Inspection Insights

Inspection

30 November 2023

Overview of 2023 inspections to-date

Purpose of the Inspection Insights

The purpose of the Inspection Insights (**Insights**) is to provide observations from our 2023 inspection work to-date and share our insights with all firms, and achieve high audit quality. It is important to note that we have only conducted a portion of the planned systems of quality management (**SoQM**) and engagement inspections, including both PIE and non-PIE engagements. The statistics of key common findings and audit quality ratings by each category of firms will be presented in the 2023 Annual Inspection Report in the first half of 2024/25, in order to provide comprehensive results for the full year.

The Insights aim to provide valuable information to practitioners so that they can learn and take immediate action to improve audit quality. We also encourage audit committees to discuss the Insights in the planning meetings with their auditors before the financial year-end audits begin. We are committed to making this information more insightful for the auditors, directors and audit committees. Therefore, the Insights in the second inspection cycle, replaced our previous publication of Interim Inspection Report. This enhancement further strengthens our commitment to delivering valuable insights to the public interest stakeholders. The following are the action that we expect practitioners to take:

- **Robustness of risk assessment process for an effective SoQM**
  Conducting a thorough analysis of quality risk factors is imperative as it forms the foundation of an effective SoQM, which, in turn, supports the quality performance of each individual engagement within the firms.

- **Importance of thorough risk identification and assessment**
  Accurately identifying and assessing the risks of material misstatement is vital. It enables auditors to develop effective audit strategies that address potential errors or fraudulent activities.

- **Effectiveness of engagement partners and engagement quality reviewers (EQRs)' reviews**
  Engaging experienced auditors to perform comprehensive reviews is essential for driving good audit quality. These reviews serve as key checkpoints, ensuring that audit procedures and conclusions meet the required standards and identifying any areas of deficiencies.

- **Enhancement of integrity and quality of the audit documentation**
  Maintaining high standards of integrity and quality in audit documentation is fundamental. Well-documented and organized audit records provide support for audit findings, conclusions, and opinions. They also enhance the learning experiences of staff and contribute to efficient review processes by internal reviewers and regulators.

Systems of Quality Management inspections

The Insights reflect the observations we have made to-date concerning the first-year implementation of the new Hong Kong quality management standards (**QMSs**). Our inspections revealed that a majority of the firms have deficiencies in complying with the new standards, particularly in the risk assessment processes which are newly introduced under the QMSs.

Quality management findings are systemic in nature and generally relevant to the firms' audit practices. Consequently, there is a direct correlation between engagement level findings and quality management findings. Deficiencies in the firms' SoQM can have an impact on the environment for individual audit engagements and the internal monitoring of audit engagements. Therefore, it is critical for firms to take robust action to ensure the thorough and effective implementation of QMSs.

During 2022, two surveys were conducted to assess the readiness and monitor the implementation progress of QMSs among all PIE auditors before the new standards became effective. Despite frequent reminders and surveys to auditors, we found that Category B, C and D firms inspected to-date have underestimated the importance of developing a robust SoQM and have not allocated sufficient time and resources for its development. In particular, they have not assigned appropriate individuals to oversee the design and implementation of the SoQM. One particularly concerning finding was the discovery of a Category C firm that showed ignorance of the new standards by failing to perform any risk assessment for the implementation of their SoQM. This lack of understanding and investment in risk-based quality management can have negative implications for the reputation and overall audit quality of the firm.

It is crucial for each firm's leadership, including Chairpersons, Managing Partners and Quality Control System Responsible Persons (**QCSRPs**), to recognize the importance of a well-developed SoQM. They should understand that devoting the necessary resources to its development and monitoring its effectiveness directly impacts the firm's risks, overall audit quality and reputation in the long term.

Engagement inspections on Licensed Corporations

Following the further reform in October 2022, we have expanded our non-PIE engagement inspections from the six Category A firms to the other categories of firms. By applying the principle of proportionality and a risk-based approach, we have selected the non-PIE engagements based on an assessment of impact on public interest arising from the risks of audit quality. This includes licensed corporations registered under The Securities and Futures Commission (**SFC licensed corporations**), which constitute a significant portion of Hong Kong's audit landscape with over 3,200 entities. From over half of the licensed corporations inspected to-date we found audit deficiencies in performing sufficient work to support the assurance of compliance with the Securities and Futures Ordinance (**SFO**).

We have been taking a progressive approach for our inspections on the non-PIE practice units. This approach attempts to balance the need for accounting firms to go through the transition and adapt to the new regulation and the need to protect the public interest. We strongly encourage all non-PIE practice units to watch the video relating to our inspection of non-PIE practice units which will be published on our official website in November, to get prepared for upcoming inspections. We will continue to maintain close collaboration with the SFC to monitor any potential non-compliance with the SFO.

Anti-Money Laundering and Counter-Terrorist Financing compliance monitoring inspections

As a member of the Financial Action Task Force (**FATF**), Hong Kong is dedicated to upholding a strong Anti-Money Laundering (**AML**) and Counter-Terrorist Financing (**CTF**) regime in alignment with the FATF's international standards. Recognizing the importance of robust risk-based supervision in the accounting sector, we have devoted our effort to AML/CTF compliance monitoring inspections (**ACMI**), to ensure the effective implementation of robust AML and CTF controls by the accounting profession in Hong Kong. This proactive approach aims to mitigate the adverse effects of criminal activities and promote integrity and stability in the financial markets. We strongly urge auditors to have continuous professional development training in order to fulfill their obligations in detecting money laundering and terrorist financing risks and recognise their important role in safeguarding Hong Kong as an international financial centre.

