



Annual Inspection Report

3 June 2021

About the FRC

The Financial Reporting Council is an independent body established on 1 December 2006 under the Financial Reporting Council Ordinance. It is entrusted with the statutory duty to regulate auditors of listed entities through a system of registration and recognition, and through inspection, investigation and disciplinary action.

The mission of the FRC is to uphold the quality of financial reporting of listed entities in Hong Kong, so as to enhance protection for investors and deepen investor confidence in corporate reporting.

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Foreword from the Chief Executive Officer

I am pleased to share with the public our Annual Inspection report, which includes the full results of our inspections of listed entity audits in our first year of inspections. The report includes the significant findings and audit quality ratings for all of the engagements we inspected, the key drivers of those ratings, and how we are responding to those findings and ratings. This report also sets out our expectation that auditors will take action to address the audit quality deficiencies we have identified to provide greater confidence to the investing public and the wider public about the quality of financial reporting by listed entities. To promote transparency and a better understanding of our work, we also provide an overview of our inspection methodology.



Our findings and expectations of auditors

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

Our inspections evaluate the quality of a selection of an auditor's engagements for listed entities and the effectiveness of the auditor's system of quality control. The FRC completed 37 engagement inspections and 18 inspections of the systems of quality control of listed entity audit firms in 2020. We found that 73%, or almost three-quarters, of the listed entity engagements that we inspected needed either improvement or significant improvement, and are therefore significantly below the high standard required of audits of listed entities. Firms of all sizes need to take robust action to address these findings and we expect audit quality results to improve substantively when appropriate measures are taken.

Our follow up actions

We will therefore be paying significant attention to the quality of the root cause analysis underpinning the remedial plan that we require each of the inspected firms to provide to us. We will expect them to provide a clear demonstration of how the remedial plan will be effective in addressing those causes and delivering substantive quality improvements as quickly as possible. We will agree a timetable for completion of the remediation steps with each firm.

Where the quality of engagements and systems of quality control inspected fell short, we are considering which follow up action(s) is the most appropriate response to our findings, from a range of possible follow up actions that include requiring the firm to take specific actions as part of their remediation and referring engagements for enforcement action.

Key drivers of our findings

The key drivers of our audit quality ratings for engagements inspected are our findings of significant deficiencies, which are broadly consistent with the types of deficiencies

identified in our recent Interim Inspection report. The lack of appropriate exercise of professional scepticism was the most common driver of poor audit quality. In 21 of the 37 completed engagement inspections, or 57%, we identified one or more findings in this area that individually had an impact on the audit quality rating due to their significance. We also identified significant deficiencies in areas relating to the auditor's response to Key Audit Matters and their evaluation of listed entities' application of accounting standards related to expected credit loss impairment.

An effective system of quality control is essential in driving consistently high quality audits and our engagement findings are a reflection of deficiencies we have found in these systems. Common deficiencies we identified relate to the allocation of resources, especially around the monitoring of partner and staff workloads to ensure teams have sufficient time to perform high quality work, and promoting an internal culture that prioritizes quality work. We also identified deficiencies in the elements of the systems of 14 of the 18 firms that should be designed to give the firm reasonable assurance over the independence of the firm and its personnel.

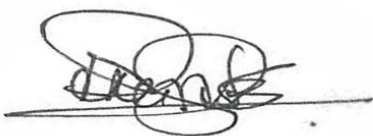
Transparency

Auditors have the primary responsibility to address the findings contained in this report, and making them public enables all firms (including those not inspected this year) to take action to make improvements to the effectiveness of their systems of quality control and in the performance of their engagements. We will hold briefing sessions with the firms we regulate to share our insights on the inspection results and our expectations of them in the future so that they can take necessary action ahead of their next audit cycle.

The role of audit committees

As we set out in our interim inspection report, audit committees have a vital role in overseeing the quality of financial reporting by listed entities and in holding their auditors to account for performing high quality audits. We continue to urge audit committee members to consider our findings on audit quality in this report and to challenge their auditor as to whether they have appropriately addressed these issues and how in their ongoing audits. We also urge them to ask their auditor if their audit of the listed entity was inspected. We have given the auditor our consent to share certain information in our reports with their audit committee, subject to keeping the information confidential, and we encourage them to do so.

We welcome the constructive engagement by listed entity audit firms with our inspection findings and their desire to improve the quality of their work that we have experienced in our first year of inspections and we acknowledge their cooperation in facilitating our work.



Marek Grabowski
Chief Executive Officer

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Section 1

Introduction

1.1 Purpose of this report

1.1.1 The purpose of this report is to set out the final results of our inspections of listed entity audits in our first year of inspections.

1.1.2 The report includes:

- Our audit quality ratings for the engagements we inspected, the key drivers of those ratings, and our observations on the implications for audit quality from the results of our inspections (section 2);
- Our full year inspection findings on engagements (section 3) and systems of quality control (section 4);
- An overview of our inspection methodology and information on the regulatory follow-up actions that we may take in response to our inspection findings (section 5); and
- Our directional observations for audit firms on implementation of the new quality management standards (section 6).

1.2 FRC's Inspection function

1.2.1 The mission of the FRC is to uphold the quality of financial reporting of listed entities in Hong Kong so as to enhance protection for investors and deepen investor confidence in corporate reporting. Therefore, the performance of high quality audits and the maintenance of effective systems of quality control are crucial to the listed entity financial reporting ecosystem. They combine to contribute and promote investor confidence and ensure Hong Kong remains a competitive international financial centre. A high quality audit is one that meets both the spirit and the letter of applicable laws and standards.

1.2.2 As the full-fledged independent auditor regulator for listed entities in Hong Kong, the FRC has the statutory duty and the powers to carry out inspections of listed entity auditors. Our inspections evaluate the quality of a selection of a PIE auditor's engagements for listed entities and the effectiveness of the auditor's system of quality control. They are carried out to determine whether listed entity auditors have complied with applicable professional standards and legal and regulatory requirements.

1.3 FRC inspection cycles and selection of PIE auditors for inspection

- 1.3.1 We carry out inspections over three-year inspection cycles. The first inspection cycle covers the period from 1 October 2019, the date from which the FRC was empowered to carry out PIE auditor inspections, to 31 December 2022.
- 1.3.2 This report covers the first year of our first inspection cycle, the period from 1 October 2019 to 31 December 2020 (**2020 Inspection**). Our inspection years are calendar years thereafter.
- 1.3.3 We inspect all PIE auditors at least once during each inspection cycle. We inspect PIE auditors with more than 100 listed entity audits (**Category A**) in each year of an inspection cycle to recognise that collectively these firms audit over 70% of listed entities, representing 90% of the market capitalisation of the Hong Kong stock market as at 31 December 2019. For each firm inspected we evaluate the effectiveness of the auditor's system of quality control, which cover policies and procedures over areas such as human resources, ethical requirements and their leadership's responsibility for audit quality within the firm.

1.4 Selection of engagements for inspection

- 1.4.1 We inspect a number of PIE engagements completed in the inspection year by each PIE auditor to be inspected. The number selected depends on the number of PIE engagements that the PIE auditor has at 31 December just prior to the start of the inspection year (at 31 December 2019 for the 2020 Inspection). The number selected is between three and five for Category A auditors, two for auditors that have between 10 and 100 listed entity audits (**Category B**) and one in other cases (**Category C**).
- 1.4.2 While our resources enable us to deliver our statutory responsibility to inspect and monitor audit quality effectively, as the current economic circumstances improve and the need for tight fiscal discipline diminishes, we hope to increase the number and complexity of the engagements that we inspect.

