

Press Release

3 June 2021

FRC issues its Annual Inspection Report

Financial Reporting Council (FRC) today issues its [Annual Inspection Report](#) (the Report) which presents the full results of our inspections of listed entity audits in our first period of inspections from 1 October 2019 to 31 December 2020. During the period, the FRC completed 37 engagement inspections and 18 inspections of the quality control systems of listed entity audit firms.

The Report includes our significant findings and audit quality ratings for the engagements we inspected, the key drivers of those ratings, and the follow up actions we are taking to respond to those findings and ratings. It also promotes transparency and a better understanding of our work, setting out our expectations of auditors and enabling all auditors (including those not yet inspected) to take action to improve audit quality. **Our findings are not about the quality of listed entity financial reporting and should not be taken as being so. Please see page 3 of the press release regarding our findings.**

Mr Marek Grabowski, CEO of the FRC remarked, “Our Annual Inspection Report 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. Nearly three quarters of the engagements that we inspected required more than limited improvement, and as such the quality of these audits was far below the standard that we expect and hence needs to be significantly improved by firms of all sizes.

In determining appropriate follow up actions, we will pay close attention to the root cause analysis that we require each inspected firm to prepare, and in particular the necessary demonstration by the firm of how their remedial plan will be effective in addressing those causes. We will consider a range of possible follow up actions that include requiring the firm to take specific actions as part of their remediation and referring the most serious cases for enforcement action if necessary.

We believe that when firms take effective actions to address their root cause analysis they will swiftly be able to deliver substantive improvements in their systems of quality control and in the quality of their audits.”

Addressing the key drivers of our findings, Mr Benjamin Rhys, Head of Inspection of the FRC said, “The Report shows that the drivers of significant deficiencies, such as the lack of appropriate exercise of professional scepticism, are broadly consistent with those identified in our Interim Inspection Report published December last year.

There is also considerable room for improvement in the system of quality control of the firms we inspected. Our engagement findings are a reflection of deficiencies we have found in these systems. Common deficiencies 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 is conducive to enhancing audit quality.”

Dr Kelvin Wong, Chairman of the FRC concluded, “Reporting of our findings enables the FRC to be accountable to the wider public interest not only through the effective discharge of our statutory functions but also by information sharing and public education. It also enables the FRC to amplify its regulatory impact by upholding high quality audits among auditors and promoting good corporate governance practices among listed entities.

We continue to urge audit committee members of listed entities to think through 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.”

Key findings of the Report:

About inspections of engagements

Readers should not assume any significant differences in audit quality between the firms based on the engagement ratings, given the relatively small number of engagements inspected for each firm.

- The report discloses the breakdown of inspection quality ratings by size of firms and also for the six firms with the largest number of listed entity audits (Category A firms).
- Only 27% (10 out of 37) of audits that we inspected required no more than limited improvements¹, indicating the quality of the remaining 27 audits was below the standard we expect
- Only one of the Category A firms had 75% of inspected audits that required no more than “limited improvement¹”. 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.
- In 81% (30 out of 37) of the audits inspected, one or more instances of lack of adequate exercise of professional scepticism were identified, with 70% of these having a significant impact on audit quality.
- In 57% (21 out of 37) of audits inspected, deficiencies in testing journal entries were identified.
- 32% (12 out of 37) of the audits inspected showed deficiencies relating to Key Audit Matters (KAMs).
- We identified deficiencies in 55% and 48% of audits where expected credit loss and revenue recognition were areas of inspection focus, respectively. We also identified deficiencies in 46%, or 11, of the 24 audits where the auditor used the work of an auditor’s expert.

¹ There are four ratings of audit quality that can be assigned to each individual engagement. For detailed explanation of the ratings, please refer to section 5.5.6 on page 32 of the Report.

About systems of quality control

- 9 out of the 18 firms inspected lacked effective tools to monitor partner and staff workloads to ensure engagement teams to have sufficient time to perform high quality work.
- In 56% (10 out of 18) of firms inspected audit quality was neither a consideration, nor a primary consideration in audit partners' performance and admission assessment.
- 56% of the firms inspected (10 out of 18) lacked effective controls over the recording of personal securities investments and the completion of personal independence confirmations.

For detailed findings and recommendations, please refer to the [Report](#).

About the Financial Reporting Council

The FRC is the full-fledged independent listed entity auditor regulator for Hong Kong. We are committed to upholding the quality of financial reporting of listed entities of Hong Kong so as to enhance investor protection and strengthen investor confidence in corporate reporting.

For more information about the statutory functions of the FRC, please visit www.frc.org.hk.

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