Importance of firm culture on integrity and commitment to audit quality

Firm culture remains a fundamental pillar in driving high-quality audits that inspire trust and confidence in the capital markets. To fulfill our regulatory responsibilities to protect the public interest, we hold not only the QCSRPs but also each firm's Chairpersons and Managing Partners accountable for setting the right tone at the top and effectively communicating the quality commitment and areas required for improvement to the engagement teams, ensuring overall audit quality, including an effective SoQM, and cooperation during the inspection process. Any behaviour that obstructs the inspection process, such as withholding full access to audit documentation or supplemental information after the completion of fieldwork, would cause negative consequences including prolonged or more frequent inspections, investigations, and disciplined actions, if any.

As discussed in our briefing session with QCSRPs of registered PIE auditors in September 2023, we are adopting a carrot-and-stick approach in our second inspection cycle. We have reduced the number of engagement inspections for firms with a substantial improvement in audit quality in the first inspection cycle, whilst we have initiated special inspections on PIE auditors with unsatisfactory inspection results. This is consistent with our proportionality approach in order to ensure that PIE auditors promptly address deficiencies in the audit quality of their engagements while not compromising the public interest.

Looking Forward

Looking ahead, we continue our inspections to monitor practice units in their duties to uphold the quality of audits and financial reporting by urging firms to continuously improve their SoQM and establish a quality-based recognition and accountability framework in performance evaluation, remuneration and career progression decisions.

We will progressively direct our regulatory powers and efforts to the non-PIE practice units and ACMI, as mentioned earlier.

With the rapid changes in technology, particularly when sophisticated IT systems are used by companies or when automated audit tools and techniques are used by firms, auditors should embrace these challenges by maintaining their professional competence and due care. On the other hand, we are also aware of the limited technological resources used by the firms we inspected to-date. It is important for each firm's leadership to recognize the values of technology, which include enhancing audit efficiency and attracting young talented professionals. As such, firm's leadership should consider how the financial resources are managed and the operational priorities are set in order to demonstrate the firm's commitment to quality.

Additionally, to align with the global focus on the climate change and the increasing need of the assurance services in relation to the Environmental, Social and Governance (**ESG**) reporting, firms should prioritize the talent development programs to upskill professionals in the accounting profession. In coming years, we will consider how auditors assess climate-related risks in the financial statement audits and climate-related disclosures, with the latter in accordance with requirements and standards set by relevant regulators and agencies, such as the Stock Exchange of Hong Kong Limited and the International Sustainability Standards Board (**ISSB**).

Last but not least, the right tone from the top, a culture of audit quality, and a good reputation for firms are vital for attracting talented professionals. This, in turn, helps sustain audit quality in the long term.

Highlights of 2023 inspection progress

The inspections conducted in the first half of 2023 have revealed that a majority of the engagements inspected so far have significant deficiencies. These deficiencies are largely consistent with the inspection findings identified during our first inspection cycle from 2020 to 2022. In this report, we will highlight the key findings from our inspections to-date during 2023.

2023 inspections to-date
(as of the end of September 2023)

20 PIE engagements inspected

- Category A[1]: 6
- Category B[1]: 9
- Category C[1]: 5

22 non-PIE engagements inspected

- Category A[1]: 1
- Category B[1]: 4
- Category C[1]: 5
- Category D[1]: 4
- Category E[1]: 8

We are progressively implementing our non-PIE inspection function.

Our risk-based selections of non-PIE engagements mainly focused on entities with more public interest.

11 SoQM inspected

- Category B[1]: 4
- Category C[1]: 5
- Category D[1]: 2

Our inspections focus on the firms' risk assessment process and how firms design appropriate responses to address their risks.

12 ACMI conducted

- First year inspection starting from 2023
- Risk-based approach is adopted
- Designated team is assigned to perform ACMI

Follow-up and Special Inspections – In progress
on firms or engagements with high risks of audit quality

[1] 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.

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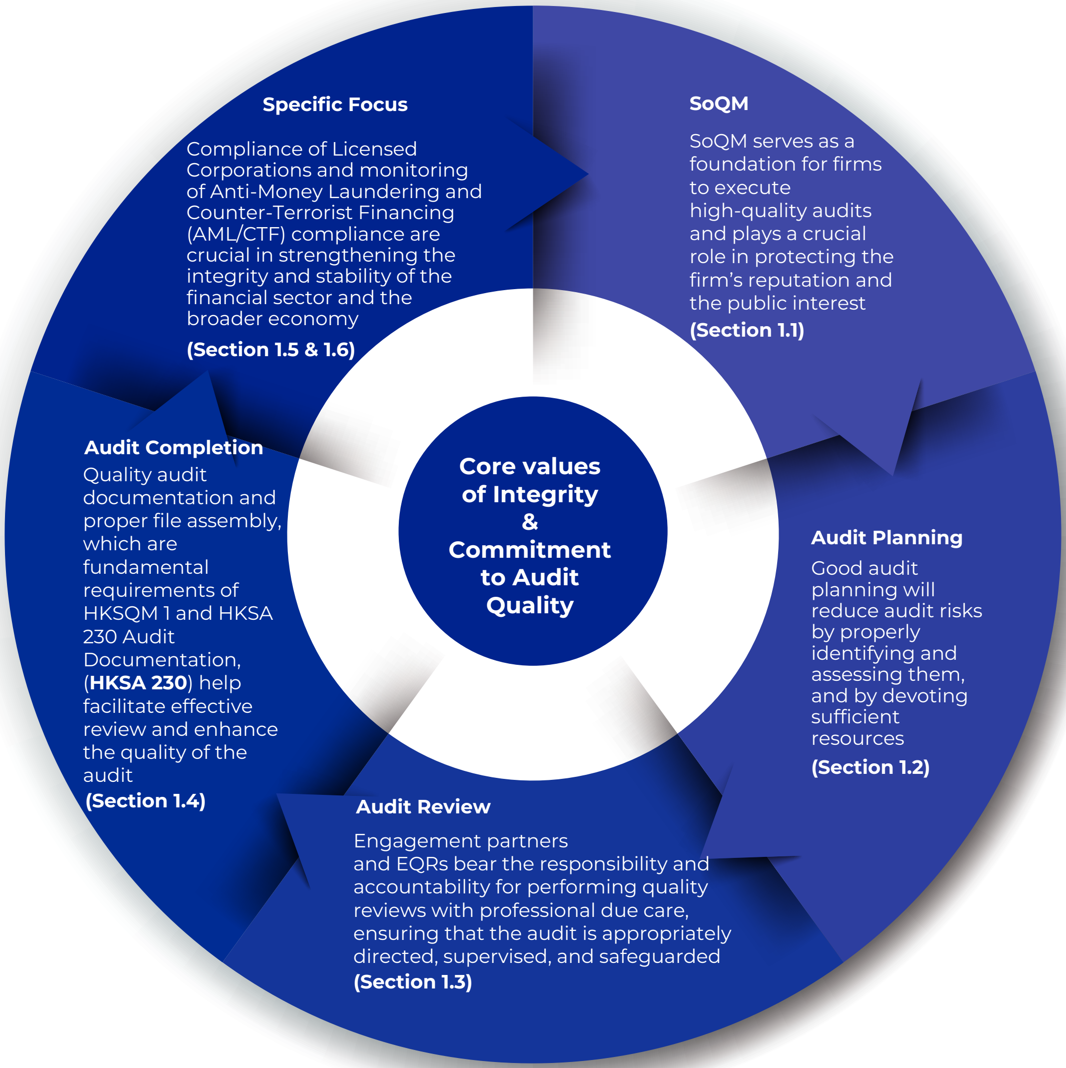
Section 1
Key insights from 2023 inspections to-date