- 1.4.3 The selection of engagements is risk-based, taking into account information we maintain about PIE auditors and listed entities, and information specific to a PIE engagement obtained from a PIE auditor when selected for inspection. For the 2020 Inspection, pending finalisation of working protocols to obtain working papers located in Mainland China, we selected engagements where working papers were available for inspection in Hong Kong.
- 1.4.4 A total of 38 engagements were inspected for the 2020 Inspection, 23 of which were engagements of Category A auditors. The inspection of one of the engagements has yet to be formally completed as our work relating to allegations into the conduct of the audit raised by a whistle-blower is ongoing. Consequently, the audit quality rating and information on deficiencies and findings relating to that engagement is not included in the data provided in this report.
- 1.4.5 Common risk factors that drove the selection of engagements included the key areas of judgement and uncertainty identified by the entity and/or the auditor, such as impairment of assets, a history of frequent changes in auditor, and whether the auditor had issued a modified audit opinion.
- 1.4.6 We do not inspect the entire working paper file and our inspectors address areas of focus for each engagement inspected. Common risk factors that drove the selection of areas on which to focus included the level of judgement and professional scepticism required, the complexity of the accounting standards to be applied, and the significance of an account balance in the context of the financial statements.

1.5 Performance of inspections

- 1.5.1 Inspectors identify aspects of an engagement or system of quality control being inspected that do not appear to comply with relevant requirements (**apparent deficiencies**). They do so based on discussion with the auditor and review of the documentation required to be maintained. They discuss apparent deficiencies respectively with relevant engagement team members or PIE auditor representatives to establish the facts. This includes considering any evidence that may be identified through such discussion but is not included in the required documentation.
- 1.5.2 Inspectors determine whether or not there are deficiencies in the performance of the engagement or in the effectiveness of the system of quality control based on the established facts. They also consider the significance of each deficiency identified to the performance of the engagement or to the effectiveness of the system of quality control. They also determine whether the impact of each deficiency on audit quality is significant either on its own or because it may be significant when considered in conjunction with other deficiencies. Significant deficiencies are referred to as findings.

- 1.5.3 Our inspectors then assign a quality rating to each engagement inspected, taking into account the number and nature of any findings for the engagement.
- 1.5.4 Inspectors also note in the course of each inspection good practices that they may observe in relation to the performance of the engagement or the effectiveness of the system of quality control, to give recognition and encouragement to the firm or the individual engagement team.
- 1.5.5 At the conclusion of our inspection, we provide a firm-wide inspection report to each inspected PIE auditor. The report includes our findings from our system of quality control and engagement inspections for the auditor, our quality ratings and key ratings drivers for each engagement inspected, and any good practice observations. The report also includes annexes containing an inspection report for each engagement inspected. Each engagement inspection report includes details of our findings and may include any observations on deficiencies that did not amount to a finding or good practices.
- 1.5.6 The quality rating for each engagement and deficiencies identified in a firm's system of quality control are compared and calibrated to inspections conducted at the same and other firms to ensure their consistency. Before being issued, each firm-wide and engagement inspection report is reviewed by the Head of Inspection or, in the case of a conflict of interest, by the Chief Executive Officer, for quality and the appropriateness of the deficiencies identified and ratings assigned to engagements.
- 1.5.7 Oversight of the Department is provided by the Inspection Committee, which performs a post issuance review of a sample of inspections conducted in an inspection year. In 2021, the inspection function's cases will be subject to review by the independent Process Review Panel, which will consider a sample of inspections conducted between 1 October 2019 and 31 March 2021 to determine whether they were performed in accordance with relevant policies and procedures.
- 1.5.8 Further details of the way we perform inspections are set out in section 5 of this report.

Section 2

Overall Audit Quality

2.1 Introduction

2.1.1 The following table provides an indication of the number and market capitalisation of listed entity engagements audited by different types and categories of auditor as at 31 December 2019:

Table 1 Number and market capitalization of listed entities and the location of their audit firm

	Number of firms	Number of listed entities audited	Hong Kong market capitalization of listed entities audited
Hong Kong	43	2,447	91.9%
- Category A	6	1,870	89.6%
- Category B	13	496	2.2%
- Category C	24	81	0.1%
Mainland China	11	68	0.8%
Overseas	23	72	7.3%
Total	77	2,587	100.0%

2.1.2 In addition to the six Category A auditors, which are inspected annually, we selected 4 Category B and 8 Category C Hong Kong audit firms for inspection during the 2020 inspection year.¹

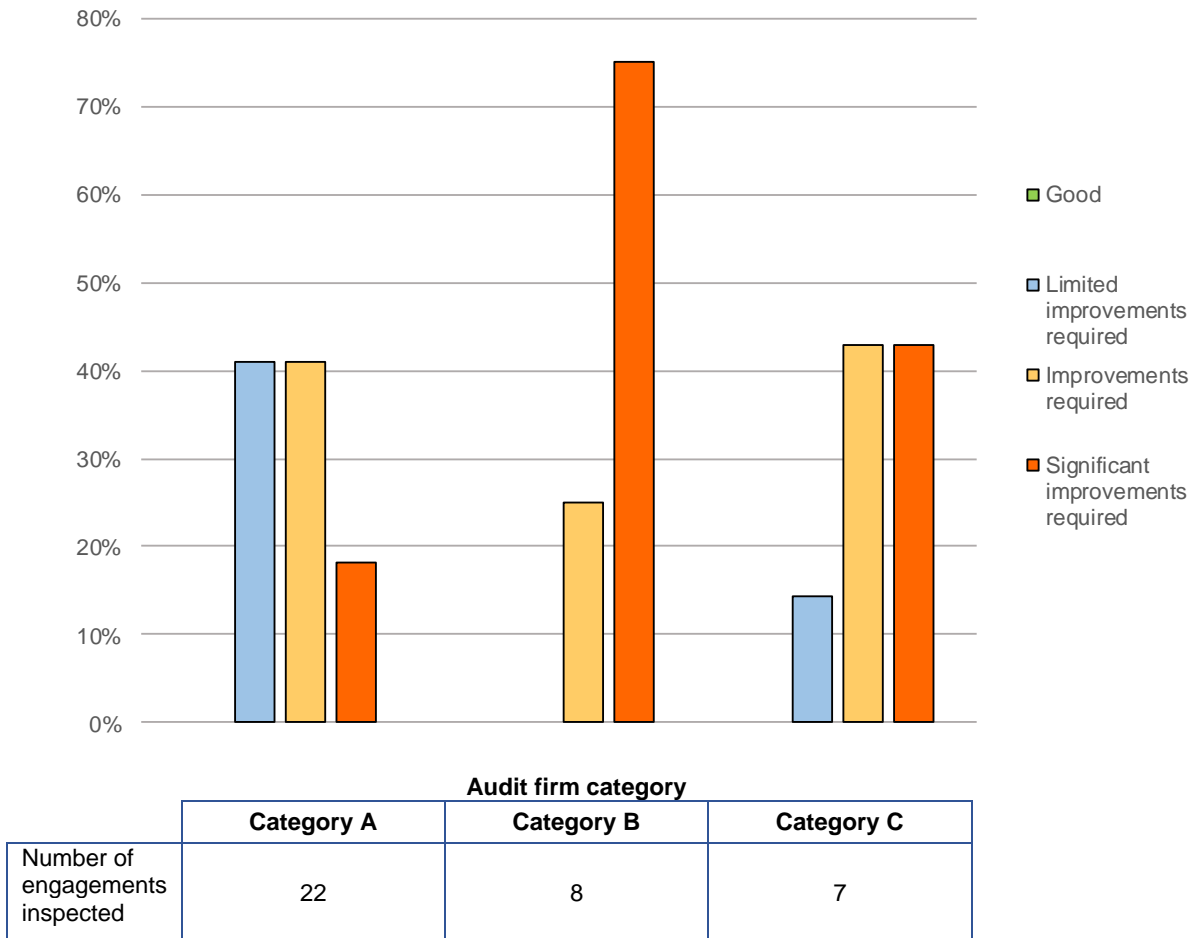
¹ Although registered as a listed entity auditor, one of the firms originally selected for inspection had not completed any listed entity engagement since the FRC's power of inspection became effective on 1 October 2019. Therefore, another firm was selected for inspection in its place.

