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

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Inspection

22 December 2023

Audit Focus

2023 Financial Year-end Audit Reminder

Introduction

As the year-end of 2023 is fast approaching, auditors should have substantially completed their audit planning, following the principles outlined in our publication Audit Focus – Effective Planning: The Key to High-Quality Audits[1]. This involves gaining a comprehensive understanding of clients' business environments and conducting a thorough risk assessment. It is imperative for auditors to remain vigilant regarding the financial and audit implications that may arise due to the continued deterioration in economic conditions and the overall performance of listed companies. This ensures that risk assessments, planned audit procedures, and resource allocations can be timely updated and effectively aligned with the audit issues prior to the financial year-end to ensure the delivery of quality audits.

Amidst the dynamic changes in the economy, ensuring audit assurance is of utmost importance as public confidence and trust become more vulnerable. In this Audit Focus, we draw auditors' particular attention to the key audit areas that could be influenced by the prevailing business risks for the upcoming year-end audits. We aim to urge auditors to exercise heightened professional skepticism on our key focus and allocate the necessary resources to effectively address them. This approach enables auditors to strengthen the credibility of financial reporting and improve overall audit quality.

Firm leadership, including Chairpersons and Managing Partners, should **communicate the significance of this Audit Focus to the entire firm** and acknowledge the pivotal role they play in driving these efforts. By doing so, they not only uphold the quality of work within the firm but also foster confidence, high morale, and professional satisfaction among the professionals.

Areas that Require Special Consideration

The following are key risk areas that could significantly impact financial reporting and audit quality in the current economic and business circumstances. Auditors are required to identify and address all relevant audit risks that may arise during the audit process.

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

a. *Audit implications of economic challenges*

Amidst persistent high interest rates, inflationary pressure and a credit crunch, entities are impacted by rising costs, alterations in contract and pricing terms, and changes in credit risks. These factors have significant audit implications for assessments of a company's ability to continue as a **going concern**, **estimated cash flow in relation to impairment assessment, expected credit loss, valuation of assets or financial instruments**, **provisions for onerous contracts,** and **liability classification**.

b. *Heightened professional skepticism in response to potential fraud risks*

The challenging economic conditions create an environment where listed companies may face increased financial pressures or incentives, making them more susceptible to fraudulent activities. Auditors must exercise heightened skepticism and **apply robust methodologies to identify audit irregularities and investigate any suspicious activities thoroughly**. This is essential to protect the integrity of financial reporting.

c. *Disruptive business models with rapid change in technologies*

Auditors must respond to the rapid pace of advancements in information technology (**IT**) and digitalization in the business models of their clients, who are **exposed to IT-related risks and cybersecurity risks in financial reporting**. Firms should ensure their competence and capabilities to identify and address those risks and consider engaging relevant experts when necessary.

d. *Auditor's professional competence and due care in the use of technologies*

Auditors encounter the challenge of effectively integrating and utilizing audit technology tools to improve the efficiency and effectiveness of the audit process. It is important for auditors to **possess professional competence and exercise due care when employing various technological tools** such as data analytics software, automation tools, electronic audit platforms, and confirmation platforms. Under the evolving technological environment, in particular, auditors should ensure the reliability and appropriateness of their confirmation procedures when obtaining electronic confirmations as audit evidence. This involves verifying the integrity and authenticity of electronic confirmations and assessing the reliability of the sources from which the confirmations are obtained.

e. *Impacts of climate change*

Climate change has wide-ranging implications for companies across various industry sectors. Auditors need to consider the anticipated operational changes as a result of climate-related factors, the financial implications from these changes and the alignment of climate-related disclosures in the environmental, social and governance (**ESG**) reporting with financial reporting. Firms must ensure that they **maintain independence and competence when providing assurance or non-assurance services** for their audit clients.

