within these firms to foster a culture centered on delivering quality audits and meeting public expectations.

III. Key findings – non-PIE auditors

Category D firms

26. The statistical results regarding the SQM findings identified within the Category D firms inspected are not intended to be disclosed this year. This decision was made to avoid drawing undue public scrutiny towards these firms as they continue to navigate a learning curve to meet the broader expectations set by the profession and the public.

Prioritize ethics and engagement performance in risk assessment

27. Firm leadership of non-PIE auditors should place more emphasis on ensuring compliance with ethical requirements and maintaining the quality of engagement performance within their firm's processes.

28. It is crucial for all non-PIE auditors, including those firms that were not subject to the 2023 inspection, to conduct a holistic review of their risk assessment.

29. They should evaluate whether additional quality objectives or quality risks are needed and design appropriate policies and procedures to meet these objectives and mitigate these risks.

30. A robust evaluation should address the following key common findings identified at their peer firms during our 2023 inspection:

    a. A general lack of policies and procedures for evaluating long associations, in one of these cases there was over 25 years audit services to the non-PIE client by the same engagement partner, which may create familiarity and self-interest threats to the firms.

    b. A lack of evaluation of whether the provision of non-assurance services will give risk to independence threats or is even prohibited under the CoE, for example, network firms acting as company secretaries of the audit clients.

c. Firms' policies and procedures not customized to address the specific quality risks associated with their circumstances, resulting in the omission of relevant procedures and policies to address these risks.

d. A lack of guidelines or ineffective audit approach, particular for key risk areas which have a high deficiency rate as set out in the following section 4.II.

e. Insufficient controls to prevent damage and unauthorized alteration to assembled engagement documentation, which may impair the integrity and quality of audit documentation.

IV. Our expectations – call for firm-wide commitment to audit quality

31. We have persistently emphasized the importance of an effective SQM to support consistent delivery of quality audits.

32. By highlighting the key significant findings identified across all categories of firms during our inspections, we aim to prompt and educate firm leaders to instigate an immediate change in their firm culture.

33. This cultural shift should focus on prioritizing audit quality as the central objective. We expect firm leadership to collaborate with us and act accordingly to reinforce a strong SQM that delivers consistent audit quality.

34. To develop a robust and resilient SQM, it is pivotal that auditors ensure they have sufficient and appropriate resources to perform necessary audit procedures.

35. As per our Report on the Analysis of the Public Interest Entity Audit Market in Hong Kong published in March 2024, high vacancy and attrition rates amongst junior grades may derail PIE auditor's effort to establish stable engagement teams and uphold audit quality.

36. In view of challenges above, firms should consider a holistic approach using specific measures to enhance overall audit efficiency:

    a. Use of service delivery centres (which perform centralized processes or activities as detailed in Hong Kong Standard on Auditing (**HKSA**) 220 (Revised) *Quality Management for an Audit of Financial Statements*).

    b. Involving competent and capable component auditors for the group audits.

    c. Utilizing competent and experienced external engagement quality reviewers (**EQR**) to support engagement quality reviews.

    d. Engaging competent and experienced external monitors to assess the firms' SQM design and implementation, policies and procedures.

    e. Deploying audit technology tools for procedures such as journal entry testing.

37. Despite the measures intended to enhance efficiency, firm leadership must still ensure they have appropriate policies and procedures in place to properly direct, supervise, and monitor the use of any external resources. The firms are ultimately responsible for the compliance with the requirements of all the applicable professional standards to their audits and must have the necessary controls and oversight mechanisms in place.

Importance of continuous monitoring and remediation for all firms

38. While the above measures may help alleviate the impact of high vacancy and attrition rates, firms must have a robust and resilient SQM. This will ensure that quality risks arising from changes in audit execution procedures are effectively addressed, and that audit quality is not compromised.

39. Firm leadership should thoroughly assess the effectiveness of their SQM to ensure that the significant findings identified in our SQM inspection are fully addressed. They should fully engage in the ongoing monitoring activities. By proactively addressing the identified issues, firms can strengthen their SQM and ensure it remains robust and effective in supporting consistent audit quality.

Section 3
Inspections of PIE Engagements

Firms which spare no effort to learn from our inspection findings drive continuous improvement in their engagement quality by reducing common findings previously identified. These include effective execution of group audits, comprehensive evaluation of auditor's expert work, and enhancement of audit documentation.

However, it is still concerning that recurring findings related to auditor's responses to assessed fraud risks, testing of significant accounting estimates, and key audit judgments persist. Firm leadership must take more assertive and proactive action to ensure consistent and high-quality execution of audits in these high-risk areas.

It is essential for firms to prioritize robust measures to address these recurring findings and mitigate the associated risks. This will be critical for enhancing the overall quality and reliability of their audit engagements.

I. Our inspections target engagements with high-risk factors

1. The primary focus of our engagement inspections is to assess auditors' compliance with relevant professional standards, laws, and regulations. Our inspections evaluate the quality of the audit work in the selected focus areas.

2. It is important to note that our inspections do not cover every aspect of the audit engagements. Therefore, our findings **do not necessarily indicate misstatements in the financial statements**. Rather, they highlight findings in the quality of the audits performed in the areas we have focused on.

3. When determining our focus areas, we consider the aspects that may pose audit challenges and audit risks. These high-risk areas are identified as having a greater potential to impact overall audit quality. By prioritizing our resources on these high-risk areas, we aim to concentrate our inspection efforts on areas that require particular attention during the audit process.

II. Key findings – areas showing improvements

4. Throughout the year, we maintain a constant dialogue with firm leadership and publish various materials (e.g., inspection insights and audit reminders). These efforts allow us to strengthen stakeholder engagement and proactively share our inspection findings and insights with the accounting profession.

5. In response to the audit quality deficiencies we identified, some firms implemented necessary improvements based on our feedback. These firms have taken significant steps to enhance the quality of their audits.

6. We have seen overall improvements in each of the three areas as shown in Table 8 in 2023 when comparing to 2022. These improvements demonstrate firm leadership's effort in acting and the enhancements to the overall audit quality.

Table 8 Number of PIE engagements inspected with at least one finding in inspection areas with improvement

	2022			2023		
	Number of PIE engagements		%	Number of PIE engagements		%
Inspection areas with improvement	**In which the area was inspected**	**With at least one finding**		**In which the area was inspected**	**With at least one finding**	
Execution of group audits	12	7	58%	15	7	47%
Use of auditor's experts	27	16	59%	20	7	35%
Sufficiency of audit documentation	55	20	36%	48	9	19%

Effective execution of group audits

7. Effective execution of group audits is pivotal for ensuring the overall quality of group audit engagements. Based on our inspection findings, firms which focus on the following two areas have delivered high quality group audits.

   a. Conduct on-site reviews to closely monitor the performance of component auditors involved in the group audit engagements. This direct oversight enables better coordination, communication, and alignment of audit procedures between the group auditors and the component auditors. This enhances the overall effectiveness of the group auditors' review of the component auditors' work.

   b. Develop and enhance guidance and templates specifically for evaluating the appropriateness and sufficiency of audit work performed by the component auditors. These resources provide clear guidelines on assessing the quality of the component auditors' work and ensuring their conclusions are well supported.

Comprehensive evaluation of auditor's expert work

8. Comprehensive evaluation of the auditor's expert work is important for the following reasons:

    a. Auditors must assess the objectivity and competence of their experts to ensure the reliability and appropriateness of the expert's findings and conclusions. A thorough evaluation helps identify any biases or limitations that could undermine the expert's work.

    b. Auditors need to evaluate whether the expert's methods, procedures, and conclusions align with the overall audit objectives and provide sufficient appropriate audit evidence to support the auditor's opinion.

    c. A comprehensive evaluation helps the auditor to identify and address any risks or limitations associated with the expert's work, reducing the likelihood of audit failures.