The audit profession plays a vital role in promoting trust and confidence in financial reporting and therefore auditors should always uphold professional competence and due care, with the core values of integrity and commitment to audit quality. These Insights provide guidance to the key aspects of the audit that firm's leadership, including Chairpersons and Managing Partners, should consider when designing and implementing policies and procedures for quality management at the firm level and each individual engagement level, and will ultimately contribute to the audit quality and the reliability and transparency of financial reporting.



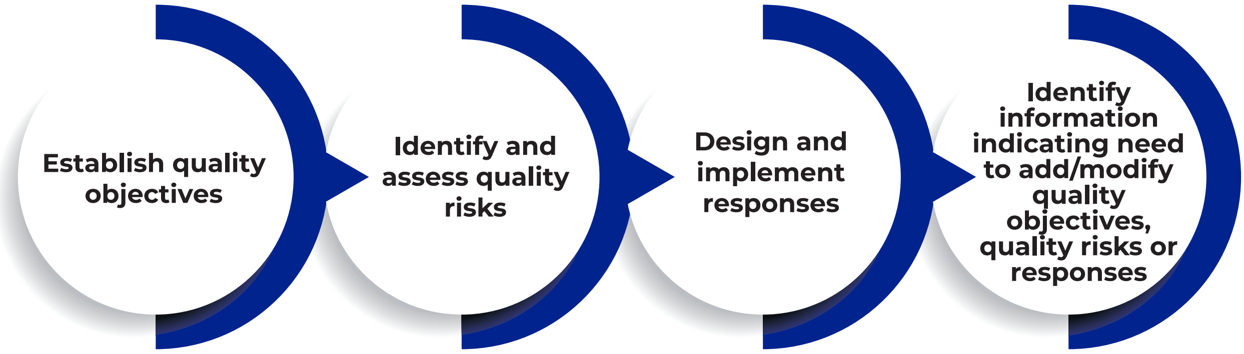
1.1 Development of systems of quality management

HKSQM 1 mandates a quality risk management process that prioritizes quality in audits and assurance engagements for all firms. It requires firms to review their SoQM to identify relevant risks affecting audit quality and establish controls that effectively address those risks. Implementing HKSQM 1 may require significant changes and enhancements to the firms' SoQM. We strongly emphasize the importance of SoQM because it is expected that a thorough implementation of HKSQM 1 will enhance audit quality over time.

A proactive, dynamic, risk-based quality management approach is pivotal to improving audit quality.

A robust risk assessment is a key for supporting an effective SoQM.

During our 2023 inspections, we focused on assessing the design and implementation of each firm's SoQM in accordance with the requirements of HKSQM 1. HKSQM 1 requires the completion of an evaluation by the firm one year from the effective date of SoQM implementation. Therefore, we will evaluate the operating effectiveness of the firm's SoQM based on the internal evaluation results starting from 2024.



Key observations on the design and implementation of the SoQM of certain Category B, C and D firms inspected in the inspections to-date are as follows.

a. Most Category B and C firms did not perform a robust risk assessment

HKSQM 1 requires firms to design a quality management system tailored to the nature and circumstances of the firms and engagements they perform. In our 2023 inspections to-date, we observed that around 70% of the Category B, C and D firms inspected have adopted the HKICPA's Quality Management Manual which was released in September 2022. Half of these firms have not tailored the quality risks and responses to their own firms' nature and circumstances, including factors such as the firm's structure, organization, business strategy, and client portfolio.

A Category C firm had not performed the risk assessment process, which indicates a serious lack of readiness in implementing the SoQM.

We expect firm's leadership to dedicate the necessary resources to develop and monitor the effectiveness of the SoQM.

b. One Category C firm has not even started its risk assessment process

It is concerning that a Category C firm had not even started its risk assessment process by the time of our inspection, which constitutes non-compliance with the QMSs. The firm's leadership did not obtain an understanding of the requirements of QMSs. Such actions and behaviours reflected a lack of commitment from firm's leadership to quality. The significant deficiency identified in its SoQM is directly correlated with the unsatisfactory quality of engagements performed by the firm.

We will initiate appropriate actions proportionate to the degree of deficiencies against any firm for its non-compliance with QMSs.