a. Audit implications of economic challenges	
Audit Red Flags	**Our expectations for auditors**
a. Going concern • Unable to secure an extension in loan repayment dates triggers a breach of financial covenants and cross-defaults due to tightening of credit availability • Feasibility of management's plan to obtain new or additional financial resources or credit facilities to support its going concern basis **b. Estimated cash flow in relation to impairment assessment** • Higher discount rate and growth rate under persistent high interest and inflation rates • Unsupported cash inflows from uncommitted capital expenditure that will enhance the assets more than their original performance • Intentionally prepared cash flow projections for more than five years without justifications **c. Expected credit loss** • Significant increase in credit risks of counterparties arising from tightening of credit availability **d. Valuation of assets or financial instruments** • Decrease in fair value of assets or financial instruments driven by rising interest rates • Higher uncertainty in the future financial performance and estimated cash flows of underlying investments **e. Provisions for onerous contracts** • More loss-making contracts due to rising costs for commitments under inflationary challenges **f. Liability classification** • Breach of loan covenants or inability to obtain a waiver from the lender on or before the financial year-end date due to tightening of credit availability	• Heighten professional skepticism for any indicators of credit or liquidity deterioration on entities and their business parties • Remain alert for impacts of high inflation and interest rates on the risk assessments and audit procedures of significant accounting estimates • Do not discharge the auditor's responsibilities in the evaluation of valuations by the auditor's experts • Assess underlying key assumptions used in the forecasts and ensure they are consistent with the disclosures made in the annual report • Evaluate the occurrence of subsequent events that may require adjustments to or disclosures in the financial statements (e.g., subsequent events that may affect the realization of assets or settlement of estimated liabilities) • Consider whether a contract meets the definition of an onerous contract and consider the time value of money when the effects on the provisions are material • Duly review loan agreements for repayment terms, loan covenants, repayment records, and correspondences with the lenders, to evaluate any possible beach of loan covenants and the liability classification as of the financial year-end date

b. Heightened professional skepticism in response to potential fraud risks	
Audit Red Flags	**Our expectations for auditors**
a. Management's integrity • Management unable or unwilling to provide underlying records or withholding information that should be readily available • Unusual change of management and those charged with governance **b. Revenue** • Complex and new business models that are outside the ordinary course of business • Exceptionally high-profit margin or loss-making businesses entered by the entity without reasonable justification **c. Bank and cash balances and financial guarantees** • Raised significant loans at high interest rates even though the entity appears to have sufficient cash flows based on the accounting records • Intentional omission of recording financial guarantee contracts **d. Loans or prepayments** • Arrangements of loans to third parties outside the ordinary course of business • Significant payments on behalf of related parties to third parties • Significant "other receivables" or "other payables" with unknown nature and details by management	• Set the right tone from the top to challenge management without fear of damaging client relationship • Perform robust fraud risk analysis by identifying fraud risk factors and assessing potential fraud risks by each assertion of the transactions or account balances and recognize that presumed fraud risk on revenue may not be the only fraud risk of the entity • Challenge status quo to transactions conducted outside the ordinary course of business, significant management's judgments and assumptions, and contradictory evidence • Strengthen firms' requirements on audit documentation to demonstrate the auditor's professional skepticism and provide an audit trail that audit procedures are appropriately and sufficiently performed • Design and perform further specific procedures when identifying areas with potential fraud indicators • Report to the AFRC through our formal communication channels if any fraudulent activities are identified

c. Disruptive business models with rapid change in technologies	
Audit Red Flags	**Our expectations for auditors**
• Disruptive business operations with complex information systems for highly digitalized processes on data and transactions • Changes in IT infrastructures and applications within the entity • Management's investment or trading in any virtual assets or virtual asset-related business, such as cryptocurrencies which are highly volatile, and lack transparency related to ownership and purpose • Significant IT control deficiencies identified by internal auditors or internal control reviewers • High risks of cybersecurity attacks with cyber-attack incidents occur	• Upskill auditors' competence and capabilities in areas that require specialized knowledge and skills • Start early communication with management to obtain an understanding of the entity's business and IT environment and the extent of use of IT applications which may impact the audit procedures to be designed • Allocate sufficient resources, including engaging the auditors' IT or any other specialists • Strengthen the firm's policies and procedures, including client acceptance policy, staff training, technical consultations, and development of audit tools and techniques specific to the audit of virtual assets or any other disruptive business models • Assess the likelihood and magnitude of financial and audit implications from the IT control deficiency or cyber-security incidents identified