9. During our inspections, we have identified the following good practices that firms in general may want to consider.

    a. Develop and enhance guidance and requirements for communicating with their internal and external experts. This ensures a clear understanding of the scope, methodologies, and key findings of the expert's work, as well as documentation of the auditor's evaluation of the expert's performance.

    b. Place greater emphasis on documenting the evaluation of the reliability and sufficiency of the work performed by the auditor's experts.

    c. Develop a checklist or a programme that specifies the procedures for evaluating the experts' work and the expected level of audit documentation on the work performed. The checklist or programme ensures that auditors have a clear record of their assessment, providing transparency and supporting the conclusions reached during the audit process.

Enhancement of audit documentation

10. Given the importance of audit documentation to audit quality, AFRC has recently published an article on The Importance of Audit Documentation Integrity. Enhancement of audit documentation provides transparency into the auditor's work and their decision-making process. It creates an auditable trail that allows for better accountability, both internally and externally.

11. Based on our findings, we observed that:

    a. An increasing number of firms are placing a particular emphasis on requiring sufficient documentation in those areas that involve significant judgment or pose significant audit risks. This ensures that auditors pay adequate attention to thoroughly documenting their procedures, findings, and conclusions in these high-risk areas. It also helps to ensure transparency, consistency, and completeness in the audit process.

    b. A greater number of firms have developed and implemented standardized templates and guidance for audit working papers in relation to areas involving significant audit risks. These intellectual resources are specifically designed to promote comprehensive documentation of audit procedures, findings, and conclusions involving significant judgment or significant audit risks. By providing clear frameworks and structured approach for documentation, firms aim to ensure that engagement teams consistently provide thorough information in these critical areas of the audit.

III. Key findings – recurring findings that require immediate corrective action

12. We have identified several key audit risk areas with recurring high deficiency rates. The persistence of these recurring findings is unacceptable. Therefore, firm leadership must dedicate extra effort and resources to effectively address these recurring issues. It is vitally important for the leaders of the audit firms to take decisive and corrective actions to rectify these persistent problems with the utmost urgency.

Repeated errors are the seeds of failure; addressing them is the path to progress.

Table 9 Number of PIE engagements inspected with at least one finding in inspection areas with the most common findings

	2022			2023		
	Number of PIE engagements		%	Number of PIE engagements		%
Inspection areas with the most common finding	**In which the area was inspected**	**With at least one finding**		**In which the area was inspected**	**With at least one finding**	
Assessment of expected credit losses (**ECL**) of financial assets	19	11	58%	15	12	80%
Impairment assessment of non-current assets	24	18	75%	15	11	73%
Procedures responsive to the fraud risks in revenue recognition	43	17	40%	40	27	68%
Procedures responsive to the fraud risks arising from management override of controls	55	26	47%	48	30	63%

13. The recurring findings identified in our current inspections are largely similar in nature to the findings from our previous inspection in 2022. This concerning trend suggests that audit firms have struggled to effectively address these persistent issues. For more detailed information on the specific recurring findings, please refer to Section 3 of our 2022 Annual Inspection Report.

Over-reliance on management

(i) Assessment of ECL

14. This finding highlights the risk of management bias in determining the appropriate amount of impairment provision related to ECL. Over-reliance on management's subjective assessment, coupled with a lack of professional skepticism, is vulnerable to inaccurate evaluation of the credit risks associated with financial assets. Undetected management bias may distort the accuracy of the financial statements and mislead stakeholders. Examples of specific findings we have identified include:

    a. Poor or no evaluation of management's assessment of the reliability of financial guarantees or valuations of pledged assets. Proper scrutiny of management's judgments in these areas is essential to mitigate the risk of bias.

    b. Insufficient procedures for verifying the accuracy and completeness of historical repayment records provided by management. Thorough testing of the underlying data is necessary to ensure the reliability of management's impairment estimates.

Trust, but verify; for the eyes of the skeptic see what the trusting miss.

(ii) Impairment assessment of non-current assets

15. Over-reliance on information provided by management in the impairment assessment of assets raises concerns about possible management bias in the formulation of significant accounting estimates and judgments. This bias can result in potential misstatement of impairment provisions, leading to an inaccurate representation of a PIE's financial position and performance. Examples of specific findings we have identified in this area include:

    a. Optimism bias in growth forecasts used in the asset impairment assessment, which cannot be reasonably justified. For instance, the adoption of a growth rate that exceeds the long-term average industry or economic growth rate without sufficient supporting evidence.

    b. Unjustifiable projections based on the budgets or forecasts covering periods longer than the typical five-year planning horizon, which may be susceptible to unrealistic assumptions or management bias.

Trust not what is told, but what is shown; the auditor's lens unveils what bias has sown.

Potential fraud risks

(i) Insufficient/inappropriate procedures responsive to the risk of fraud in revenue recognition

16. This finding in the audit process has a significant impact and can profoundly undermine the reliability of revenue recognition, which is a critical aspect of financial reporting. Examples of specific findings we have identified in this area include:

    a. Insufficient assessment of the appropriateness and accuracy of the methods used by management to measure progress towards the complete satisfaction of a performance obligation. This can result in inaccurate revenue recognition, potentially inflating or deflating revenue figures reported by the entity, particularly for long-term contracts.

    b. Insufficient understanding and evaluation of contract terms and conditions can lead to incorrect accounting treatments being applied. This can result in misstated revenue figures and ultimately misleading financial statements presented to stakeholders.

(ii) Failure to recognize the importance of audit procedures in identifying and addressing potential fraud risks

17. This finding is particularly concerning as it relates to the sufficiency and effectiveness of the audit procedures undertaken to address potential fraud risks. It indicates a concerning gap in the audit procedures that should have been performed to adequately mitigate the risks of fraud. Without the implementation of robust and comprehensive fraud-focused procedures, there is a heightened likelihood of undetected fraudulent activities, which can have severe consequences for stakeholders and the overall integrity of financial reporting. Examples of specific findings we have identified in this area include:

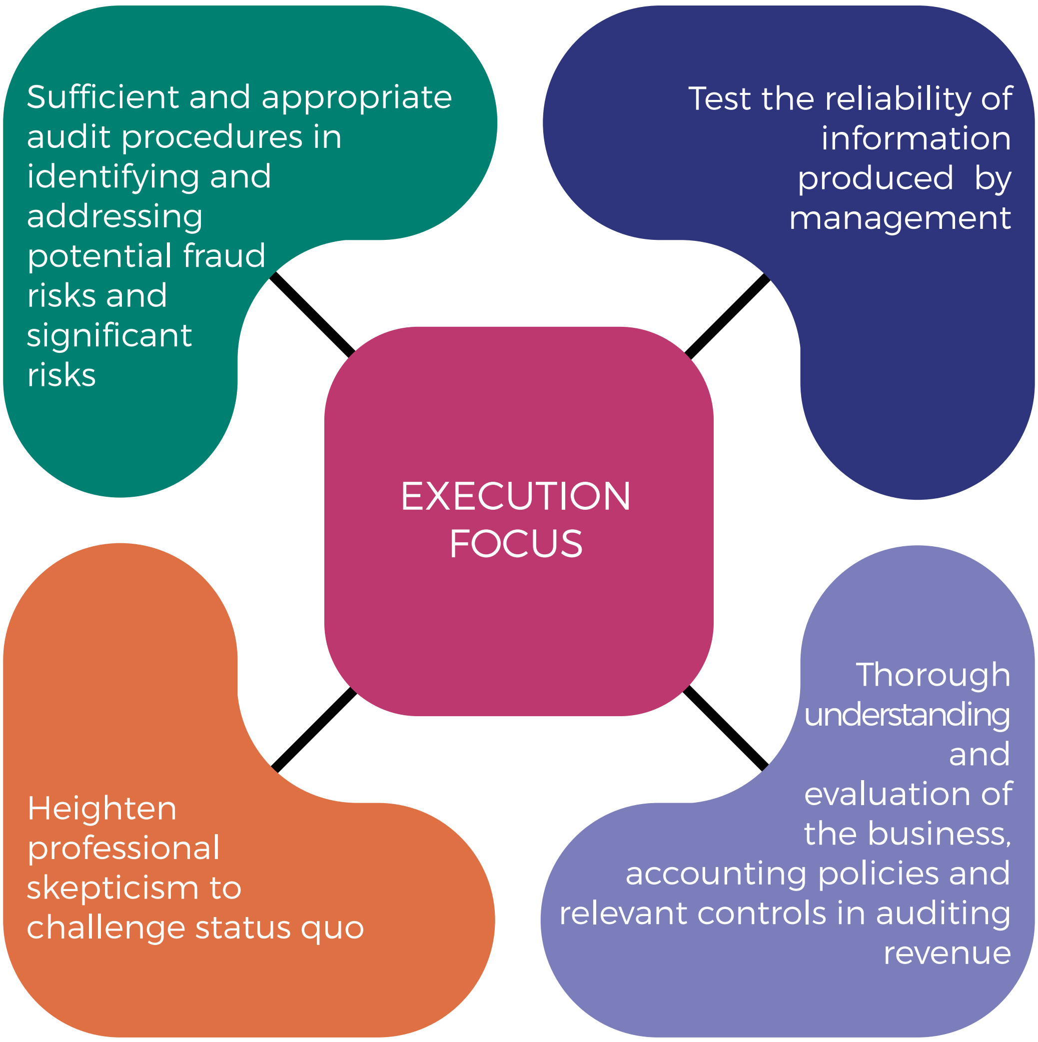
    a. The engagement teams did not perform a sufficiently rigorous and comprehensive fraud risk assessment, nor did they effectively identify journal entries exhibiting potentially fraudulent characteristics, such as unauthorized transactions, unusual transactions, or unusual account combinations. Had these indicators been identified by the auditors, it should have triggered further substantive audit procedures to investigate and address any potential risks of fraudulent activities.

b. The engagement teams placed an over-reliance on management representations or information provided by the entity without adequately evaluating the reliability and completeness of such information. This over-reliance on management's representations, which may not be accurate or complete, can potentially conceal fraudulent activities and undermine the integrity of the audit process.

Fraud's shadow lurks where auditors don't dare. Uncover it not, and stakeholders beware.

IV. Our recommendations and expectations

18. Firm leadership should ensure a consistent quality execution across their audit engagements, particularly in following critical areas, in order to deliver consistently high-quality audits.



Section 4
Inspections of Non-PIE Engagements

As 2023 marked the first year of inspections for Category D firms, a higher rate of deficiencies was anticipated. Given the expectation gap we have seen, dialogue is the key. We have maintained an ongoing constructive dialogue with these firms, sharing the observations and findings we have identified through the inspection process. This interactive and educational approach is designed to enhance the firms' comprehension of our expectations, thereby empowering them to prioritize the allocation of resources towards those areas requiring immediate improvement.

The inspection results of the Category D firms suggest that these firms may need to critically self-assess their skillsets and knowledge gaps to address any identified shortcomings. This is particularly crucial in the areas of developing their audit personnel and recruiting appropriate expertise, where necessary.

When conducting audits of regulated industries or compliance work for licensed corporations registered with the SFC, it is of paramount importance for firms to consistently maintain and regularly update their specialized knowledge, regardless of whether the engagements are for PIEs or non-PIEs. Failure to do so can compromise the quality and effectiveness of the audit and compliance work taken.

I. Our inspection approach is proportionate and risk-focused

1. Adopting a risk-based approach to non-PIE engagement inspections, we primarily focus on entities with more public interest elements.

2. In the 2023 inspection, we inspected 42 non-PIE engagements, which included 22 audits of licensed corporations registered with the SFC. The licensed corporations, though not classified as PIEs by law, play a crucial role in the financial ecosystem and serve a broad range of stakeholders.

3. Additionally, we also conducted 11 follow-up engagement inspections of eight non-PIE practice units referred by the HKICPA as previously mentioned in section 1.V, further underscoring our commitment to ensuring consistent delivery of quality audits across the accounting profession.

4. Based on our inspection questionnaire conducted in September 2023, we gained valuable insights into the audit activities of both PIE auditors (Category A, B, and C firms) and non-PIE auditors (Category D and E firms).

5. The data revealed that these two groups of auditors conducted over 1,500 and 1,300 licensed corporation audit engagements, respectively, during 2022. This substantial volume of regulated audits undertaken by both the PIE and non-PIE auditors underscores the critical importance of all audit practitioners, regardless of their client base, possessing specialized knowledge and expertise in auditing regulated industries and performing compliance-related work. PIE auditor or not, audit quality prevails.

II. Key findings – non-PIE engagements completed by Category D firms

6. We inspected 13 Category D firms and 25 of their engagements. We found common findings in the following key audit areas. This is irrespective of whether the audits were related to SFC licensed corporations or not.

   a. A lack of robust audit approach to effectively evaluating the information produced by the entity and utilizing it appropriately for the auditor's purposes.

   b. An inadequate understanding of client's business, leading to findings in audit risk assessment and the inappropriate design of audit procedures.

   c. Insufficient attention being paid to the fundamental requirements of auditing standards, which resulted in incomplete population coverage before executing audit procedures.

7. Although our inspection findings for non-PIE engagements may bear some similarities to the issues identified in PIE audits, the nature and the underlying causes of the findings often differ. Non-PIE engagements are generally less complex. However, our inspections have revealed that the findings in these audits often lie in the fundamental aspects of the audit procedures (as outlined in paragraphs 9 to 17 in this section).

8. Given the fundamental nature of the findings in non-PIE audits, we believe that these audit firms have significant opportunities to enhance their skill sets and bridge any existing knowledge gaps. By taking appropriate action to address the three key factors outlined below, non-PIE auditors can effectively elevate their practices to better comply with professional standards. More importantly, firm leadership across the non-PIE space should also prioritize and strengthen their SQM, as discussed in section 2.III.

Lack of robust audit approach to effectively evaluating the information produced by the entity and used for the auditor's purposes

9. Auditors should adopt an evidence-based mindset and demonstrate their ability to robustly evaluate the information produced by their audit clients and evaluate its appropriateness for the auditors' intended purposes. By strengthening their audit approach to critically analyzing the information provided by their clients, audit firms can enhance the reliability of their audit evidence and the overall quality of their work.

10. Our inspections revealed that some Category D firms lack awareness of the fundamental requirement to obtain audit evidence regarding the accuracy and completeness of information produced by their audit clients before placing reliance on them. For instance, when clients provided monthly statements showing commission income received from customers, the auditors should not have simply relied on this information at face value. Instead, they should have performed audit procedures to test the reliability of the client-produced information before using it as the basis for revenue testing.

Verification is the bedrock of a robust audit. It is non-negotiable.

Inadequate understanding of client's business and inadequate audit risk assessment led to inappropriate design of audit procedures

11. We found that some auditors did not adequately evaluate the potential risks associated with revenue or profit manipulation across different financial years (cut-off risks). This lack of a robust risk assessment process from the start undermined the basis for determining appropriate audit sampling and procedures related to revenue, and led to an unsupported and potentially inappropriate audit approach and conclusions.