- 2.1.3 To prevent the selection of auditors that have not completed listed entity engagements, and to provide us with accurate and timely information on auditor appointments for the purposes of selecting firms and engagements for inspection, in December 2020 a guideline was Gazetted and issued to all Hong Kong and Mainland audit firms requesting them to notify us within 7 business days of a change in auditor appointment from 1 February 2021 onwards.
- 2.1.4 Mainland audit firms were not selected for inspection in 2020 due to their relatively small share of listed entity audits, which represented less than 1% of the capitalisation of the Hong Kong stock market. Where the FRC wishes to inspect a Mainland audit firm that is appointed as the auditor of a Hong Kong listed entity we will request assistance from the Supervision and Evaluation Bureau of the Ministry of Finance of the People's Republic of China (**SEB**) under the Memorandum of Understanding signed with them.
- 2.1.5 Overseas firms audited approximately 7% of the Hong Kong stock market by capitalisation and 3% by number of listed entities. We did not select overseas auditors to inspect in 2020 because of the relatively small share of the market audited by them.
- 2.1.6 For 2020 Inspection our work was focused on audit firms and audit working papers in Hong Kong. Moving forward, we intend to work closely with the SEB on the inspection of Mainland firms and also working papers in Mainland China, while developing working protocols and agreements for inspections in overseas jurisdictions.

2.2 Inspection results and our responses

Overall inspection results

Chart 1 Engagement inspection results by size of firm

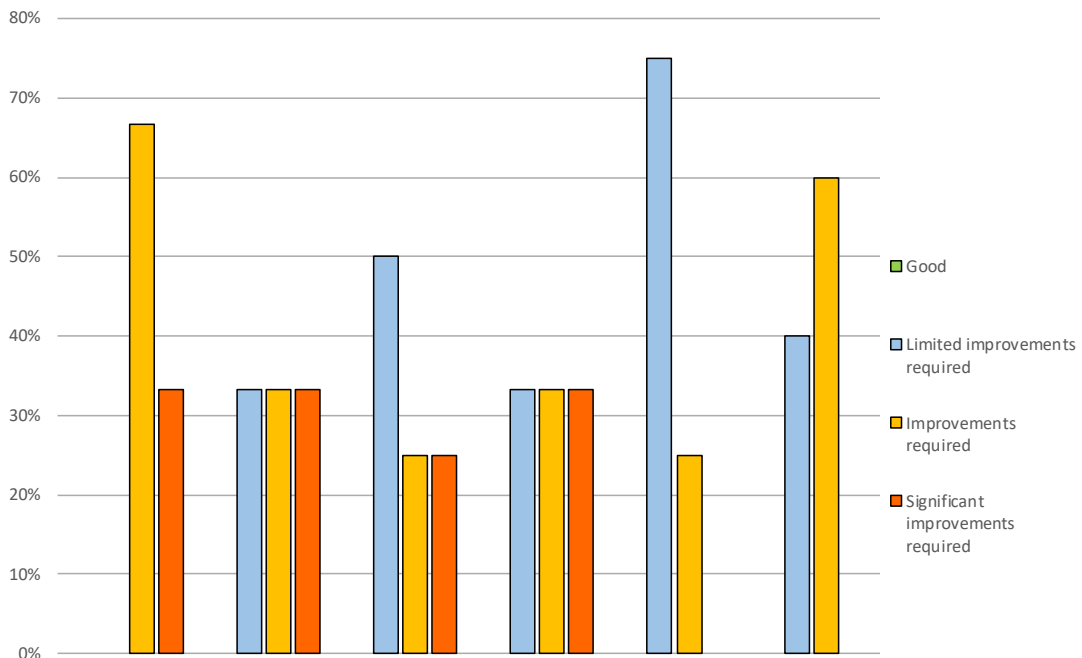


2.2.1 Chart 1 sets out the percentage of our engagement inspections completed that were assigned each of our quality ratings. Only ten, or 27%, of the 37 engagements for which inspections were completed were rated as requiring no more than “limited Improvement”, which is the standard we expect of listed entity audits. The quality of the other 27, or 73%, engagements for which we completed inspections were below this standard, indicating that quality needs to be significantly improved across all categories of firms.

2.2.2 Chart 2 sets out, for our completed inspections of Category A firm engagements, the percentage of engagements assigned each of our quality ratings. Publishing an individual firm’s audit engagement quality ratings provides transparency about the quality of a firm’s listed entity audit engagements and also provides a powerful incentive to firms to improve the quality of their listed entity audits, which would enhance confidence in the quality of financial reporting by PIEs.

Inspection results by Category A auditor

Chart 2 Engagement inspection results by Category A auditor²



BDO	Deloitte	EY	HLB	KPMG	PwC	Number of completed engagement inspections
3	3	4	3	4	5	

2.2.3 **Care should be exercised in interpreting the significance of differences in audit quality between the firms based on the engagement ratings shown above, given the relatively small numbers of engagements inspected for each firm.**

² The firms were: BDO Limited (**BDO**), Deloitte Touche Tohmatsu (**DTT**), Ernst & Young (**EY**), HLB Hodgson Impey Cheng Limited (**HLB**), KPMG and PricewaterhouseCoopers (**PwC**)

- 2.2.4 The results of our inspections of audits of Category A firms are disappointing, with only one firm having 75% of inspected engagements requiring no more than “limited improvement”. The results demonstrate that the quality of the audits performed by these firms, which audit 90% of the market capitalisation of listed entities, needs to be raised.

Analysis of inspection results

- 2.2.5 Engagements classified as “improvements required” or “significant improvements required” are considered to be less than satisfactory and had one or more findings in the application of professional standards in an area of significant audit risk or a key audit matter (**KAM**), or had a number of findings that collectively led to a significant impact on audit quality.
- 2.2.6 The lack of appropriate exercise of professional scepticism was the most common driver of poor audit quality, with 21 of the 37 engagements, or 57%, having one or more findings in this area which individually had an impact on the audit quality rating due to their significance. We also identified a large number of deficiencies in areas relating to the auditor’s response to KAMs and their evaluation of listed entities’ application of accounting standards related to expected credit loss impairment.
- 2.2.7 Conversely, although there was a high incidence of findings relating to inadequate documentation and journal entries testing, these were more likely to have a less significant impact on the audit quality rating.
- 2.2.8 The nature of our audit quality findings are consistent with those from other jurisdictions. Although we have observed these findings at a higher frequency, we expect audit quality to improve in these areas when firms respond appropriately.
- 2.2.9 Deficiencies identified in the testing of journal entries, the performance and disclosure of Key Audit Matters, and documentation of audit procedures, are all areas which can be significantly improved through enhanced internal processes and guidance by individual firms, and we expect the number of findings in these areas to decrease when appropriate measures are implemented.
- 2.2.10 Similarly, many of the findings related to the use of the work of an auditor’s expert can be prevented through firms developing templates and guidance that mandate, and match, the requirements of the relevant professional standards.

- 2.2.11 An effective system of quality control drives consistently high quality audits, and deficiencies in these controls have a direct impact on the engagement ratings. Key areas for improvement are resource management, including the effective monitoring of partner and staff workloads, and promoting an internal culture of quality by aligning performance evaluation with the firm's commitment to audit quality.
- 2.2.12 Although the inspection results may not be representative of overall audit quality across the market, given the relatively small number of engagements inspected and our risk-based selection criteria, we expect all firms to take robust action to address audit quality concerns in the areas identified by our inspections.

Actions by firms

- 2.2.13 In all cases, we require firms that have been inspected to identify the underlying causes of the deficiencies and develop an appropriate remediation plan to prevent them from reoccurring. We will evaluate both the quality of this root cause analysis and the appropriateness of the proposed actions, and discuss and agree the timetable for completion of the remediation steps with the firms.
- 2.2.14 The new Quality Management Standards, which were recently adopted in Hong Kong, must be implemented by auditors by December 2022. Their implementation programmes will require firms to comprehensively review their systems of quality control and will provide them with an opportunity to enhance their controls and processes to perform consistently high quality work.
- 2.2.15 We have generally found firms to be constructive in dealing with our comments and judgements when they are discussed at the close of an inspection. We are also encouraged by their stated desire to take action to improve audit quality.