d. Auditor’s professional competence and due care in the use of technologies	
Audit Red Flags	**Our expectations for auditors**
a. Data analytics software, automation tools, or electronic audit platforms • Lack of guidance on how to properly use the newly launched digital audit tools • Insufficient training and support for the engagement teams, particularly the engagement partners and engagement quality reviewers • Limitations of use or disclaimers in the third-party service providers of IT applications or electronic platforms applied in the audit process **b. Electronic means of audit confirmation** • Management’s refusal to send confirmations or restriction on the ways of sending and receiving confirmations • Risks of alteration and the proof of origin of the response • Suspicious domain name or source address for audit confirmation received • Unknown/unspecified identity of the respondents • Abnormal response rates	• Ensure competence and readiness of the engagement teams before adopting new audit tools • Evaluate whether the use of any third-party service providers of IT applications is reliable and appropriate for the intended purpose • Assess the security of the data transmission to address the integrity and confidentiality of data • Exercise professional judgments to determine the appropriate steps to take when intending to rely on the confirmation received through electronic means or any other automation tools • Emphasize the auditor’s responsibilities to maintain control over the confirmation process • Perform further procedures to verify output from the use of technologies or the source of confirmation responses when there is any doubt about reliability

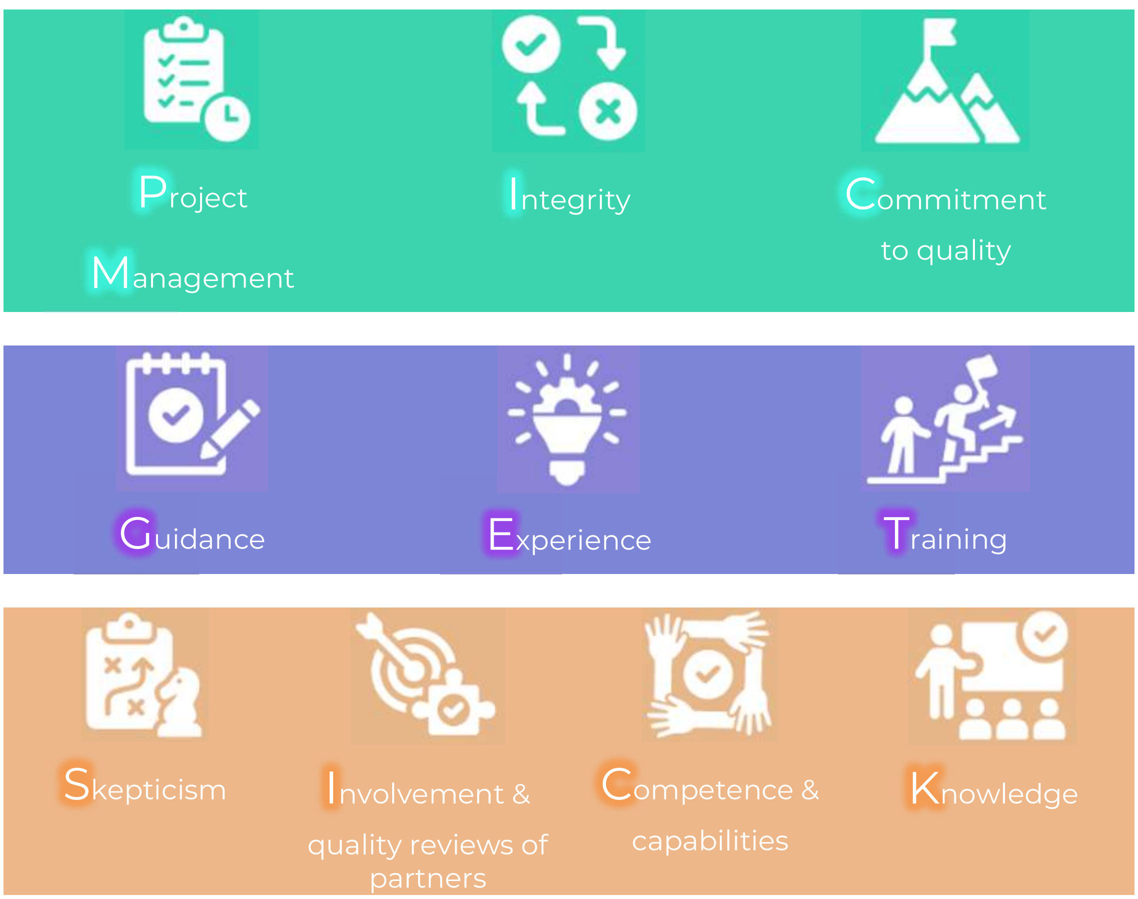
e. Impacts of climate change	
Audit Red Flags	**Our expectations for auditors**
• Significance of the ESG assurance or non-assurance services to the audit clients which may create self-interest threats to independence • Significant changes in operations with impact on accounting estimates, e.g., (a) useful lives of assets, (b) forecast periods in expected future cash flow estimates, (c) decline in demand for products that are responsible for environmental damage, (d) possible restructuring and capital expenditures in the cash flow projections • Inconsistency of climate-related disclosure with the information obtained for the risk assessment	• Evaluate the independence requirements, before acceptance of assurance or non-assurance services related to ESG reporting of audit clients • Upskill auditors' competence and capabilities on the ESG-related requirements and matters • Assess climate-related impacts on significant transactions, estimates, and disclosures, including: - whether climate-related matters bring along indicators that an asset may be impaired - whether there is a need for restructuring or enhancing the asset performance which may require changes in assumptions used in cash flow projections and - whether the assumptions related to climate-related matters may become material to the financial statements which may require more detailed disclosures • Consider any material inconsistency of other information, including sustainability reporting, against the financial information of the audit clients