Focus Areas

SoQM – Risk Assessment Process

Identifying and assessing the quality risks properly

- Certain key risks impacting the quality objectives of the firms were not identified, for example, quality risks arising from the use of service providers, which may include using a component auditor that is not within the firm's network or an auditor's external expert or an external monitor.
- The basis for identifying quality risks, including the likelihood of occurrence and impact to the firm, was lacking.
- The identified quality risks did not consider the specific circumstances of the firms due to the adoption of the HKICPA's Quality Management Manual without modification.

Designing appropriate responses in their risk assessment processes

- Inadequate or irrelevant responses were formulated that could not effectively address the identified risks, for example, on the ongoing monitoring activities.
- There were no established policies and procedures in place to support the designed responses, for example, for the use of resources including an auditor's external service provider.
- The mapping between the risk assessment and the responses to the quality risks was absent.

The list below does not attempt to cover all areas of components under the SoQM. Instead we focuses on certain specific components of the Category B, C and D firms inspected to-date. The full inspection results will be presented in the 2023 Annual Inspection Report.

Specific component	Key observations
Governance and Leadership	❖ Did not demonstrate how the firms' leadership dedicates necessary senior resources to develop and monitor the firm's SoQM effectively. ❖ Did not demonstrate how the firms' strategic decision-making process could directly or indirectly affect the firms' commitment to quality. ❖ Did not have a process in place to communicate on a regular basis the examples and demonstrations of positive values and behaviour.

Specific component	Key observations
Use of service providers	❖ Did not identify the quality risk and design different policies and procedures to address the action of the individuals external to the firms during the performance of an engagement. ❖ Did not sufficiently consider and evaluate the nature of resources provided by service providers, as well as how and to what extent they would be utilized by the firms. This failure could hinder the identification and assessment of quality risks related to the use of such resources.
Ongoing monitoring and remediation process	❖ Did not establish or sufficiently design ongoing monitoring activities to effectively monitor audit quality and respond to possible systemic deficiencies related to the performance of audits.
Information and communication	❖ No sufficient policies and procedures in place to effectively communicate information to external service providers or network firms, thus hindering the proper functioning of resources. ❖ Did not establish policies and procedures that require communication with those charged with governance regarding how the SoQM supports the consistent performance of quality audit engagements.

Key insights for auditors

- Clearly define the firm's mission, vision, and core values to demonstrate a strong commitment to quality. Hold firm's leadership, including Chairpersons and Managing Partners or equivalent, accountable for the effective implementation of SoQM, even when utilizing external resources from service providers.

- Conduct a comprehensive and robust risk assessment that takes into account factors such as the firm's structure, business models, and available resources, including human resources, technological resources, and service providers.

- Develop a detailed plan and strategy to allocate and utilize resources, including human resources, technological resources, intellectual resources and service providers, effectively, ensuring that the quality objectives are met.

- Establish an ongoing monitoring process, rather than relying on one-off assessments, to continuously evaluate the operating effectiveness of the SoQM. This will enable timely identification of deficiencies and allow for prompt corrective action.

- Establish appropriate forms of communication with external parties, including those charged with governance. This communication can take various forms, such as written audit quality reports that communicate the firm's audit quality indicators or internal/external inspection findings.

1.2 Proper identification and assessment of the risk of material misstatement

Performing a high-quality risk identification and assessment, which include a robust evaluation of inherent risk factors (including fraud risk factors) and control risk factors, is essential in the financial statement audits.

The occurrence of potential fraud, leading to material misstatements in the financial statements and/or non-compliance with laws and regulations, has become of increasing concern to all stakeholders, especially investors. Auditors have a clear responsibility to identify, assess and appropriately address fraud risks during audits of financial statements. To provide greater assurance to users of financial statements, auditors should enhance their approach to risk assessments as required by HKSA 315 (Revised 2019) (2023) *Identifying and Assessing the Risks of Material Misstatement* (**HKSA 315**).

In July 2023, we issued Audit Focus – Importance of Effective Audit Planning[2] urging auditors to take a proactive approach and commence the audit planning process well in advance of the financial year-end. Effective audit planning is the key to ensuring high-quality audits.

Focus Areas

Risk Assessment Process in identifying significant risks of material misstatement at the financial statement level or assertion level

- Identify the related risk of material misstatements that may arise from the entity's use of information system, and the relevant controls in the entity's IT processes that address such risks.
- Identify possible fraud risk factors resulting from unusual changes in the business model or significant transactions that are outside the normal course of business. Failure hinders the design of appropriate audit procedures to address such risks.
- Obtain a comprehensive understanding of the control environment and control activities, as well as to identify the key controls that are relevant to the audits.

A robust analysis of risk factors is vital in performing risk assessments as it serves as a foundation for designing and implementing an effective Audit Strategy.

This helps to provide greater assurance to stakeholders by ensuring that the financial statements are free of material misstatements.

[2] AFRC, Audit Focus Effective Planning: The Key to High-Quality Audits, 31 July 2023, https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/2023_Audit_Focus_Effective_Audit_Planning.pdf

Key insights for auditors

- ✦ Devote sufficient time and resources during the risk assessment process to develop a good audit plan.

- ✦ Perform a more robust risk assessment process by:
  a. Obtaining sufficient appropriate evidence as the basis for the risk assessment.

  b. Evaluating fraud risk factors by considering incentives or pressure to commit fraud, perceived opportunities to do so, and any rationalization for committing fraudulent acts.

  c. Evaluating the specific revenue streams or assertions that give rise to fraud risks.

- ✦ Obtain evidence regarding the design and implementation of the entity's internal controls over significant transactions that are outside the normal course of business. Particular attention should be given to the possibility of management override.

- ✦ Engage IT specialists to assist in identifying IT applications and other aspects of the entity's IT environment that are susceptible to risks arising from the entity's use of IT. Additionally, involve them in testing general IT controls and automated controls within the IT applications.