12. In our inspections, we observed instances where non-PIE auditors selected only the last five sales invoices before the year-end and the first five after for the sales cut-off test, without a sufficiently justified basis for this limited sample. Such an approach failed to provide a comprehensive evaluation of the sales cut-off.

13. Some auditors also demonstrated a limited understanding of their clients' revenue recognition processes. These auditors did not consider examining relevant external evidence to ascertain the proper transfer of control of goods or services. Instead, they relied solely on checking the sales invoices or client-provided monthly statements, without verifying the underlying information.

Cutting corners leads to a shaky foundation.

Auditing standards require the auditor to ensure the population is complete before performing audit procedures

14. The core responsibility of an auditor is to obtain sufficient and appropriate audit evidence to express an opinion on the financial statements. A key aspect of this is to ensure the completeness of the population being audited.

15. HKSA 330 *The Auditor's Responses to Assessed Risks* requires auditors to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

16. An incomplete audit is like a house built on sand. With an unstable and incomplete foundation, it is doomed to collapse. If the auditor does not pay care and attention to verify the completeness of the population before performing audit procedures, there is a risk that the audit evidence obtained may not be representative of the full population. This could lead to inaccurate conclusions and an inappropriate audit opinion.

17. In 2023, we found a common yet fundamental finding in the journal entry testing. Some firms we inspected did not evaluate whether the population from which journal entries were selected for testing was complete. This can undermine the reliability of the test results, compromise the conclusions, and defeat the objective of an audit test.

Incomplete population verification undermines the audit and compromise the audit conclusions.

Specific concerns from our observations

18. During our inspections (including the follow-up inspections of non-PIE practice units referred by the HKICPA), we found that one Category D firm and one Category E firm did not perform basic audit procedures, such as obtaining bank confirmations. Instead, they simply issued modified audit opinions to circumvent proper audit procedures. Our findings suggested that these two firms did not properly evaluate:

    a. Whether it was possible to perform alternative procedures to obtain sufficient appropriate audit evidence for issuing an unmodified opinion.

    b. Whether the inability to obtain sufficient evidence was due to circumstances beyond the entity's control, the nature or timing of the auditor's work, or limitations imposed by management, which may trigger other audit implications.

    c. Whether they should have continued accepting the audit engagement if a modified opinion was expected to be issued.

19. We do not expect this to be a widespread issue among non-PIE audits. However, as a general reminder, non-PIE auditors must fulfil their professional responsibilities diligently and rigorously. Issuing inappropriate audit opinions to avoid proper audit procedures is a dereliction of their duties to conduct quality audits.

Shortcuts betray public trust in auditors – quality audits demand diligence, not dereliction.

III. Key findings – audit and assurance engagements of SFC licensed corporations

The importance of regulated entities in HK

20. Regulated entities, such as brokers, fund managers, and other financial services firms, handle significant amounts of client assets, including investments and money. Their audited financial statements provide crucial information to other regulators and investors about the financial health, stability, and compliance of these entities.

21. Audited financial statements of regulated entities contribute to the transparency and reliability of market information, which is essential for maintaining investor confidence and market integrity. Accurate and reliable financial reporting helps prevent fraudulent activities, market manipulation, and other misconduct that could undermine the overall capital market.

22. The SFC relies on audited financial statements to monitor the financial position, financial risk management, and compliance of regulated entities.

23. While audit and assurance engagements of regulated entities involve confirming compliance with complex rules and regulations, auditors are expected to have sufficient expertise in these regulatory requirements to properly fulfill their responsibilities. Auditors of regulated entities hold the key to market trust. Their rigorous work upholds Hong Kong's financial integrity. Failure to maintain the necessary expertise and conduct through audits could undermine the SFC's ability to effectively oversee and safeguard the integrity of Hong Kong's financial markets.

Role of auditors in the audit and compliance work of licensed corporations

24. A sound and effective control environment is crucial for licensed corporations to prevent or detect unauthorized use of client monies for unintended purposes. The auditor's compliance work on testing the design and effectiveness of these controls is key to both preventing and identifying any misappropriation of client monies in these licensed corporations.

25. The SFC sets liquidity requirements for licensed corporations to safeguard their financial stability and client assets. If auditors do not perform their compliance work properly, it can lead to inaccuracies in the financial reporting of these firms going unnoticed. This could result in a misrepresentation of the liquid capital that the firms maintain. In turn, this undermines the SFC's ability to accurately evaluate the firms' true liquidity position and their capacity to meet financial obligations.

26. As such, it is important for firms to assess their resources and capabilities, to ensure that they are able to carry out the audit and assurance work for licensed corporations' compliance with the Securities and Futures Ordinance and thus fulfill their responsibilities as stipulated in Hong Kong Standard on Assurance Engagements 3000 (Revised) *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries* (**PN820**).

Common findings on assurance engagements of SFC licensed corporations

27. Although the presence of the following findings in the auditors' compliance work does not necessarily imply non-compliance by licensed corporations, it does give rise to significant concerns about the quality of the auditor's work.

Table 10 Number of non-PIE assurance engagements inspected with at least one finding in inspection areas with the most significant/common findings

	2023		
	Number of non-PIE assurance engagements		%
Inspection areas with the most significant/common findings	**In which that area was inspected**	**With at least one finding**	
Most significant findings related to potential non-compliance with PN820			
*Securities and Futures (Client Money) Rules (**CMR**)* Did not identify that client money was not transferred into segregated account within 1 business day	19	1	5%
Securities and Futures (Financial Resources) Rules Did not identify that financial-returns were not correctly compiled from records of the licensed corporations	6	2	33%
Other common findings			
Insufficient/inappropriate procedures to test controls over CMR	19	12	63%
Insufficient procedures to test controls over renewal of standing authority	19	10	53%
Insufficient procedures to test controls over Securities and Futures (Client Securities) Rules (**CSR**)	19	8	42%

28. Based on our inspections, the root causes of the common findings likely stem from a combination of factors, such as:

    a. Insufficient understanding or application of the relevant regulatory requirements and standards by the engagement teams.

    b. Deficiencies in the audit firms' methodology, training, or quality control processes for this type of engagement.

    c. Inadequate scoping, planning, and risk assessment by the engagement teams.

    d. Lack of specialized expertise or resources within the audit firms to properly address the unique complexities of auditing and providing assurance services to licensed corporations.

29. The common findings on assurance engagements of SFC licensed corporations include the following.

    a. Insufficient/inappropriate procedures to test controls over CMR

    i. No assessment as to whether the licensed corporations were entitled to receive interest income on client money held in the segregated accounts.

    ii. Client money withdrawals and deposits were regarded as one single population for the test of controls, notwithstanding the controls over these two processes were not homogeneous.

    b. Insufficient procedures to test controls over renewal of standing authority

    i. Did not design and perform audit procedures to test whether written confirmations of the renewal of the standing authority were sent to clients of the licensed corporation within one week after the date of expiry.

    c. Insufficient procedures to test controls over CSR

    i. Did not design and perform audit procedures to test the Company's controls over deposits and withdrawals of client securities, including paper share certificates.

IV. Our recommendations and expectations

30. Non-PIE auditors must provide sufficient training and professional development opportunities to their staff. This will improve the auditors' abilities to address the common findings identified in sections 4.II and 4.III above. In turn, this will contribute to enhancing the overall audit quality.

31. Auditors conducting audit and assurance work for licensed corporations need specific expertise. They require an understanding of the Information Technology (**IT**) control environment, including access to programs and data, program changes, computer operations and program development and acquisition as required by paragraph 65 of PN820. They also need knowledge of the licensed corporations' business processes and the SFC requirements. Auditors should ensure that they have the necessary resources and professional competencies during the client acceptance and continuance process. This will allow them to properly evaluate if they are able to undertake audit and assurance engagements for licensed corporations.