Actions by the FRC

- 2.2.16 The FRC is taking robust action against those auditors who deliver poor quality audits or have deficiencies in their systems of quality control.
- 2.2.17 Inspected engagements rated as "significant improvements required" are likely to be referred for enforcement action, such as investigation or discipline. Other cases where improvements are required may also be referred, depending on the nature of the findings identified.

- 2.2.18 Other actions we may consider include performing a further inspection or requiring the auditor to take a specific corrective action. We follow up on firms' progress in implementing their agreed remediation plan, including reviewing or testing the effectiveness of the actions taken. Where an auditor fails to appropriately remediate deficiencies we may require the auditor to take a measure or corrective action which, if not complied with, may result in enforcement action.
- 2.2.19 To provide firms with greater transparency about our findings and expectations, all Hong Kong listed entity auditors will be invited to debriefing sessions, at which we will share our insights on the inspection results, including both deficiencies and good practices observed, and our expectations for the coming inspection period. We will also conduct online public education sessions to inform the wider stakeholder audience, such as preparers of financial statements and company directors, of audit quality matters and best practices.
- 2.2.20 In the third quarter of 2021, the FRC will issue a letter to all listed entity auditors setting out key areas to be considered when planning audits in the next audit cycle. We will analyse the results of the root cause analysis performed by auditors into the deficiencies identified in the 2020 Inspection and communicate key matters for consideration and action by auditors. We will again issue an interim inspection report to provide a timely update of our inspections at the midpoint of our 2021 Inspection, and our directional observations on them, to alert auditors to common deficiencies identified from our work so that appropriate action can be taken during the performance of engagements.
- 2.2.21 We will continue to review the appropriateness of the risk factors for our engagement selections, to identify engagements for inspection that present a greater risk to audit quality and investor confidence.

Action by audit committees

- 2.2.22 Audit committees have a pivotal role in the quality of financial reporting through their oversight of auditors. In setting expectations for their auditors and challenging the quality of their work, we urge them to consider our key findings and challenge their auditor as to whether they are taking the necessary action to ensure that audit quality findings do not occur on their audits. We also urge audit committees to ensure listed entities have robust internal governance and sufficient resources to provide high quality financial reporting.
- 2.2.23 In 2021, the FRC will issue guidance for audit committees to effectively discharge their responsibility over financial reporting and their oversight of the assessment of the listed entity's relationship with its auditor and the auditor's performance of audit and non-audit engagements for the listed entity.

Section 3

Our inspections of engagements

3.1 Introduction

- 3.1.1 The tables on the following pages show the number of engagements we inspected that had one or more findings in key areas, disaggregated by the number of listed-entity audits a firm completes annually (Table 2) and by their significance in driving the audit quality rating (Table 3). Table 2 includes comparative totals as shown in our Interim Inspection Report (see our [Interim Inspection Report](#) for the disaggregation of our interim findings).
- 3.1.2 The auditor's procedures over the entity's application of the revenue recognition and expected credit loss impairment standards, and the use of an auditor's expert were not inspected for all engagements and therefore the total of relevant engagements for findings in each of those areas is less than the total of thirty-seven inspections completed.
- 3.1.3 In interpreting the data in the following tables, **it is important to recognize that our findings do not necessarily indicate that the financial statements are materially misstated** but rather that the quality of the audit has been affected by deficiencies in important aspects of the work.

Table 2 Findings disaggregated by category of firm

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected:				
	Annual				Interim
	Total	Category A	Category B	Category C	Total
Lack of professional scepticism					
- Going concern					
- Asset impairment	30 / 37	16 / 22	8 / 8	6 / 7	16 / 18
- Business rationale	81%	73%	100%	86%	89%
- Fraud					
Deficiencies in testing of journal entries	21 / 37	11 / 22	6 / 8	4 / 7	10 / 18
	57%	50%	75%	57%	56%
Deficiencies relating to Key Audit Matters	12 / 37	5 / 22	4 / 8	3 / 7	7 / 18
	32%	23%	50%	43%	39%
Deficiencies in evaluating the application of accounting standards					
Revenue recognition					
- Principal or agent	12 / 26	10 / 18	0 / 4	2 / 4	9 / 12
- Performance obligations	46%	56%	0%	50%	75%
- Timing of recognition					
Expected credit loss impairment					
- Credit quality assessment	11 / 20	5 / 10	4 / 5	2 / 5	5 / 13
- Significant increase in credit risk	55%	50%	80%	40%	38%
- Recoverability					
Deficiencies in using the work of an auditor's expert	11 / 24	7 / 17	2 / 2	2 / 5	7 / 13
	46%	41%	100%	40%	54%
Inadequate documentation	25 / 37	12 / 22	6 / 8	7 / 7	14 / 18
	68%	55%	75%	100%	78%

3.1.4 Comparative totals as shown in our Interim Inspection Report have been provided to illustrate the progression of our findings through the second half of our inspection year.

Table 3 Significance of findings on audit quality rating

Key areas of findings	Number of engagements to which findings relate / number of relevant engagements inspected:		
	Total	Findings which have a greater impact on audit quality rating	Other findings
Lack of professional scepticism	30 / 37 81%	21 / 30 70%	9 / 30 30%
Deficiencies in testing of journal entries	21 / 37 57%	4 / 21 19%	17 / 21 81%
Deficiencies relating to Key Audit Matters	12 / 37 32%	9 / 12 75%	3 / 12 25%
Deficiencies in evaluating the application of accounting standards			
Revenue recognition	12 / 26 46%	4 / 12 33%	8 / 12 67%
Expected credit loss impairment	11 / 20 55%	9 / 11 82%	2 / 11 18%
Deficiencies in using the work of an auditor's expert	11 / 24 46%	3 / 11 27%	8 / 11 73%
Inadequate documentation	25 / 37 68%	0 / 25 0%	25 / 25 100%

3.1.5 Findings which are individually significant in their own right have a greater impact on an audit quality rating. Other findings are those significant deficiencies which impact an audit quality rating in combination with other deficiencies.

3.2 Lack of adequate exercise of professional scepticism

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

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

Without adequate exercise of professional scepticism, the auditor may not challenge management sufficiently or be sufficiently critical in their evaluation of audit evidence, and may not therefore obtain or properly evaluate all the evidence needed to form the basis for their opinion. It is particularly important to apply professional scepticism in areas where management assumptions used in preparing the financial statements have a material impact and where there is a higher risk of management bias or fraud.

3.2.1 A lack of adequate exercise of professional scepticism was the most common finding identified across all inspections and had the most impact to audit quality due to the significance of the areas to which they related. We identified one or more instances of a lack of adequate exercise of professional scepticism in 30 of the 37, or 81%, of the engagements we have inspected. These findings had a significant impact on the audit quality rating in 21, or 57%, of engagements inspected.

3.2.2 In almost 90% of the 21 engagements where a lack of adequate exercise of professional scepticism had a significant impact on the audit quality rating, findings related to an area of significant risk or KAM. Examples include:

- Insufficient challenge of key assumptions adopted by management

Engagement teams did not obtain sufficient appropriate audit evidence to evaluate the reasonableness of key assumptions made by management in determining estimates, including cash flow forecasts and discount rates used in going concern and asset impairment assessments, even where business prospects were significantly impacted by the COVID-19 pandemic.

In several engagements we inspected, where management assumed substantial growth in revenue and cost savings in cash flow forecasts, the engagement team placed excessive or even sole reliance on management representations and did not critically evaluate and challenge whether management's cash flow forecasts were realistic and supportable.

Engagement teams did not evaluate the reliability of source data, such as financial information used in cash flow forecasts and the impact of historical forecasting inaccuracies.