- ✦ Recognize the auditors' duties and responsibilities to report significant matters to regulators if they come to the auditor's attention. This includes breaches in laws and regulations that are relevant to the regulators.

1.3 Effective reviews by engagement partners/engagement quality reviewers

To achieve the quality objective, firms have a responsibility to establish policies and procedures that promote and monitor the effectiveness of reviews conducted by engagement partners and/or EQRs. We emphasize the observations regarding the performance of engagement partners or EQRs to urge firms to enhance their policies and procedures regarding engagement reviews with professional diligence.

Ineffective reviews conducted by Engagement Partners and EQRs continue to be a significant area of concern regarding deficiencies.

Firms must cultivate a culture that reflects their commitment to quality and timely reviews.

Focus Areas

Ineffective supervision and review

- A failure to identify audit deficiencies related to significant risks that were later identified by our inspectors.
- Insufficient evidence of how the EQRs evaluated or reviewed the significant judgments made by engagement teams and the conclusions reached, except for a signed EQR completion checklist.

Key insights for auditors

✦ Implement ongoing measures to monitor the workloads and areas of expertise of partners, ensuring that engagement partners or EQRs are appropriately assigned with sufficient competence, independence, integrity, and objectivity to fulfill their roles.

✦ Establish an audit milestone program that outlines specified completion timelines for key audit activities and requirements on the audit hours allocated to engagement partners and EQRs. This program aims to promote timely reviews before the financial year-end of audit clients.

✦ Develop a set of audit quality indicators and establish programs to hold engagement partners and EQRs accountable for audit quality. This may include implementing rewards or disciplinary action, as appropriate, for reviewers when internal or external inspections reveal significant audit deficiencies or commendable practices.

1.4 Integrity and Quality of Audit Documentation

HKSQM 1 requires that firms establish policies and procedures to ensure the prompt completion of the assembly of engagement files and to uphold the integrity, accessibility, and retrievability of engagement documentation.

Timely and thorough preparation of sufficient and appropriate audit documentation is essential for enhancing the quality of the audit and facilitating an effective review and evaluation of the audit evidence obtained. This process must be take place before the auditor's report is finalized.

During our inspections, we have observed certain deficiencies in the file assembly process. These include:

We have ZERO tolerance regarding auditors engaging in unauthorized alterations of audit documentation.

The AFRC has the authority to impose sanctions on professionals who have engaged in misconduct, including cancellation or non-issuance of a practicing certificate.

Specific areas	Key observations
Improper alteration of archived working papers	❖ One instance where the engagement team created and completed certain working papers after the file assembly date, followed by backdating them before the auditor's report date. This practice is a breach of the Code of Ethics for Professional Accountants issued by HKICPA (**CoE**), as it creates the false impression that the working papers were prepared and approved by the engagement team during the audit. ❖ Insufficient information regarding a. the reasons behind the additional working papers for the audit procedures conducted, the conclusions reached, and their impact on the auditor's report; and b. the timing and individuals responsible for making and reviewing these changes.
Failure to control the accessibility or retrievability of final file	❖ Several instances where engagement team members retrieved manual working papers without proper authorization. This indicates a lack of adherence to established protocols and controls regarding access to working papers. ❖ Insufficient records or documentation regarding the retrieval of working papers, resulting in a loss of information in the final audit files. This can impede the ability to trace and understand the audit procedures performed and the conclusions reached.
Insufficient audit documentation to evidence the auditor's work	❖ Did not sufficiently document the extent of audit procedures performed, for example: a. Insufficient documentation of justifications for significant judgments made during the audit. b. Inadequate details regarding the supporting documents inspected during the audit, such as abstracts of contract terms or copies of agreements. c. Lack of documentation regarding the determination of sample size and the basis for sample selection.

Specific areas	Key observations
Failure to assemble all relevant working papers in the final file	❖ Did not establish policies and procedures for engagement teams to assemble compliance working papers as required by paragraph 81 of HKSAE 3000 (Revised) Assurance Engagements Other than Audits or Reviews of Historical Financial Information (**HKSAE 3000**). ❖ Inadequately assembly of audit documentation in accordance with paragraph 14 of HKSA 230. These include instances where the following items were not appropriately assembled: a. Group engagement team's referral instructions to component auditors. b. Signed valuation reports of management's experts. c. Communication with those charged with governance.

Key insights for auditors

- ✦ Strengthen Controls: Implement stronger controls, both in IT systems and manual procedures, to prevent backdating or altering working papers after the file assembly date. This ensures the integrity of the documentation.

- ✦ Enhance Policies and Procedures: Develop clear policies and procedures to control access to and retrieval of audit files. Keep proper records of file access and establish guidelines for maintaining the accessibility and retrievability of audit files.

- ✦ Check File Completeness: Before completing the file assembly process, establish procedures to verify the completeness of all audit documentation. Use checklists or review processes to ensure that all required working papers, including significant judgments, supporting documents, and communications, are included in the final audit files to avoid loss of information.

- ✦ Publish guidelines for the requirement of audit documentation: The audit documentation must be compiled in a way that allows an external reviewer/inspector to be able to understand and, if necessary, reperform the audit work. Final audit files must be kept and maintained properly in place that are readily available for external inspections from time to time.

1.5 Non-PIE engagement inspections of licensed corporations

Our risk-based approach to non-PIE engagement inspections primarily focuses on entities with a greater public interest, including SFC licensed corporations. The scope has expanded to include Category B, C and D firms in addition to Category A firms that were covered in the 2022 annual inspection.