32. Non-PIE auditors should take the following actions:

a. Enhance continuous professional development, by staying updated with the latest changes in HKSA. Knowledge is a treasure, but practice is the key to it.

b. Ensure timely, proactive, and sufficient involvement of engagement partners/ directors to provide direction and supervision to address significant audit issues, especially areas involving significant judgment. An ounce of prevention is worth a pound of cure.

c. Prioritize assigning staff with appropriate specialized knowledge and relevant experience to engagements related to the regulated industry, particularly the audits and assurance work of licensed corporations. The right tool for the right job.

Section 5
Anti-money Laundering and Counter-terrorist Financing Compliance Monitoring Inspections

Accountants are often the first line of defense against money laundering. They are the gatekeepers against financial crimes. Therefore, it is important for them to fully understand their legal AML obligations to ensure that their expertise and services are not used to further criminal activities.

I. Role of the AFRC

1. As the regulatory body designated under the AMLO, the AFRC inspects practice units for the purpose of ascertaining their compliance with customer due diligence (**CDD**) and record keeping requirements under the AMLO and the AML Guidelines. We evaluate the ML/TF risk presented by different types of the practice units on an on-going basis. We also work with other law enforcement agencies to identify and understand the international and domestic ML/TF typologies.

2. We use a risk-based approach in the ACMI, focusing on firms with higher ML/TF risk which is indicated by the level of client risk, the country or geographic risk. In future, we will continue to enhance this risk-based approach by considering emerging threats and trends, findings of our inspections, and information from other law enforcement agencies, and market intelligence.

II. Role of accountants

3. Accountants provide a wide range of services, including trust and company services, to clients both locally and internationally. Their roles and the ML/TF risks they encounter may vary depending on the specific services they provide. Some accounting services are more susceptible to potential money laundering, as outlined in the paragraphs 600.2.1 & 600.2.2 of the AML Guidelines issued by the HKICPA.

4. The AML Guidelines which are intended to provide guidance in relation to Financial Action Task Force Recommendations, the global standard for AML/CTF. These, aligned with accountants' ethical obligations as professionals, will provide accountants with significant assistance in avoiding giving assistance to criminals or facilitating criminal activities. It also reflects accountants' gatekeeper responsibilities, which include identifying and verifying clients and beneficial owners, conducting due diligence, reporting suspicious transactions or financial crimes, and maintaining client records.

III. Key findings – common findings

5. While all firms are subject to our ACMI, we select firms which are assessed as having higher ML/TF risks for monitoring and inspections. Of the 42 firms we inspected, findings were identified in 70% of them, and the nature of the findings was largely consistent across these firms. The overall inspection results indicate that many firms and their personnel generally lack sufficient awareness and understanding of their obligations under the AMLO and the AML Guidelines.

6. The table 11 below summarizes the common findings we identified in our first-year inspection of firms' compliance with the AML Guidelines as well as our expectations for firms going forward. It is critical that all firms, regardless of their size, urgently evaluate the appropriateness and adequacy of their AML policies, procedures, and controls to ensure full compliance with the AML Guidelines. Failure to address these findings proactively and timely could result in enforcement actions and regulatory sanctions.

For AML and CTF compliance, a stitch in time saves nine.

Table 11 Common findings identified of firms' compliance with the AML Guidelines and our expectations for firms

(1) Financial sanction screening It is an offence under regulations made under United Nations Sanctions Ordinance (Cap.537) to make available any funds or other financial assets or economic resources to, or for the benefit of, such designated persons or entities that are subject to targeted financial sanctions.
Key observations a. Firms generally did not conduct name checks of their clients and the beneficial owners of their clients against the latest lists of designated individuals and entities. Firms should perform such check before establishing a business relationship with clients, and on an ongoing basis as soon as practicable, after the lists of designated individuals and entities was updated. b. Firms did not evaluate if potential matches were correctly identified as positive hits. **Our expectations** We expect firms to conduct proper financial sanction screening to avoid the provision of services to designated persons or entities who are subject to targeted financial sanctions.

(2) CDD procedures

The procedure is a crucial element of an accountant's AML/CTF compliance as required by section 620 of the AML Guidelines and schedule 2 of the AMLO. Hence, there is no compromise nor negotiation regarding an accountant's compliance with this obligation.

Key observations

a. Firms did not perform timely and adequate customer due diligence before accepting a business relationship.

b. Firms neglected to conduct ongoing due diligence to ensure client's information is up to date.

c. Firms omitted to assess the risk level of their clients. For instance, enhanced due diligence procedures need to be performed when a client or its beneficial owner(s) is a politically exposed person.

d. Firms did not identify and verify their clients, beneficial owners, or persons purporting to act (**PPTA**) on behalf of the client, which generally can be achieved by obtaining and referring to documents, data or information provided by a reliable and independent source, e.g., HKIDs.

e. Firms did not obtain additional information related to PPTA's authority to act on behalf of the client.

Our expectations

Our inspection results indicate that firms generally lack adequate procedures and controls, sufficient ongoing monitoring, adequate risk assessment frameworks, robust identity verification processes, and sufficient due diligence on PPTA. If these issues are left unaddressed, they could lead to systemic weaknesses in AML/CTF compliance across firms.

We expect firms to design and implement policies and procedures so that the level of CDD and ongoing CDD procedures meets the requirements of the AMLO and the AML Guidelines and addresses the ML/TF risk identified.

(3) AML/CTF policies and controls

Firms should assign a responsible person to take charge of firm-wide controls. This will enable firms to detect and prevent ML/TF activities.

Key observations

a. Firms omitted to perform a firm-wide risk assessment nor design appropriate policies, procedures and controls in response to the ML/TF risks.

b. Firms neglected to carry out compliance reviews to assess the effectiveness of the AML/CTF procedures.

Our expectations

a. We expect firms to design and implement a robust risk assessment to identify ML/TF compliance risk areas so that firms can put the right resources at the right place and provide timely and necessary support to their personnel who perform the AML/CTF procedures.

b. We expect firms to conduct appropriate compliance reviews on the implementation of AML/CTF policies and procedures. This will help ensure the effective implementation of the AML/CTF procedures.

(4) Staff hiring and training

Firms' leaders should employ competent and ethical staff and promote a compliance culture. They should equip their staff with a good understanding of ML/TF risks and the firm's AML/CTF policies and procedures, failing which firms risk being unable to discharge their duties.

Key observations

a. Firms omitted to provide regular AML/CTF training to key management and staff, especially newly hired staff.

b. Firms did not perform name screening procedures to ensure the integrity of newly hired staff.

c. Firms' management and their staff generally do not have sufficient knowledge and expertise for designing an effective AML/CTF system. This shows a lack of compliance culture among firms' leaders.

Our expectations

a. We expect firms to provide sufficient training for key management and staff. This should ensure that they possess appropriate technical competence to design, develop, and adhere to their firms' AML/CTF system, and policies and procedures.

b. Fostering a compliance culture contributes towards to greater vigilance, risk awareness, and proactive engagement in the firms' AML/CTF efforts.

Other observations

7. We found that many firms are not aware of their responsibilities and the requirements in the AML Guidelines and the AMLO. In particular, firms need to keep their CDD records on microfilm or in the database of a computer.

IV. Our recommendations and expectations

8. Accountants are the gatekeepers and their commitment to AML/ CFT compliance is paramount. We believe that firms' commitment to compliance is crucial in tackling the ML/ TF risk. Firms subject to our ACMI are required to respond to each of the findings we have identified. We expect them to provide us with their remedial action plan to fully address those findings. If we have concerns that a firm is not sufficiently committed to, or is unable to address those findings, or there is repeated or egregious non-compliance, which could have wider consequences, we will take proportionate action, which may range from close monitoring of their implementation of appropriate remedial action to enforcement action.

