

## Press Release

23 June 2022

### **FRC issues (i) Consultation Conclusions and (ii) the 2021 Annual Inspection Report**

The Financial Reporting Council (the **FRC**) today issues the [Consultation Conclusions](#) and the [2021 Annual Inspection Report](#) (the **Inspection Report**).

Mr Marek Grabowski, CEO of the FRC, said, “We are pleased to release the Consultation Conclusions and the Inspection Report. The Inspection Report contains useful insights and significant recommendations that are highly important to the sustainable development and continuous improvement of the accounting profession.”

#### **The Consultation Conclusions**

The Consultation Conclusions sets out the FRC's conclusions to the consultation relating to its disciplinary process and sanctions approach in the [Consultation Paper](#). It is the result of the FRC's effective and comprehensive engagement with stakeholders. Since the Government's announcement of the Further Reform in June 2021, the FRC has held 50 meetings, webinars and media interviews with relevant stakeholders including regulatees, users of financial statements, other regulators and the general public. In March and April 2022, 10 webinars were held which were attended by over 6,000 participants.

The FRC received 20 written submissions from a broad range of respondents. The majority of respondents showed overall support for the regulatory principles behind the FRC's proposals. In particular, respondents generally agreed that the proposed disciplinary process is transparent, fair and provides a reasonable opportunity to be heard to regulatees, and were supportive of the principle-based approach to sanctions to achieve effective regulatory outcomes.

Ms Hester Leung, Head of Discipline, said, “We are pleased to note that the respondents generally agreed with the regulatory principles behind our proposals. We have considered their comments and feedback, and made appropriate amendments to the draft documents to address some of the comments and to further clarify the intent and practical aspects of our proposals. I am confident that the Consultation Conclusions will facilitate the efficient and effective discharge of our disciplinary function in a transparent and fair manner.”

The relevant disciplinary policies applicable to PIE auditors and registered responsible persons will come into effect on 24 June 2022, whereas those applicable to professional persons (i.e. CPAs and practice units) will take effect after the commencement of the Further Reform on 7 October 2022.

## **The 2021 Annual Inspection Report**

The Inspection Report presents the full year results of our inspections of listed entity audits completed in 2021. During the year, the FRC completed 50 engagement inspections (2020: 37), 17 inspections of the systems of quality control of listed entity audit firms (2020: 18) and 4 narrow-scope inspections (2020: nil). Highlights of the 2021 inspection results include:

### **Engagement inspections:**

1. There is a year-on-year improvement in the overall audit quality:
  - i. The proportion of inspected engagements rated “Good” and “Limited improvements required” was 32% (2020: 27%).
  - ii. Among the Category A firms, the proportion of inspected engagements rated “Good” and “Limited improvements required” was 45% (2020: 41%) whereas only 10% was rated “Significant improvements required” (2020: 18%).
2. There is a significant improvement in the exercise of adequate professional skepticism by the auditors in 2021. The proportion of inspected engagements identified to have the deficiency of “the lack of adequate exercise of professional skepticism” reduced significantly to 46% (2020: 81%).
3. Auditors need to timely and seriously improve their evaluation of management’s application of accounting standards for revenue and expected credit loss as the quality of work in these two areas deteriorated in 2021. The proportion of inspected engagements identified as having an insufficient evaluation of management’s application of the expected loss model was 71% (2020: 55%). Concerning the insufficient evaluation of the management’s application of the revenue accounting standard, 70% of the identified deficiencies significantly impacted audit quality (2020: 33%).

### **Inspection of the systems of quality control (SQC):**

4. For the Category A firms, for the first time, we carried out a thematic review on the policies and procedures over two elements of the SQC. Our aim was to identify common areas for improvement and good practices among the Category A firms. Firms in the other categories are strongly encouraged to consider the results and, where applicable, to early adopt these to improve their practices.

5. Common deficiencies of the SQC identified in Category B and C firms, which include internal monitoring, independence and promotion of a culture of quality within the firm, are largely consistent with those reported in 2020. We again strongly advise them to urgently consider our findings in the 2020 and 2021 Annual Inspection Reports and take timely actions to strengthen their policies and procedures.

### **External Auditor’s Guide to Performing Root Cause Analysis**

Listed entity auditors subject to our 2020 inspections were required to perform root cause analysis (**RCA**) and formulate a remediation plan to address our inspection findings. However, as noted in our 2021 Interim Inspection Report published on 3 November 2021, the RCA and the remediation process were not sufficiently well understood by many of the firms inspected. On 17 June 2022, the FRC published an [External Auditor’s Guide to Performing Root Cause Analysis](#) (the **RCA Guide**). RCA allows audit firms to discover the underlying causes of audit quality deficiencies and hence is a powerful tool for improving audit quality. The RCA Guide therefore intends to assist audit firms in performing a robust RCA and formulating a plan of action to prevent matters that may affect audit quality from recurring in their future audits.

Ms Eva Lau, Acting Head of Inspection, remarked, “The Inspection Report and the RCA Guide enable audit firms’ proactive monitoring and timely remediating issues relating to audit quality. The Inspection Report highlights characteristics of high quality audits, good practices observed, and pinpoints root causes of common deficiencies identified. We expect auditors to learn from these key findings and make improvements where applicable.

On the other hand, the board of listed companies is collectively and ultimately responsible for the integrity of their company’s financial statements. Directors are charged with approving the financial statements prepared by the company management, presenting them for audit, and laying them before an annual general meeting of the company for shareholders’ approval. They should ensure that their companies have robust internal governance and adequate resources to prepare high quality financial information. As audit committees assist the boards in discharging their responsibilities, we urge audit committees to challenge management as to whether they are providing the auditors with quality information and to consider our key findings when challenging their auditors as to whether and how the auditors have properly addressed the common deficiencies identified in the Inspection Report.”

Dr Kelvin Wong, Chairman of the FRC, concluded, “The Consultation Conclusions helps set the right tone regarding ensuring our regulatory principle and practice are practical and fair to the professional without comprising public interest. The publication of the 2021 Annual Inspection Report and the RCA Guide signifies our strong belief

that regulation can be both coercive and educational. Through this consistent and transparent effort to communicate and be accountable to the market, we want to ensure our regulations are relevant to, and understood by the market for the purpose of promoting a self-imposed improvement culture within audit firms and across the profession.”

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### **About the Financial Reporting Council**

The FRC is the 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](http://www.frc.org.hk).

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