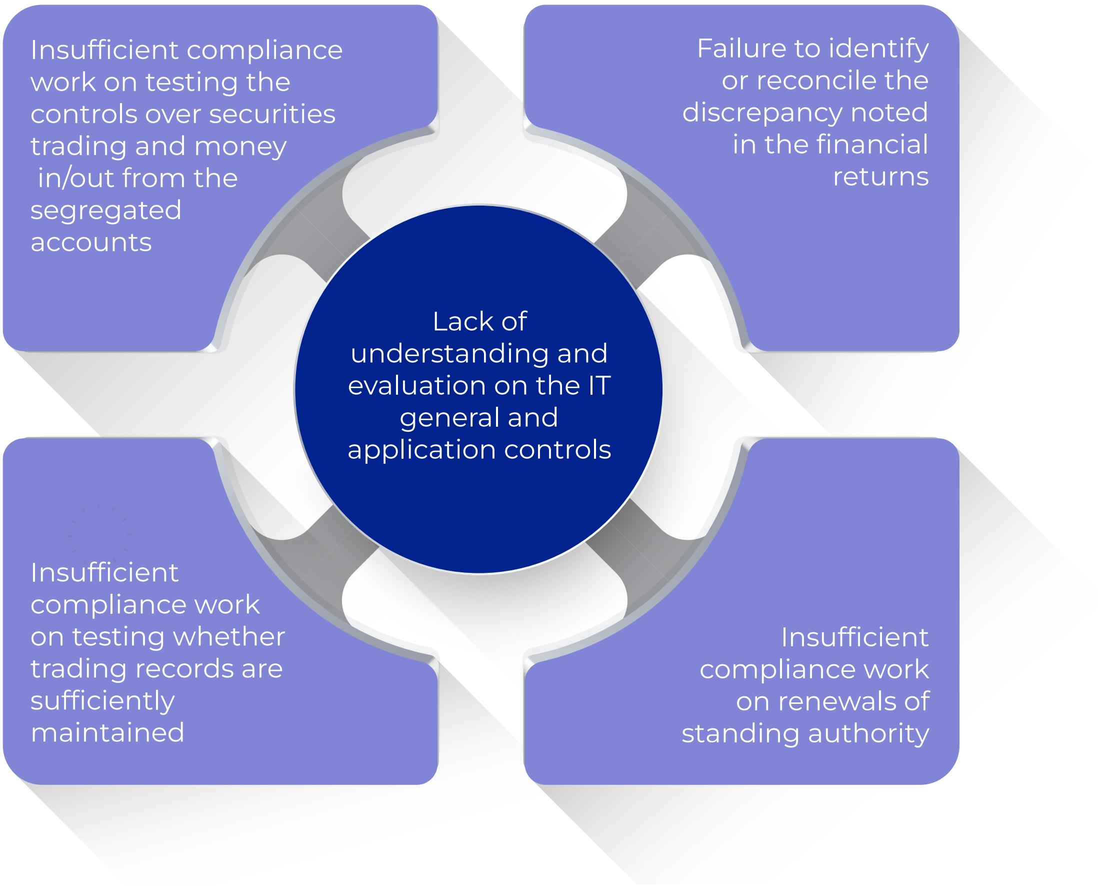
Auditors of licensed corporations have an important role in protecting client securities and monies. They are required to perform sufficient work to support their conclusions in the compliance reports and their opinions in the auditors' reports. These reports are critical in ensuring the compliance of licensed corporations with the relevant requirements under the SFO.

During our inspections, we primarily examine key reporting matters in the compliance reports and review the corresponding auditor's reports and related engagement documentation.

Over half of the licensed corporation engagements inspected to date have been found to have deficiencies related to auditors' compliance work, and most of them were related to "insufficient work on renewals of standing authority".

Non-PIE practice units should always carry out sufficient work and document such to support their assurance reports.

Based on our inspections, we have identified common deficiencies in licensed corporation engagements. It is imperative for firms to take immediate action to ensure that engagement team members performing audits or compliance work for licensed corporations possess sufficient expertise to design and execute appropriate procedures that support their conclusions on the compliance work relating to the relevant SFO requirements.



Focus Areas

Compliance work of auditors

Many of the deficiencies found in the audit of licensed corporations were related to HKSAE 3000 and the Practice Note 820 (Revised) "*The Audit of Licensed Corporations and Associated Entities for Intermediaries*" (**PN820**) issued by the HKICPA.

For compliance work in relation to licensed corporations, HKSAE 3000 requires auditors to obtain reasonable assurance regarding compliance with specific rules, such as the Securities and Futures (Client Money) Rules (**CMR**), (Client Securities) Rules (**CSR**) and (Keeping of Records) Rules (**KRR**). PN820 provides guidance on the expected procedures to be performed, unless alternative procedures with the same testing objectives are performed by auditors.

Specific areas	Key observations
Lack of understanding and evaluation on the entity's use of IT systems	❖ Did not obtain an understanding on IT control environment of their audit clients to assess the impact of the significant use of the IT systems on the risk of material misstatements in financial statements. ❖ Did not test or sufficiently test the controls over the audit clients' IT systems upon which the design and operating effectiveness of the internal controls over compliance were dependent.
Insufficient compliance work on Financial Resources Rules compliance	❖ Did not perform appropriate procedures on the year-end submitted returns to identify the discrepancies between the monthly financial returns and the audited financial statements.
Inappropriate compliance work on CMR and CSR	❖ Did not design and perform appropriate procedures to evaluate whether the licensed corporations comply with the requirement to pay money other than client money out of segregated accounts, and payment of client money into and out of segregated accounts under sections 4, 5 and 10 of the CMR. ❖ Did not design and perform appropriate procedures on testing of controls over the deposits and transfer of securities and securities collateral in accordance with section 10(1) of the CSR.
Insufficient compliance work on KRR	❖ Did not design and perform appropriate procedures to evaluate whether the licensed corporations kept sufficient trading records, including but not limited to all monies received or disbursed and all orders or instructions concerning securities, futures contracts or leveraged foreign exchange contracts that were received or initiated.

Specific areas	Key observations
Insufficient compliance work on renewals of standing authority	❖ Did not perform sufficient procedures to ascertain whether the licensed corporation had timely renewed the client's standing authority to ensure compliance with section 8(4) of CMR and section 4(4) of CSR by giving its clients written notices confirming the renewal of the standing authority to the clients within one week after the expiry date.