Section 6
Looking Forward

I. An enhanced approach to encourage better audit quality

1. Based on the results of our first inspection cycle from 2020-2022, we identified gaps and deficiencies in how firms were addressing quality risks in audits. Rather than taking a purely punitive approach, we believe a more proactive and collaborative stance is needed to drive meaningful improvements in audit quality and compliance across the accounting profession. Through the collectively effort of both the AFRC and the regulated market, this should ultimately benefit the entire profession and elevate the entire ecosystem towards high quality financial reporting.

2. To that end, we have enhanced our inspection approach, which reflects a fundamental shift towards a proactive, collaborative, and outcome-oriented approach to drive sustainable improvements in audit quality and compliance.

    a. First, we are placing greater emphasis on risk assessment. Rather than solely relying on historical data, we are actively monitoring emerging risks and trends in the accounting profession and financial markets. This allows us to identify potential areas of concern before issues worsen. By requiring firms to address the identified deficiencies on a timely basis, we aim to induce and foster a greater sense of ownership and accountability within the firms themselves.

    b. Second, we are strengthening our collaboration with other regulatory bodies, standard setters, and audit committees of PIEs. By actively engaging these stakeholders, we gain valuable insights into emerging risks and best practices, which we then share as recommendations to the accounting profession. This collaborative approach ensures that our inspections remain relevant and responsive to the evolving need of the public and the accounting profession.

The rising tide lifts all boats.

3. We summarize below our key initiatives, measures and actions in the 2023-25 inspection cycle which aim to promote audit quality and safeguard the interests of investors and the public.

Inspection approach	a. Continuously enhance and refine our inspection approach to respond effectively to emerging risks in the market. b. An increased focus on firms' commitment to audit quality at the leadership level and maintain a risk-focused approach when selecting firms for specific scope inspections.
Inspection frequency	Firms exhibiting higher risks of not delivering quality audits are subject to increased frequency of inspections. Risk factors included, inter alia: a. A significant increase in the number and complexities of audits without a commensurate increase in the firm's resources and capabilities. b. Partners carrying excessive workloads that could potentially compromise on quality. c. Poor compliance record and inadequate quality-focused mindset. For instance, failure to design and implement appropriate policies, procedures, and controls for achieving quality objectives; unsatisfactory AQR on engagements; and inadequate or ineffective remediation of both engagement and firm-level deficiencies identified in the AFRC's inspections.

2024 inspection focus areas	HKSQM 1 requires firms to complete an evaluation of their SQM by 15 December 2023. Our 2024 inspection will pay particular attention to: a. Firms' evaluation of the design, implementation, and effectiveness of their SQM, including RCAs and remediation plans. b. Firms' governance structures and leadership's commitment to upholding audit quality. c. Firms' use of resources, including technological resources, for consistent performance of quality audits.
	To address the emerging risks in the market, we will put more focus on the following sectors: a. Financial services. b. Businesses involving holding or trading of virtual assets.

Our inspections will evaluate firms' readiness and compliance with the new and revised professional standards, such as HKSA, specifically, the revised auditing standard HKSA 600 (Revised) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* which became effective for the periods beginning on or after 15 December 2023.

During our inspections, we will evaluate whether:

a. Firms have updated their intellectual resources, such as audit methodology, for the requirements of the newly effective standards.

b. Firms have provided appropriate guidance and training to their audit personnel on the new and revised standards.

In 2024, we will also pay particular attention to areas which require the involvement of team members with specialized skills in IT (i.e., IT audits) and how auditors respond to fraud risks.

a. Given the extensive use of IT systems in financial reporting and the growing complexity of the IT control environment, we need to understand how firms (i) identify the risks arising from the use of IT and IT general controls, and (ii) evaluate the design and implementation of controls to address those risks.

b. Auditors play a vital role in maintaining the integrity of financial information. We will scrutinize firms' fraud risk assessment and audit procedures, and how their policies, procedures, and controls are designed to address identified fraud risks. This will allow us to assess whether auditors are upholding their professional responsibilities and meeting the public expectation regarding the quality and reliability of audits.

Other measures and actions to improve audit quality	We will continue to proactively engage the profession, both the PIE and the non-PIE practice units, to share findings and insights from our inspections.
	We will continue to strengthen our collaboration with various local and overseas regulators, creating positive impacts through these strategic partnerships. These multi-agency collaborations allow us to strengthen regulatory oversight, improve audit quality, and better protect investors and the public interest across different sectors and markets. a. Working with the Hong Kong Stock Exchange to closely monitor the quality of work by PIE auditors involving late changes in auditors or for PIEs under trading suspension. Our persistent monitoring has led to marked improvements in PIEs' disclosure practices regarding auditor resignations, with more detailed information being provided beyond just audit fee disagreement. b. Maintaining a strong strategic collaboration with the SFC to address any potential non-compliance issues identified during our inspections of licensed corporations and/or entities engaged in virtual asset business. c. Maintaining a close collaboration with the Ministry of Finance for inspections of cross-border audit engagements, especially when the audit working papers are located on the Mainland.

II. It takes two to tango – the roles and public expectations of audit committees of listed entities

4. The audit committee of a listed entity plays a vital role in overseeing a company's financial reporting processes. They are accountable to the board of directors in fulfilling their oversight responsibilities in:

    a. Overseeing the company's financial reporting processes and internal controls.

    b. Monitoring the work of independent auditors.

    c. Overseeing the company's internal audit functions.

    d. Ensuring the company's compliance with legal and regulatory requirements.

5. The public has an increasing focus on the communication between audit committees and auditors. There has been a growing public expectation for more robust and transparent dialogue between audit committees and auditors.

6. The public expects audit committees and auditors to enhance the scope and depth of their communications, including more comprehensive reporting on key risks, significant findings, and other observations from the audit process. Increased dialogue and information sharing can strengthen overall governance and accountability within listed entities.

7. As outlined in paragraphs 25 and 26 of section 1, it is essential that the AFRC's inspection findings are effectively communicated to audit committees. These findings include our assessment of the audit firms' SQM and any deficiencies we identified in individual audit engagements.

8. We urge audit committees to request their auditors to share the AFRC's inspection results and findings. This can help audit committees and auditors strengthen their respective roles and responsibilities and driving continual improvement of financial reporting and audit quality.

9. To facilitate a more robust dialogue, we suggest audit committees consider asking auditors the following questions:

   a. What were the recent AFRC inspection results, findings, and observations?

   b. Were the engagement partner or the EQR subject to the AFRC inspection in the past three years? If yes, what were the inspection results?

   c. If deficiencies were identified, what are the root causes and how has the firm addressed them?

10. Our Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment of Auditors provides specific guidelines and suggested questions to help audit committees assess the audit quality of their auditors.

III. Upholding financial reporting quality and its importance to Hong Kong as an international financial centre

Investing in technology – the importance of IT audits

11. A chain is as strong as its weakest link. In today's digital age, companies rely heavily on IT systems to conduct their business. IT audits enable auditors to identify risks of error or fraud, evaluate data integrity, and assess the effectiveness of the IT governance and controls which play a vital role in safeguarding stakeholder interests.

12. By evaluating controls, and security measures, auditors can identify potential vulnerabilities and control deficiencies, particularly related to cybersecurity, that could lead to financial loss, reputational damage, or regulatory non-compliance.

13. Accurate and reliable information is critical for auditors to perform their audit procedures effectively. IT audits assess the integrity and accuracy of data stored and processed within the IT systems. This ensures that the financial statements and other information relied upon are trustworthy and free from material misstatements. By examining IT systems and data, auditors can detect unauthorized access or suspicious activities indicative of fraudulent behavior, enabling companies to take appropriate action.