- Insufficient challenge of the business rationale for complicated and unusual transactions, and the related risk of fraud

We identified instances where the engagement team did not maintain a questioning mind to critically challenge the business rationale and commercial substance of transactions which might indicate the presence of fraud or the misappropriation of assets involving related parties.

- Lack of consideration of relevant facts and available evidence, including contradictory evidence

There were instances where the engagement teams did not consider impairment indicators identified during the engagement or from publicly available information such as announcements of the listed entities.

3.3 Deficiencies in testing of journal entries and other adjustments

Auditing standards require the auditor to test the appropriateness of journal entries and other adjustments made in the preparation of financial information in all audit engagements. This is because, although the level of risk of management overriding controls will vary from entity to entity, the risk is nevertheless present in all entities and such override of controls has often been used to perpetrate fraud in the process of preparing the financial statements.

3.3.1 We identified deficiencies in testing journal entries in almost 60% of engagements inspected. Of these, four engagements had a number of deficiencies in this area that collectively indicated that the engagement teams had insufficient audit evidence to support their conclusions. We set out below the common deficiencies identified across a number of firms we inspected:

- Lack of sufficient documentation on the correlation between the indicators of fraud risk that are entity specific and the criteria used to identify high-risk journals for testing, which led to the auditor omitting relevant journals from their audit procedures.
- Failure to evaluate the completeness of the population of journal entries on which audit procedures were performed.

- Journal entries with amounts below an arbitrary threshold were not tested, even though the journal entry was identified by the engagement team as having an indicator of a risk of fraud. This could result in the auditor not identifying fraudulent accounting entries perpetrated through processing multiple journals that, though not individually significant, could collectively be material.
- Lack of sufficient documentation of the details of the selected journal entries and the audit work performed, such as the full nature of the selected journal entries and the nature of the supporting documents examined.

3.4 Deficiencies relating to Key Audit Matters

Failure to appropriately identify or communicate how the auditor addressed KAMs undermines the value of the auditor's report in providing an understanding of the entity, of areas of significant management judgement, and about how the auditor dealt with the areas of most significance in the audit.

- 3.4.1 We identified significant deficiencies relating to KAMs in approximately one third of the engagements inspected, with 75% of these findings being assessed as having a significant impact on audit quality. The findings in this area largely relate to where engagement teams had not performed all of the procedures that were described in the auditor's report as having been completed to address the KAM. Deficiencies in this area may result in the auditor incorrectly concluding that they have sufficient appropriate evidence on which to draw a conclusion, and therefore may result in an unjustified auditor's report. Findings in this area are likely to have a significant impact on the audit quality rating of an inspected engagement.
- 3.4.2 Findings that did not have a direct impact on the audit quality rating generally related to the omission or insufficient description of why the auditor considered a matter to be a KAM or how that KAM was addressed in the audit.

3.5 Deficiencies in evaluating the application of accounting standards

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

Revenue recognition

3.5.1 In 46% of the engagements where revenue recognition was an area of inspection focus, engagement teams had not adequately assessed the appropriateness of the entity's application of HKFRS 15 *Revenue from Contracts with Customers*.

3.5.2 The areas where significant deficiencies were identified include:

- Whether the entity was acting as principal or as agent in transactions.
- The identification of separate performance obligations.
- Timing of revenue recognition.

3.5.3 Other findings in this area include:

- Insufficient evaluation of management's application of a portfolio approach under HKFRS 15.
- Insufficient audit procedures performed to test the accuracy and completeness of warranties.
- A lack of assessment of the appropriateness of the accounting method under consignment arrangements.

Expected credit loss

3.5.4 We generally found auditors had difficulty in evaluating management's assessment of expected credit losses on financial assets, despite this being the second year of application of HKFRS 9 *Financial Instruments* for many listed entities. We found that 55% of the relevant engagements we inspected contained one or more findings in this area, with the quality of audit work needing greatest improvement where the audited entities were involved in money lending as a non-core business. Findings in this area were a key driver of the overall audit quality rating in 9 of the 11 engagements identified as having a significant deficiency as this area was often identified as a KAM or a significant risk by auditors. Findings with the largest impact on audit quality ratings include:

- Insufficient or inappropriate audit procedures over the entity's identification of significant increases in credit risk and the staging of loans and receivables.

There were a number of engagements where the auditors did not appropriately understand and evaluate the entity's identification of a significant increase in credit risk and the staging of loans and receivables. There were instances where the auditor did not evaluate the appropriateness of management's rebuttal of the presumption that default occurs no later than when a financial asset is 90 days past due.

- Insufficient challenge of management's assessment of the credit quality of a receivable balance.

We identified instances where the engagement teams placed sole reliance on management's assessment of the credit quality of receivable balances and did not perform an adequate independent evaluation.

- A lack of challenge on the business rationale and commercial substance for lending transactions, including consideration of possible related party relationships.

3.5.5 Other findings in this area include:

- Insufficient audit procedures over the assessment of historical loss rates and the amount an entity loses when a counterparty defaults on a debt (also known as Loss Given Default or LGD).
- A lack of consideration of how an entity had determined its forecasts of future economic conditions.

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

An auditor may use an expert to perform work in a field of expertise other than accounting or auditing which the auditor intends to use as audit evidence. Deficiencies in this area may result in the auditor placing unjustified reliance on the work of the expert, which may result in the auditor incorrectly concluding that they have sufficient appropriate evidence on which to draw a conclusion.

- 3.6.1 We identified deficiencies in 46% of the engagements we inspected where the auditor used the work of an auditor's expert. Findings in this area were consistent with our interim inspection report and related to the engagement team's failure to evaluate the adequacy of the scope of work and procedures performed by the auditor's expert.

- 3.6.2 In a number of instances, the engagement team did not evaluate and perform additional procedures to address the caveats made by the auditor's expert and consequently placed undue reliance on their work. This led to the engagement team having inadequate audit evidence on which to draw a conclusion.
- 3.6.3 We also identified a number of significant deficiencies where the auditor did not have an agreement with the auditor's expert on the scope of work and the specific procedures to be performed by each of the auditor's expert and the engagement team. We also identified that a number of firms did not have internal policies or guidance on the extent of documentation of the expert's work to be retained on the engagement file.

3.7 Inadequate documentation

Audit documentation provides evidence that the audit was appropriately planned and executed, including recording the procedures performed, the evidence obtained and the basis for the conclusions made by the auditor. It enables auditors to be held accountable for their work and is therefore an important incentive for proper performance of the audit.

- 3.7.1 In almost 70% of the engagements we inspected, engagement teams had not adequately documented the matters considered in reaching conclusions, or the detailed procedures performed. However, these findings do not necessarily indicate that engagement teams did not obtain sufficient appropriate evidence in the areas concerned. Although the majority of these findings did not have a significant impact on the audit quality rating individually, they are nonetheless an indicator of a lack of an effective review by the engagement partner and engagement quality control reviewer.

3.8 Insufficient planning

Planning an audit involves establishing the overall audit strategy for the engagement in order to reduce audit risk to an acceptably low level. Early planning is important to a high quality audit as it helps auditors identify potential audit risks at an early stage and plan an appropriate response to those risks.

- 3.8.1 Although we have not reported this area as a key finding in the Tables, we identified that where less time was spent in audit planning, either due to late appointment as auditor or through poor organization, the audit was generally of a lower quality.

- 3.8.2 Firms should ensure that they have sufficient time and relevant resources to effectively plan and conduct an audit. This is especially important where a firm is considering accepting an appointment near or after the financial reporting date and firms should decline an appointment where they do not have the time and resources needed to perform high quality work.
- 3.8.3 Firms should also ensure that the key areas of planning work are completed in a timely manner and with appropriate involvement of senior members of the engagement team.

Section 4

Our inspections of systems of quality control

4.1 Introduction

An effective system of quality control drives consistent, high quality audits. It should provide the firm with reasonable assurance that it and its personnel comply with professional standards and applicable regulatory and legal requirements; and that reports issued by the firm or engagement partners are appropriate in the circumstances.