Key insights for auditors

- ✦ Ensure all engagement team members, including the engagement partner and engagement quality reviewer, have the necessary knowledge, experiences, and are familiar with the relevant laws and regulations under the SFO.
- ✦ Establish robust policies and procedures for conducting pre-issuance reviews to ensure the work performed complies with HKSAE 3000.
- ✦ Map the procedures performed during the engagement to the guidance provided in PN820 to ensure that the work conducted is sufficient and appropriate.
- ✦ Engage an IT specialist when necessary to test the IT general and application controls in order to ensure the reliability of the information generated from the system.
- ✦ Provide adequate training to audit staff on the relevant rules and regulations of the SFO, as well as on how to design and perform appropriate procedures related to compliance work.

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

Auditors play an important role in safeguarding against, deterring, and detecting money laundering and terrorist financing. Professional accountants are bound by the CoE to conduct themselves with integrity and professionalism and to act in the public interest, not only the interests of their clients.

The reason for launching ACMI in our 2023 inspections of practice units is to ascertain whether firms have observed, maintained or applied the Guidelines on AML and CTF for professional accountants as set out in Chapter F of the CoE. Adequate "know your client" procedures are expected to be executed by firms as a front-line procedure in identifying the potential risks of financial crime.

Understanding of AML/CTF requirements

AML/CTF policies, procedures and controls

Suspicious transaction reporting (STR)

Staff hiring and training

Sanction screening
Mandatory to apply when performing any services specified and/or other than those specified in para 600.2.1 or 600.2.2

Client due diligence procedures (CDD)
Mandatory to apply when performing any services specified in para 600.2.1 or 600.2.2

Ongoing monitoring

More than 50 number of findings were observed from 12 ACMI conducted to-date. Such high rate of deficiencies reveals that many practice units are not giving sufficient attention to AML and CTF Guidelines.

Approximately 30% of the deficiencies are related to the policy setting and execution of sanction screening.

Specific areas	Key observations
Insufficient AML/CTF policies and controls	❖ Did not develop and maintain a set of appropriate and specific AML/CTF policies, procedures and controls. ❖ Did not execute the firm-wide ML/TF risk assessment to assess the risks nor design appropriate policies, procedures and controls in response to these risks.
Lack of policies and procedures over STR	❖ Lack of policies and procedures regarding the submission of STR, resulting in a lack of understanding by the Money Laundering Reporting Officer (**MLRO**) and staff on their roles and responsibilities in identifying and reporting suspicious transactions. ❖ Did not establish a formal reporting channel and mechanism for handling STR such that the disclosure reports could reach the MLRO without undue delay.
Insufficient policies and procedures on staff hiring and training	❖ Did not provide regular AML/CTF training to staff. ❖ Did not perform name screening procedures to ensure integrity of newly hired staff.
Inappropriate sanction screening	❖ Did not conduct name checks of clients and their beneficial owners against the latest lists of designated individuals and entities before establishing a business relationship. ❖ Lack of evaluation and follow-up procedures on the results of name checks when a match was found with relevant authorities. ❖ Did not include countries subject to targeted financial sanctions.

Specific areas	Key observations
Inappropriate client due diligence procedures	✣ Did not maintain policies and procedures regarding the determination of different types of CDD procedures, including CDD, Simplified CDD and Enhanced CDD. ✣ Did not establish nor maintain effective procedures for identifying whether any audit clients or beneficial owners of the clients are politically exposed persons.
Insufficient ongoing monitoring	✣ Failure to conduct on-going name screening on the beneficial owners and any relevant individuals to ensure they are free from any connections to illicit activities. ✣ Failure to maintain the policies and procedures required for conducting regular reviews of high-risk clients' profiles to ensure CDD information remains up to date and relevant. ✣ Did not take reasonable steps to ensure that the sanction screening databases used for monthly monitoring purposes are kept up to date.

Key insights for auditors

- Apply a risk-based approach to identify and assess the ML/TF risk they may be exposed to. Determine the likelihood and potential impact of ML/TF activities and evaluate the level of risk associated with different clients, engagements, and transactions within the firms.
- Design and implement internal AML/CFT policies, procedures, and controls that are appropriate for the identified ML/TF risks. Regularly review and update these policies to address changing risks.
- Assess the ML/TF risks associated with customers or proposed business relationships, which helps determine the extent and frequency of CDD measures and ongoing monitoring required. Higher-risk customers or relationships should be subjected to more thorough screening and monitoring.

Section 2
Other key reminders to auditors

2.1 Firm culture on the importance of integrity and commitment to quality

Audit quality is foundational to instilling confidence and public trust in the capital markets and it remains our highest priority. Tone at the top, leadership and a clear set of values and conduct are essential to set the framework for quality.

Cultural environment	Firms should create an environment which demonstrates a commitment to quality through its culture and recognises its role in serving the public interest.
	This responsibility is firm-wide rather than at the individual audit level, with the chief executive or managing partner assigned the responsibility and accountability for the SoQM.
Systems and policies	Systems and policies should be in place to hold personnel accountable for their actions and behaviour that affect quality, for example on the evaluation, compensation, promotion of those involved.
	Right tone from the top should allow audit partners to challenge client judgements without fear of any negative consequences of losing the client and revenue.

Recent inspection findings	Most of the recent inspection findings were related to engagement performance, indicating inadequate policies and procedures to promote quality as an essential culture.
	The significant findings have a direct bearing on leadership's tone at the top in driving a culture of sustainable high audit quality.

2.2 Change of auditors

Firms have a responsibility to consider the public interest before making decisions about resigning from audits or accepting appointments from clients. Any change of auditors can potentially affect public interest if listed companies use the changing of an auditor as a way to influence audit opinions in their favour. Stakeholders such as audit committees, investors, and regulators should consider auditor resignations as red flags.