14. Annex 3 highlights the following key considerations for auditors in their audit strategies to address the need for IT audits:

    a. Factors influencing the complexity of a client's IT environment, affecting the need for IT audits.

    b. Considerations in the use of IT audit service providers.

    c. Strategic approaches and long-term considerations for IT audits.

Preparing for the assurance work in relation to sustainability reporting and ensuring independence and competence when delivering quality work

15. According to the conclusions on climate disclosure requirements issued by the Hong Kong Stock Exchange on 19 April 2024, all listed entities are mandatorily required to disclose Scope 1 and Scope 2 greenhouse gas emissions. The new requirements will come into effect for the financial year beginning on or after 1 January 2025. To deliver quality assurance work, firms must be able to sufficiently evaluate the following areas in relation to the impact of sustainability reporting and climate change.

    a. Their independence and competence when providing assurance or non-assurance services for their audit clients.

    b. The climate-related impact of significant transactions, estimates, and disclosures.

    c. Any material inconsistency of other information, including sustainability reporting, with the financial information reported by the listed entities.

16. There is a growing need for accountants to understand and effectively communicate sustainability performance and its impact on financial reporting. Firms should develop their taskforce to ensure that they have the relevant expertise and experience to deliver quality work in the audits of financial statements or other assurance or related services.

17. An ounce of foresight is worth a pound of hindsight. Addressing these areas is crucial for firms to position themselves for the new business opportunity. However, firms must acquire knowledge and gain expertise to provide credible and reliable assurance on sustainability reporting, which is becoming an integral part of Hong Kong's reporting ecosystem. Maintaining independence and competence when handling such engagements is essential to preserving the integrity and trustworthiness of sustainability disclosures.

Annex 1

List of PIE auditors subject to 2023 inspection

We prioritize our risk-based inspection on firms that hold the largest portion of the Hong Kong-listed entity markets. Our approach and effort are proportional to the level of public interest by classifying firms into different categories. The approach we use to categorize firms determines the scope and frequency of our inspections, the number of engagements selected for inspection, and the assessment of the practice units' SQM.

During our first inspection cycle, we only published the names and AQR of Category A firms. As they are subject to annual inspection, disclosing their names and their AQR not only enhanced transparency and accountability, but their inspection results across years also provide valuable information to both the firms and their stakeholders. We have seen this approach generally effective in prompting Category A firms to improve their audit quality.

However, for Category B and C firms, we only disclosed their AQR but not the firms' names. There were two reasons behind this decision. First, they were normally subject to our inspections only once every three years, so year on year comparisons would not provide a like-to-like comparison. Second, our proportionate approach to Category B and C firms resulted in relatively fewer engagement inspections for these firms during the first inspection cycle.

Transparency breeds confidence, quality breeds success. Given our cumulative experience gained since 2020, in the second inspection cycle, we have maintained our disclosure of the overall AQR of Category B and C firms without disclosing the individual inspection results of these firms on a name basis in this report.

However, by enhancing the transparency through disclosing the names of Category B and C firms inspected in Annex 1, we aim to:

a. Promote transparency in the regulatory process and hold audit firms accountable for the quality of their work.

b. Inform stakeholders, such as investors and the public, which firms have been subject to our inspections, and allow key stakeholders to engage with such firms regarding their inspection results.

c. Create market discipline as investors and listed entities may use this information to make more informed decisions about which audit firms to engage.

d. Incentivize audit firms to improve their standards and address any deficiencies identified during inspections.

e. Signal to the public and the accounting profession that the AFRC is actively monitoring and enforcing quality standards

The following table sets out the PIE auditors that we inspected in 2023 and their respective categorization. Within each category, the firms are listed in alphabetical order, without any reference to the specific coding we used in table 5 in section 1.IV.

Category A Firms (6 firms)	Category B Firms (8 firms)	Category C Firms (6 firms)
BDO Limited	CCTH CPA Limited	Ascenda Cachet CPA Limited
Deloitte Touche Tohmatsu	CL Partners CPA Limited	BOFA CPA Limited
Ernst & Young	Crowe (HK) CPA Limited	CWK CPA Limited
HLB Hodgson Impey Cheng Limited	Elite Partners CPA Limited^	Linksfield CPA Limited
KPMG	Grant Thornton Hong Kong Limited	Reanda Lau & Au Yeung (HK) CPA Limited
PricewaterhouseCoopers	Mazars CPA Limited	Yongtuo Fuson CPA Limited
	McMillan Woods (Hong Kong) CPA Limited^	
	Prism Hong Kong and Shanghai Limited^	

^ Firms subject to our 2023 specific scope inspection

Annex 2

Details of the significant SQM findings and our expected actions by firm leadership of the Category A to C firms

Category A firms

Key significant findings	Our expected actions by the firm leadership
Engagement performance	
a. Most of the engagement directors of one Category A firm have been subject to the AFRC's inspection more than once. Yet, recurring significant findings were found in their engagements, indicating a lack of effective supervision and review by the engagement directors. b. During the engagement inspection of another Category A firm, it was discovered that certain audit work had not been performed as suggested by the audit documentation, raising integrity concerns.	a. Tighten monitoring activities on engagement partners or directors who had unsatisfactory inspection results. b. Develop a quality review programme that assigns an independent reviewer (other than the EQR) to evaluate the quality of a PIE engagement before the auditor's report is issued. c. Emphasize that there is zero tolerance for integrity issues and reflect this in the performance evaluations and promotion policies. d. Encourage the utilization of whistle-blowing channels to report any potential misconduct or integrity concerns to the firms and/or the AFRC.

Category A firms *(Continued)*

Key significant findings	Our expected actions by the firm leadership
Monitoring & remediation	
One firm had recurring incidences where its internal completed file monitoring review did not identify significant findings subsequently identified by the AFRC's inspectors. This suggests potential limitations in the firm's ability to consistently identify and remediate important audit quality matters through its own quality review procedures. It raises concerns about the effectiveness of the firm's internal quality review mechanisms in ensuring consistent delivery of quality audits.	a. Enhance the firm's policies and procedures that require individuals performing the monitoring activities to have the necessary competence and capabilities, including sufficient time, to perform the monitoring effectively. This may include providing tailored training to the personnel responsible for the monitoring, specifying the scope of review, which include areas related to the AFRC's inspection findings, as well as emphasizing the importance of timely and thorough documentation of the findings and observations identified in the process. b. Ensure the objectivity of the individuals performing the monitoring activities, such as prohibiting any engagement team members or the EQR of an engagement from performing any inspection of that engagement or engagement for a subsequent financial period.

Category B and C firms

Key significant findings	Expected actions by firm leadership
Risk assessment process	
One firm did not perform the risk assessment process indicating an ignorance of the requirements of the new QMS.	a. Identify and assess quality risks relevant to the firm by understanding conditions, events, circumstances, actions or inactions that relate to the nature and circumstances of the firm and its engagements. b. Establish outcome-based quality objectives on which the firm focuses. c. Design and implement appropriate responses to address the assessed quality risks.
Governance and leadership	
We noted multiple incidences of significant non-compliance with CoE or QMS, indicating that firm leadership did not dedicate appropriate resources to developing and monitoring the firms' SQM.	Allocate and maintain sufficient resources to establish and operate a robust and resilient SQM to provide reasonable assurance that the firm and its personnel fulfil their responsibilities and conduct engagements in accordance with professional standards.