We inspect a firm's system of quality control to determine if it meets the requirements of Hong Kong Standard on Quality Control 1 "*Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*" and other relevant standards, to identify and share good practices and to make recommendations for improvements.

- 4.1.1 Highlighted below are the most prevalent findings identified across the eighteen firms inspected in 2020, and the corresponding recommendations for improving the firm's system of quality control. Consistent with our interim inspection report, the findings related to resources, promoting an internal culture of quality and independence. In addition, we identified deficiencies regarding the internal monitoring in the firms inspected.
- 4.1.2 As reflected in our engagement inspection results, 73%, or 27 of 37 completed inspections did not reach necessary standards of quality. Engagement findings are reflections of the firm's system of quality control and we expect all firms to consider their controls in the areas described in this section and assess the need to develop a plan to improve or remediate the matters identified in order to drive improvements in audit quality. In addition, we encourage auditors to communicate relevant findings with audit committees proactively in order to facilitate their oversight role in the audit process with the consideration of such findings.

4.2 Resources

- 4.2.1 As described in the results of our inspections of engagements, poorer audit quality generally stems from those audits where insufficient time was spent at the planning stage or where the engagement partner or engagement quality control reviewer was not involved at critical phases of the audit. It is important that partners and staff have appropriate time and resources to be able to plan and conduct an effective audit.

Common areas for improvement

- 4.2.2 Despite its importance, we identified that nine out of the eighteen firms we inspected lacked effective tools to monitor partner and staff workloads to ensure engagement teams have sufficient time to perform high quality work.

Areas of good practice

- 4.2.3 We identified good examples of firms having an effective process in place to monitor the workload of partners and staff, including a system which sent an alert to business unit leaders when an individual worked more than a predefined number of hours so that appropriate action could be taken to ensure that individual had sufficient time to perform high quality work.
- 4.2.4 We identified good practice at three firms where expected dates for completion of key phases of the engagement were actively set and monitored to ensure early involvement of the engagement partner and other engagement personnel. Key phases include planning, the completion of key audit procedures and engagement quality control reviews.

Our recommendation

- 4.2.5 Firms should implement effective processes to monitor workloads and drive timely and sufficient partner involvement at key stages of an engagement.

4.3 Promoting an internal culture of quality

- 4.3.1 The promotion of a quality-oriented internal culture depends on a tone being set by a firm's management that emphasizes the need to achieve quality in all the engagements that the firm performs. Such a culture, if effective, should result in audit quality being a key consideration and overriding commitment in all decision-making and operations of the firm, from senior management to engagement teams. One important way to develop such a culture is through implementing policies over performance evaluation, compensation and promotion that demonstrate the firm's overriding commitment to quality.

Common areas for improvement

4.3.2 Consistent with our findings from our interim inspection report, the performance assessments of partners are often dominated by factors other than audit quality, such as business development, indicating that senior management see this as a higher priority than audit quality. In ten of the eighteen firms we inspected, quality of work was either not a consideration, or not a primary consideration, in audit partners' performance evaluation and admissions assessment. We also identified a number of firms where disciplinary actions and the results of internal or external engagement inspections were disregarded or insufficiently emphasized in performance assessments.

Areas of good practice

4.3.3 We observed good examples where performance evaluation and compensation policies were used to reinforce the importance of quality. These included:

- Where audit quality was the only, or one of a very limited number, of considerations in audit partners' performance evaluation.
- Requiring candidates to have a satisfactory rating from a recent internal monitoring exercise before admission as partner or director.
- Incorporating a separate component on audit quality in the partner admissions assessment.

Our recommendation

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

4.4 Independence

4.4.1 A strong ethical framework, including controls over maintaining independence, is a key element of an effective system of quality control. Independence of mind and appearance are necessary to enable auditors to express a conclusion without bias, conflict of interest, or undue influence. It is also essential for assessing the threats and safeguards in providing non-audit services to audit clients, and to evaluate the overall impact, if any, on independence. In fourteen out of the eighteen firms inspected, deficiencies were identified in respect of the firms' policies and procedures designed to provide them with reasonable assurance on the independence of the firm, its personnel, or auditor's experts involved in engagements.

Common areas for improvement

Independence of personnel

4.4.2 We identified that ten out of the eighteen firms lacked effective controls over the recording of personal securities investments and the completion of personal independence confirmations. Common deficiencies included:

- The timeliness of recording such information and completing confirmations were not effectively monitored by the firms.
- Firms did not require their personnel to declare immediate and close family members' financial interests in, and business relationships with, audit clients and their related entities.
- Firms did not carry out checks to test the accuracy of information on personal investments or confirmations of independence

Our recommendation

4.4.3 Firms should strengthen and actively monitor compliance with controls over personal independence, including independence of immediate and close family members.

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

Identification and evaluation of firm's relationships with audit clients and their related entities

4.4.5 Ten of the firms we inspected, including those conducting a large number of listed entity engagements, did not have effective tools and processes to record the firm's relationships with audit clients and their related entities, for the purpose of determining whether the firms within their network firms were independent of their listed entity clients.

Our recommendation

4.4.6 Firms should implement robust procedures and introduce tools to effectively maintain up-to-date and complete records of the firm's relationships with listed entity clients and their related entities.

Partner rotation

- 4.4.7 To reduce familiarity and self-interest threats to an acceptable level, the Code of Ethics requires that key audit partners, including the engagement partner and engagement quality control reviewer, of a listed entity audit are rotated after seven years and are then subject to a cooling off period following rotation.
- 4.4.8 We identified that half of the firms inspected, and in particular those Category B and C firms, did not have effective controls in place to monitor the rotation of key audit partners. We noted instances where firms did not maintain complete records of key audit partner involvement in listed entity engagement and also where firms had not updated their policies to reflect the extension of the cooling off period requirements for audits of financial statements effective in 2019.

Our recommendation

- 4.4.9 Firms should maintain complete records of the length of involvement on listed entity audits of key audit partners and design effective controls to prevent breaches of partner rotation requirements. Firms should ensure their key audit partner rotation policies comply with the Code of Ethics.

4.5 Internal monitoring

- 4.5.1 Firms are required to establish a monitoring process to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively. The monitoring process includes an ongoing consideration of the effectiveness of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement performed by each engagement partner.

Common areas for improvement

- 4.5.2 We inspected five engagements that had been subject to a firm's internal monitoring program and categorized as being of satisfactory audit quality. However, in all these engagements, including those in larger firms within an international network, we identified significant deficiencies in audit quality and categorized them as "Improvements required" or "Significant improvements required". These firms have been required to undertake a review to identify the reasons for the significant differences in the assessments of audit quality, including the scope of their engagement inspection work program, the structure of the monitoring program, and the experience and competence of the internal reviewers.

Our recommendation

- 4.5.3 Firms should assess the design of, and resources available to, their internal monitoring program to ensure that it provides the firm with reasonable assurance over the effectiveness of their quality controls.

4.6 Evaluation and remediation of identified deficiencies in the monitoring process

- 4.6.1 Evaluating the root causes of deficiencies identified from internal monitoring and determining appropriate remedial actions are important for firms to enhance the effectiveness of their systems of quality control and improve audit quality. Where audit firms do not perform root cause analysis in sufficient detail or with sufficient thoroughness, it is likely that any responses will only target the symptoms of the problems, rather than the causes, thereby increasing the likelihood of issues reoccurring.

Common areas for improvement

- 4.6.2 Six of the firms we inspected either did not perform a root cause analysis for deficiencies identified from external or internal inspections, or where an analysis was performed the root causes identified and remedial actions proposed were inappropriate or not implemented.

Our recommendation

- 4.6.3 Firms should carry out a robust root cause analysis for deficiencies identified for the purpose of determining and implementing appropriate remedial actions to improve the firm's system of quality control.