It is vital that the firms with the necessary expertise and capability are retained for audits. When these firms choose, or are being requested, to resign, it can have negative consequences for the audit quality and effectiveness of the audit process, impacting the public interest. Additionally, we have become aware of a concerning trend where auditors are resigning shortly after the annual general meetings of listed companies, during which they had sought re-appointment. To address these concerns, auditors and listed companies should enhance robust quality management procedures to support acceptance and continuance decisions and increase transparency to the public. Resigning immediately after seeking re-appointment can potentially undermine the confidence and trust placed in the audit profession.

The progress that has been made following the AFRC's regulatory actions is published in AFRC Addresses Concerns Surrounding Auditor Changes[3]. We will continue to monitor market developments and identify any potential misconduct arising from auditor changes.

PIE auditors and audit committees are urged to follow the recommendations and practice notes outlined in the Guidance Notes on Change of Auditors[4] published in September 2023. By adhering to these guidelines, auditors and audit committees can ensure compliance with best practices and maintain the integrity of the audit process.

2.3 Climate risks and climate-related disclosures

Both listed companies and auditors have to be aware of the proposed changes by The Stock Exchange of Hong Kong Limited regarding mandatory climate-related disclosures under the ESG framework. The proposed Listing Rules will require listed companies to enhance the climate-related disclosures and such requirements are expected to substantially aligned with the ISSB Climate-related Disclosures Standard. These proposed changes are expected to come into effect for financial years beginning on or after 1 January 2025.

In light of these developments, auditors should begin to incorporate independent assessments of climate-related risks during their risk assessment procedures. This means considering the impact of climate-related risks on the financial statements, including areas such as asset valuations. Auditors should also read the climate-related disclosures to identify if any material inconsistencies with the financial statements when these are presented within the other information in the annual reports.

By performing these assessments, auditors can contribute to the accuracy and transparency of climate-related disclosures, ensuring that relevant information is appropriately presented to stakeholders. This aligns with the growing importance of climate risk management and disclosure in the global landscape.

[3] AFRC Addresses Concerns Surrounding Auditor Changes, 28 September 2023, https://www.afrc.org.hk/en-hk/Documents/Publications/periodic-reports/AFRC_Addresses_Concerns_Surrounding_Auditor_Changes.pdf

[4] AFRC, Guidance Notes on Change of Auditors, September 2023, https://www.afrc.org.hk/en-hk/policy-and-governance-publications/guidance-notes-on-change-of-auditors/

2.4 Technology changes in audits

Technology is increasingly significant in audits whether in the IT environment of firms or their audit clients. Auditors of most Category A firms are using automated tools and techniques to make audits more efficient and improve their audit quality. For example, they use these tools to sort out any journal entries with potential fraud characteristics and check if they are appropriate. This is more effective than manually inspecting many thousands of entries. Auditors should consider the use of technology in their audit processes, which can bring numerous benefits.

While these tools have many benefits, it is important for firms to manage them carefully. They need to ensure that the inputs and outputs are reliable and that the audit procedures based on the tool's findings are appropriate to address the relevant audit risks. To address the challenges posed by rapid technological changes, firms should have appropriate policies and procedures to ensure proper development or acquisition, implementation, maintenance, and usage of automated tools and techniques. Compliance with paragraph 32(f) of HKSQM 1 is vital for performing high-quality audits.

By embracing technology and implementing proper policies and procedures, firms can harness the benefits of automated tools and techniques while upholding the integrity and reliability of the audit process.

2.5 Talent development in the accounting profession

Over the years, accounting firms have faced challenges in attracting and retaining talent in the profession. While technology innovation and audit transformation initiatives are essential, we emphasize that skilled professionals are irreplaceable when it comes to ensuring audit quality. Firms should prioritize talent development by offering continuous professional development opportunities, fostering a culture of high quality standard, providing clear career paths, offering competitive compensation and benefits, and supporting the talent with high technological resources, to attract talent to the profession.

Annex 1
Glossary

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

ACMI	AML/CTF Compliance Monitoring Inspection
AFRC	Accounting and Financial Reporting Council
AML	Anti-money laundering
AML and CTF Guidelines	Guidelines on AML and CTF for professional accountants as set out in Chapter F of the Code of Ethics (Professional Accountants) issued by HKICPA
CDD	Client due diligence procedures
CMR	Securities and Futures (Client Money) Rules
CoE	The Code of Ethics (Professional Accountants) issued by HKICPA
CSR	Securities and Futures (Client Securities) Rules
CTF	Counter-terrorist financing
EQRs	Engagement quality reviewers
ESG	Environmental, Social and Governance
FATF	Financial Action Task Force
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSA	Hong Kong Standard on Auditing
HKSA 230	HKSA 230 *Audit Documentation*
HKSA 315	HKSA 315 (Revised 2019) (2023) *Identifying and Assessing the Risks of Material Misstatement*

HKSAE 3000	HKSAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*
ISSB	International Sustainability Standards Board
IT	Information technology
KRR	Securities and Futures (Keeping of Records) Rules
MLRO	Money Laundering Reporting Officer
PIE	Public interest entity
PN820	Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities for Intermediaries*
QCSRPs	Quality Control System Responsible Persons
QMSs	New and revised quality management standards, namely, Hong Kong Standard on Quality Management 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements and Conforming Amendments to HKSAs and Related Material Arising from the Quality Management Projects*, Hong Kong Standard on Quality Management 2 *Engagement Quality Reviews* and Hong Kong Standard on Auditing 220 (Revised) *Quality Management for an Audit of Financial Statements* and the equivalent international standards issued by the International Auditing and Assurance Standards Board
SFC	Securities and Futures Commission
SFC licensed corporations	Licensed corporations registered under The Securities and Futures Commission
SFO	Securities and Futures Ordinance
STR	Suspicious transaction reporting
SoQM	Systems of quality management