Importance in continuing professional development of specialized talent and early partner involvement

Based on our reviews of the root cause analysis conducted by the firms, the following are the common causes of deficiencies identified in our previous inspections. We expect firms to establish an effective system of quality management (**SoQM**) to enhance the skills of their talent in the following areas and promptly take remedial **action to address deficiencies in "*PIC/MIC GET SICK*"**. The continuous efforts made by firm leadership are of utmost importance in maintaining a strong talent pool and delivering high-quality audits.

To demonstrate commitment to audit quality, **firms should take accountability and responsibility for providing ongoing professional training**, particularly in specialized knowledge related to emerging business environments. This goes beyond meeting minimum requirements and underscores the importance of staying updated and equipped to navigate the evolving landscape of the audit profession.

In addition to that, **retaining the audit trail in the auditor's documentation** is critical as it can benefit the learning experiences for junior auditors and enhance the quality reviews of partners. It offers reviewers a better understanding of the audit process carried out by junior auditors who lack experience and knowledge. We re-emphasize the importance of **early involvement by engagement partners and engagement quality reviewers** during the audit process. This ensures that the engagement team members receive timely support and guidance, enhancing the quality of work.



Communication between external auditors and entities' internal auditors or internal control reviewers

Auditors can greatly benefit from reviewing and evaluating the work conducted by the internal auditors or internal control reviewers of an entity. Their findings and observations offer valuable insights into the entity's internal control systems and risk management processes. By obtaining information from them, auditors can effectively identify any actual, suspected, or alleged fraud that may impact the entity and determine if there are significant internal control deficiencies that could have implications for the audit. Such collaboration also improves corporate governance and strengthens the overall internal control environment of the entity.

Private session for Audit Committees and Auditors, particularly sharing on past inspection results

Effective corporate governance underlies the quality of financial reporting. Listed entities should be encouraged to establish a private meeting between the audit committee and the auditor before the end of reporting periods, without management being present. It is also highly recommended that audit committees obtain an understanding of the past inspection results of the firms and the audit partners in charge, as well as evaluate the impact of the change in auditors when considering the appointment of auditors. This information is vital in helping audit committees discharge their responsibilities effectively. Such open and close communication serves important purposes:

- ✓ Promoting transparency, independence, and effective oversight of financial reporting and audits.
- ✓ Enhancing audit committees' understanding of financial reporting and audits, enabling them to fulfill their oversight responsibilities effectively.
- ✓ Building a trusting and respectful relationship between the audit committee and the auditor.

Self-reporting matters with regulatory concerns to the AFRC

Implementing self-reporting mechanisms for regulatory concerns to the appropriate regulatory body, such as the AFRC, is a tangible demonstration of a firm's unwavering dedication to upholding professional standards and ethical guidelines. By integrating these mechanisms into their SoQM, firms exhibit a strong commitment to transparency, accountability, and regulatory compliance.

By working collaboratively with us, firms can address these issues and implement necessary improvements to enhance audit quality and allow us to detect and prevent potential issues at an early stage. Such mechanisms not only safeguard the public interest but also foster a culture of transparency and responsibility within the accounting profession.

Evaluation of the systems of quality management

Firms should read our insights on the development of SoQM in our Inspection insights[2] to ensure that their SoQM are operating effectively. By now, firms should have completed their evaluation of SoQM and any deficiencies identified should be remediated immediately to ensure the delivery of quality audits.

[2] AFRC Inspection Insights, 30 November 2023, https://www.afrc.org.hk/media/qlsgzsdp/inspection-insights_en.pdf