Section 5

Overview of inspection

5.1 Introduction

5.1.1 To promote transparency in our work we set out below an overview of our inspection methodology and approach, including how we conduct inspections, evaluate our findings and assign audit quality ratings, and the actions that can be taken in response. We also describe the oversight of the inspection function and cooperation within the FRC.

5.2 Our inspection methodology

5.2.1 The FRC is responsible for inspecting listed entity auditors and the objectives of an inspection are to monitor and promote audit quality. An inspection focuses on how a listed entity auditor conducted listed entity engagements and on the effectiveness of that auditor's system of quality control, to determine whether the applicable professional standards and legal and regulatory requirements have been complied with.

5.2.2 The FRC has a responsibility to inspect all listed entity auditors wherever they may be located. Where the FRC wishes to inspect a Mainland auditor we would request assistance from the SEB under the Memorandum of Understanding (**MoU**) signed with them. Overseas auditors may be inspected directly by the FRC or through reliance on inspections performed by a firm's home regulator.

5.2.3 Hong Kong auditors that audit more than 100 listed entities are selected for inspection annually and the remaining auditors are selected for inspection at least once in every three-year inspection cycle. In addition, an auditor or a specific listed entity engagement may be inspected at any time if there are indications of a potential risk to audit quality that needs to be addressed, which may arise, for example, from a complaint or referral received.

5.2.4 For firms selected for inspection, we inspect the firm's system of quality control and a number of individual listed entity engagements. These engagements may include audits of listed entities and listed collective investment schemes, reports to be included in listing documents, and reports to be included in circulars issued in respect of very substantial acquisitions and reverse takeovers under the Listing Rules of The Stock Exchange of Hong Kong.

5.2.5 The FRC's methodology for selecting engagements and the areas of our inspection focus in each engagement are weighted towards engagements and areas we consider to have a higher risk to audit quality.

- 5.2.6 A number of factors affect the risk to audit quality. Risk factors may relate to the impact of general economic conditions, aspects of the listed entity's governance and internal control, the economic environment in which it operates, the frequency and reasons for changes in its auditor, or aspects of the audit that may require the auditor to exercise significant professional judgement in performing the related audit work and evaluating the results. This may, for example, include audit work on aspects of the financial statements that involve high levels of estimation uncertainty or complexity in the application of relevant financial reporting standards. Risk factors may also relate to aspects of the effectiveness of the auditor's system of quality control.
- 5.2.7 We also incorporate an element of unpredictability during the selection process, such as selecting engagements on a discretionary basis or with reference to the auditors' internal monitoring results.
- 5.2.8 In addition, we exchange information with our Department of Investigation and Compliance and take into consideration complaints or referrals received by them and the results of their financial statements review program in our engagement selection processes.
- 5.2.9 We maintain a database of all entities listed in Hong Kong. The database is updated continuously and comprises information on the listed entity's businesses and governance, its auditor and key information from its published financial information and auditor reports. Prior to the commencement of an inspection, the listed entity auditor is required to provide further information specific to each of their listed entity engagements.
- 5.2.10 We identify the presence of audit quality risk factors in engagements from the information we maintain and have received from the auditor. A weighting is applied to these risk factors to generate a shortlist of engagements. Each engagement on the shortlist is individually reviewed to determine the final list of engagements to inspect.
- 5.2.11 To maintain our objectivity and impartiality, each inspector is required to sign a confirmation declaring he or she has no conflict of interest with both the audit firm and the listed entity engagement to be inspected.

5.3 Audit working papers located in the Mainland

- 5.3.1 Data from The Stock Exchange of Hong Kong shows that as at 31 December 2020 approximately 52% of the listed companies in Hong Kong were Mainland enterprises, representing in excess of 80% of the market's capitalization. Furthermore, approximately 70% of the audits conducted by the eighteen auditors we inspected in 2020 involved work performed in the Mainland. These auditors collectively audit entities representing over 90% of the market's capitalization.

- 5.3.2 In view of the significance of these listed companies to the capital markets in Hong Kong, it is of strategic importance for the FRC to gain access to audit working papers located in the Mainland for inspection purposes, which will further enhance our effectiveness as an independent auditor regulator.
- 5.3.3 The main principle in the MoU signed between the FRC and the SEB in 2019 is mutual reliance based on regulatory equivalence achieved by both parties. The MoU also facilitates our access to audit working papers located in the Mainland for the purposes of investigation. In December 2020, the FRC obtained the first audit working papers from audits conducted in the Mainland for investigation purposes, demonstrating the effective cross-boundary collaboration with the SEB under the MoU.
- 5.3.4 During 2020, we held formal liaison meetings and maintained regular dialogue with the SEB on the operating protocols to enable the FRC to obtain audit working papers located in the Mainland for inspection purposes. Although changes in working arrangements and restrictions on travel both to and within the Mainland caused by COVID-19 slowed the advancement of these discussions, significant progress has been made with the support of the SEB.
- 5.3.5 Pending finalisation of such discussions, in 2020 we inspected engagements where working papers were available for inspection in Hong Kong. However, we also made some initial requests for the SEB's assistance in obtaining audit working papers located in the Mainland for a small number of listed entity engagements.

5.4 How we conduct our inspections

- 5.4.1 The scope of our inspections cover a firm's system of quality control and a selection of listed entity engagements.
- 5.4.2 An inspection of the system of quality control covers how that system is designed and operates in practice, and on how it impacts listed entity engagements. We assess the compliance of the auditor's system of quality control with Hong Kong Standard on Quality Control 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (HKSQC 1)*.
- 5.4.3 An inspection of the system of quality control is carried out principally through discussions with the auditor's leadership and management, review of the required documentation to be maintained by the auditor and by evaluating and testing the auditor's relevant policies and procedures.

- 5.4.4 An inspection of a listed entity engagement is performed by assessing the auditor's compliance with any statement on professional ethics, or standards on accounting, auditing or assurance practices, issued by the HKICPA and international bodies such as the IAASB and IESBA or specified under the Listing Rules, or comparable standards allowed by the Securities and Futures Commission or by Hong Kong Exchanges and Clearing. An inspected is conducted through the review of the required documentation to be maintained by the auditor and discussions with the engagement team.
- 5.4.5 An engagement inspection does not involve the review of all the audit working papers of the selected engagement, nor is it designed to identify every weakness/and or deficiency of the selected engagement. We generally focus our attention on audit areas we believe to be of greater complexity and areas of greater significance or with a heightened risk of material misstatement to the financial statements. An inspector focuses on the appropriateness of key judgements made in reaching the conclusion and the sufficiency and appropriateness of the evidence obtained.

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

- 5.5.1 The effectiveness of the system of quality control of an auditor is not rated. Individual engagements which are selected for inspection are rated for audit quality based on our inspection findings.
- 5.5.2 A finding relating to the systems of quality control represents a significant deficiency relating to the firm's policies and procedures in complying with or applying HKSQC 1. We also make recommendations based on our experience and observed best practice, and provide insights to improve the overall system of quality control. In addition, we evaluate whether the engagement findings identified indicate issues only at the level of particular engagements or at the level of the system of quality control that are required to be addressed at a firm-wide level.
- 5.5.3 An observation represents a deficiency that does not amount to a finding but should be drawn to the attention to the auditor. Observations are discussed with the auditor at the final stage of inspection and are not included in the inspection report.
- 5.5.4 A finding relating to an engagement represents a significant deficiency in applying applicable professional standards that amounts to a significant deficiency on its own or that may do so in combination with other deficiencies. The significance of individual deficiencies to the quality of an audit varies widely. Our judgement on the significance of a deficiency takes into account the nature and extent of a deficiency together with the facts and circumstances giving rise to the deficiency.

5.5.5 At the conclusion of an inspection, we consider findings or the combined impact of the number or nature of findings to arrive at an overall evaluation of the audit quality of that engagement and determine an audit quality rating. In determining the significance of inspection findings or the overall audit quality rating of an engagement we may seek advice from members of the FRC’s Honorary Advisory Panel or the Inspection Committee.