Category B and C firms *(Continued)*

Key significant findings	Expected actions by firm leadership
Relevant ethical requirements	
A number of firms did not comply with the ethical and independence requirements in CoE. Examples include: a. Provision of internal control review services over financial reporting. b. Practising partners/directors acting as the directors of audit clients.	a. Do not provide prohibited non-assurance services to audit clients. b. Establish policies and procedures to evaluate the level of independence threats and effectiveness of actions, individually or in combination, that the firm could take to reduce the independence threats to an acceptable level before acceptance of non-assurance services. c. Evaluate the robustness of established policies and procedures to mitigate risks of breaching fundamental principles and independence requirements as required by the CoE.

Category B and C firms *(Continued)*

Key significant findings	Expected actions by firm leadership
Engagement performance	
Significant recurring findings were identified with multiple firms where there were insufficient direction and supervision of audit engagements and ineffective reviews. Multiple firms have findings in audit documentation, including: a. One firm altered archived working papers with sign-offs backdated, indicating potential misconduct issues. b. One firm issued auditor's reports for a few non-PIE audit clients with no evidence of audit work performed on material items. c. One firm did not complete the final file assembly of a number of engagements (both PIE and non-PIE engagements) within the 60 days rule as required by HKSQM 1 and HKSA 230 *Audit Documentation*.	a. Establish policies and procedures to ensure sufficient partner/direct supervision and reviews, e.g., standardized review procedures for areas involving significant judgment and estimation. b. Develop monitoring procedures for partner/director workload, especially for audits with a higher-risk or of a larger-size. c. Establish appropriate policies, procedures, and controls to ensure completeness, timeliness, and integrity of audit documentation by reference to our publications The Importance of Audit Documentation Integrity and Inspection Insights.

Category B and C firms *(Continued)*

Key significant findings	Expected actions by firm leadership
Resources	
Two firms did not have a quality-orientated recognition and accountability framework for director and staff performance evaluation, remuneration, and career progression decisions. One firm did not establish policies and procedures to monitor the heavy workload of two directors. These two directors were responsible for the operational responsibilities of the firm's SQM and a significant number of PIE and non-PIE engagements. Engagements completed by these two directors, either in the capacity of engagement director or EQR, were subject to our 2023 inspections, with significant findings identified.	a. Develop a robust performance evaluation mechanism to hold audit partners/directors and staff accountable for their actions and behaviors. b. Develop robust policies and procedures to monitor partner workload, specifically ensuring the engagement partners and EQR have a reasonable workload that allows them to dedicate sufficient time to perform quality audits.
Monitoring & remediation	
Two firms did not effectively remediate all the deficiencies identified in the previous inspections. This indicated that either the design of remedial actions was not effective or there was a failure to implement the actions according to the remediation plans submitted to the AFRC.	a. Perform an effective RCA by reference to An External Auditor's Guide to Performing Root Cause Analysis. b. Assign an independent coach to perform the RCA in order to identify the actual root causes and to design appropriate remediation actions. c. Evaluate the effectiveness of the design and implementation of the RCA and remediation plans to avoid recurrence of deficiencies.

Annex 3

Key considerations for auditors in addressing the need for IT audits

Factors influencing the complexity of client's IT environments, affecting the need for IT audits

1. Audit clients operating in industries such as financial services, retail, manufacturing, food and beverage, and hospitality often require IT audits in response to the elevated risks from the greater complexities in their IT environment. In planning audit procedures in response to IT complexities and IT risks, auditors should consider the following key factors in the clients' IT environment that contribute to the necessity of an IT audit:

   a. Significant volume of transactions.

   b. Large number of data inputs, complex interfaces and complex calculations with underlying automation.

   c. Heavy reliance on an application to process or maintain data and/or perform automated controls.

   d. Custom-developed applications or more complex systems with significant customization.

   e. Heavy reliance on system-generated reports for their daily operations.

2. These elements should be considered for industries beyond the ones mentioned above. Effective IT audits that address these key factors can provide audit clients with the transparency, quality assurance, and confidence they need to navigate the increasingly complex and technology-driven business landscape.

Considerations in the use of IT audit service providers

3. When IT audits form part of the overall audit strategies in response to the assessed IT risks, firms may engage IT audit service providers to perform certain IT audit procedures. This may include identifying, testing and evaluating relevant IT general controls and IT application controls, or substantively test IT process activities. Firms should meticulously consider the following factors when leveraging the expertise of IT audit service providers:

   a. Conduct a thorough research to identify reputable providers with proven expertise and a track record of conducting comprehensive IT audits.

   b. Carefully assess the competence, capabilities and objectivity of the IT audit service providers to ensure the necessary procedures aligned with the firm's overall strategy.

   c. Clearly define the scope of work, covering areas such as data security, network infrastructure, and IT governance, to ensure that the IT audit service provider's efforts are tailored to address the specific needs and risks of the client.

   d. Closely evaluate the testing results and assess the implications for the overall financial statement audit, ensuring the IT audit findings are seamlessly integrated into the broader audit process.

Strategic approaches and long-term considerations for IT audits

4. In the long run, to enhance audit efficiency and effectiveness of audit processes in response to the escalating IT risks, firms should focus on strategically developing or strengthening their in-house IT audit talent. This can be achieved through a multi-faceted approach:

   a. Identify existing staff members with suitable aptitudes and relevant experience in areas such as security operations, IT administration, and infrastructure management, and consider transitioning them into specialized IT audit roles.

b. Nurture engagement team members who possess the potential to excel in IT audit functions and provide them with comprehensive training and continuous development opportunities to hone their skills.

c. Actively encourage interested staff to pursue professional certifications, such as the Certified Information Systems Auditors credential, to deepen their expertise and stay abreast of evolving industry standards and best practices.

d. Recognize that developing a robust IT audit talent pool is an ongoing process that requires sustained commitment and long-term strategic planning.

e. Invest in comprehensive, firm-wide learning and development initiatives to ensure the continuous enhancement of the firm's IT audit capabilities.

5. When assessing the long-term cost and benefit of IT audits, firms should consider a range of factors including:

a. Cost savings from the reduction of manual audit procedures, as IT can automate and streamline various processes.

b. Limitations on performing substantive procedures alone, highlighting the need for IT audits to ensure the integrity and reliability of data from IT systems.

c. The essential role of IT audits in addressing IT-related risks, as required by HKSA 315 (Revised 2019) (2023) *Identifying and Assessing the Risks of Material Misstatement.*

Annex 4
Glossary

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

ACMI	AML/CTF compliance monitoring inspections
AML	Anti-money laundering
AML Guidelines	Guidelines on AML and CTF for professional accountants as set out in Chapter F of the CoE issued by HKICPA
AMLO	Anti-Money Laundering and Counter-Terrorist Financing Ordinance
AQR	Audit quality ratings
CDD	Client due diligence
CMR	Securities and Futures (Client Money) Rules
CoE	Code of Ethics for Professional Accountants
CSR	Securities and Futures (Client Securities) Rules
CTF	Counter-terrorist financing
ECL	Expected credit losses
EQR	Engagement quality reviewers
HKICPA	Hong Kong Institute of Certified Public Accountants
HKICPA QMS Manual	Quality management manual template issued by the HKICPA
HKSA	Hong Kong Standard on Auditing

HKSQM 1	HKSQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*
HKSQM 2	HKSQM 2 *Engagement Quality Reviews*
IFC	International financial centre
INC Department	Investigation and Compliance Department
IT	Information technology
ML	Money laundering
non-PIE	non-public interest entity
PIE	Public interest entity
PN820	Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries*
PPTA	Persons purporting to act
QMS	Quality Management Standards, consist of HKSQM 1, HKSQM 2 and HKSA 220 (Revised) *Quality Management for an Audit of Financial Statements*
RCA	Root cause analysis
SFC	Securities and Futures Commission
SQM	Systems of quality management
TF	Terrorist financing

Contacts

If you have any enquiries 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