5.5.6 There are four ratings of audit quality that can be assigned to each individual engagement. The four ratings of audit quality are:

Category 1	Good
Category 2	Limited improvements required
.....	
Category 3 #	Improvements required
Category 4 #	Significant improvements required

Indicates a less than satisfactory inspection result

5.5.7 An engagement rated as either Category 3 or 4 does not necessarily indicate that the financial statements are materially misstated but rather that there were one or more findings that collectively have a significant impact on audit quality. An engagement categorized as less than satisfactory may also indicate that there was inadequate audit evidence to support the basis of conclusion on the financial statements.

5.5.8 During the course of our inspection we hold frequent meetings with the engagement team and the auditor to discuss our findings. Prior to the conclusion of the inspection, we agree with the auditor factual information on the procedures performed during the engagement to address the area of concern relating to each finding, so that the inspector makes an assessment of the severity of the finding and the overall audit quality of the engagement on a fair and accurate basis.

5.5.9 As part of the final stage of an inspection, a dated draft inspection report is sent to the auditor to provide an opportunity to respond to our assessment. On receipt of the written responses from the auditor, or expiration of the period allowed for responding, the inspector may amend the draft report before turning it into an inspection report.

5.5.10 The auditor is required to respond in writing with a plan to remediate the findings identified in relation to the effectiveness of the system of quality control or the performance of individual engagements in the inspection report. We evaluate the appropriateness of the proposed remediation actions and discuss and agree the timetable for completion of the remediation steps with the auditor. We may also review or test the effectiveness of these remediation actions in the subsequent inspection year and determine if any further follow-up action is required. Such follow-up action may include carrying out a further inspection in relation to the firm or a specific engagement.

5.6 Consequences of inspection

5.6.1 The FRC may take a range of follow-up actions in respect of an inspection report under section 21H of the FRCO, including:

- requiring the auditor to take a measure or corrective action;
- conducting a further inspection;
- initiating an enforcement action through conducting an investigation or imposing a disciplinary sanction; and
- taking any other follow-up action that is considered appropriate.

5.6.2 In relation to an inspection of an engagement, an enforcement action is appropriate where the FRC determines that, or has reason to enquire whether, the auditor's work is prejudicial to the public interest or, for example, that the auditor has been negligent in its work or failed to apply a professional standard. Category 4 rated engagements will be considered for enforcement action due to the significance of the deficiencies in applying relevant professional standards that led to such a rating. Category 3 rated engagements may be considered for enforcement action, depending on the nature of the findings identified.

5.7 Oversight

5.7.1 The Inspection Committee advises the Board on matters concerning the inspection function and comprises Board directors and Honorary Advisors with relevant expertise. The Committee also provides oversight of the work of the inspection function and, where requested, advises on the evaluation of individual findings, the overall audit quality rating of inspected engagements and on our assessment of deficiencies in systems of quality control.

5.7.2 The Inspection Committee also undertakes an ex post annual review of a sample of completed inspections and reports their findings and recommendations to the Board.

5.7.3 In addition, the Process Review Panel for the Financial Reporting Council (PRP) is an independent body appointed by the Chief Executive of the HKSAR to provide an external check and balance with the aim of ensuring fairness in the FRC's decision making, due process, and the proper use of its regulatory powers. The panel reviews and advises the FRC on the adequacy of its internal procedures and operational guidelines governing the actions and decisions made in the performance of its regulatory functions. The panel will consider the FRC's first year of application of its inspection process during its 2021 review. Reports from the PRP are submitted to the Financial Secretary annually.

5.8 Working with the Department of Oversight, Policy and Governance

5.8.1 We discuss our observations from inspections with the Department of Oversight, Policy and Governance of the FRC to provide input to FRC policy and governance initiatives, including addressing systemic issues in the audit market, oversight of the HKICPA and guidance provided to audit committees and other stakeholders.

Section 6

Looking ahead

6.1 Introduction

6.1.1 This section sets out our directional observations for audit firms on the implementation of revised auditing standards for accounting estimates and the new quality management standards.

6.2 Revised auditing standards for accounting estimates

6.2.1 HKSA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures*, which became effective for audits of annual financial statements ending on or after 31 December 2020, establishes new requirements for auditing accounting estimates, with a focus on determining what drives the risk of material misstatement of an accounting estimate and responding appropriately. The revised standard reinforces the need for the auditor to exercise professional scepticism. Engagement teams are expected to diligently adhere to the revised standard and their application of the new requirement will be one of our inspection focuses in 2021.

6.3 Quality Management Standards

6.3.1 In December 2020 the International Auditing and Assurance Standards Board (**IAASB**) approved the replacement of the current suite of quality control standards with three new and revised quality management standards. In April 2021, the HKICPA adopted the Quality Management Standards and issued the following equivalent new and revised quality management standards:

- 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* (**HKSQM 1**);
- Hong Kong Standard on Quality Management 2 *Engagement Quality Reviews* (**HKSQM 2**); and
- Hong Kong Standard on Auditing 220 (Revised) *Quality Management for an Audit of Financial Statements* (**HKSA 220 (Revised)**).

6.3.2 HKSQM 1, HKSQM 2 and HKSA 220 (Revised) (collectively the **Quality Management Standards**) have been developed with an aim to:

- (i) require audit firms to design, implement and operate a system of quality management (**SQM**) to manage the quality of engagements performed by the firms;
- (ii) address the appointment and responsibilities of engagement quality (**EQ**) reviewers; and
- (iii) deal with the specific responsibilities of the auditor regarding quality management at the engagement level for an audit of financial statements, and the related responsibilities of the engagement partner (**EP**).

6.3.3 Firms are required to design and implement an SQM compliant with HKSQM 1 by 15 December 2022. HKSQM 2 and HKSA 220 (Revised) are also effective on 15 December 2022.

Major changes to the Quality Management Standards

6.3.4 HKSQM 1 replaces HKSQC 1, which is the standard by which we currently assess the effectiveness of an auditor's systems of quality control.

6.3.5 HKSQM 1 introduces a risk-based approach focused on achieving audit quality objectives and firms are required to identify and assess the risks to achieving these objectives. The firm is then required to design and implement responses that address those risks to quality.

6.3.6 The new standard introduces the following:

- Increased firm leadership responsibilities and accountability - reinforcing the firm leadership is crucial to support the SQM. Leadership is responsible for establishing policies and procedures in place to provide rigorous monitoring and testing of the SQM, and the timely and effective remediation of deficiencies noted;
- Enhanced communication - requires firms to establish policies and procedures to identify information that indicates the need for changes to the SQM. It emphasizes the use of information systems and the continual flow of information both within and outside the firm; and
- Increased resource needs - expands the resources required to operate the SQM and perform engagements.

6.3.7 HKSQM 2 is a new standard that addresses the scope of engagements subject to an EQ review, the eligibility criteria for an individual to be appointed as an EQ reviewer, and the EQ reviewer's responsibilities relating to the performance and documentation of the EQ review.

- 6.3.8 HKSA 220 (Revised) clarifies and strengthens the key elements of quality management at the engagement level.
- 6.3.9 The Quality Management Standards introduce the concept of scalability – that is, the application of the SQM and the nature, timing and extent of EQ reviews will depend on the nature and circumstances of a firm, and its engagements, such that the Quality Management Standards can be adopted by firms in a way that is appropriate to their size and complexity.
- 6.3.10 Successful implementation of the Quality Management Standards will require significant management time and effort. We therefore urge firms to start planning for the implementation of the Quality Management Standards.

Our response to the Quality Management Standards

- 6.3.11 The FRC's inspection methodology will be updated in response to the Quality Management Standards. The focus of our SQM inspections will shift from how a firm has identified risks to how it achieves quality objectives, the design and implementation of measures to address these risks, and how it monitors and evaluates the SQM as a whole. In addition, in our inspections in 2021 and 2022, we will assess auditors' progress in implementing HKSQM 1.

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