



## Introduction

This edition includes updates on:

- The outcome of our engagement and consultation on the Further Reform
- Gazettal of the subsidiary legislation for the Further Reform
- Our survey on progress by PIE auditors in implementing the new and revised quality management standards
- Publication of our 2021 Annual Inspection Report
- External Auditor's Guide to Performing Root Cause Analysis
- Trend of PIE auditor resignations and removals and our preliminary concern
- Publication of Annual Report for FY2021-22
- Commencement of levies funding collection
- Launch of the FRC's third Summer Internship Programme

## Further Reform:

### (i) Engagement and Consultation Conclusions

FRC held a press briefing on 23 June 2022 to publish the [Consultation Conclusions](#) relating to its consultation exercise on the proposed disciplinary process and sanctions approach.



Dr Kelvin Wong, Chairman (middle), Ms Hester Leung, Head of Discipline (right) and Ms Eva Lau, Acting Head of Inspection (left) meet the media on 23 June 2022

Since the Government's announcement of the Further Reform of the accounting profession 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. The 10 webinars held since the issuance of the Consultation Paper were attended by over 6,000 participants. Our Consultation Paper and Consultation Conclusions reflect our commitment to improve transparency, efficiency and effectiveness of regulation through stakeholders' engagement.



FRC holds webinars to explain the Consultation Paper to stakeholders

We received 20 written submissions from respondents comprising (a) audit firms/ representative associations, (b) professional bodies, (c) listed company directors, (d) users of financial statements and (e) other local regulators/legislator. The majority of respondents showed overall support for the regulatory principles behind our proposals.

Respondents generally agreed that the proposed disciplinary process is transparent, fair and provides a reasonable opportunity to be heard to regulatees. They were supportive of the principle-based approach to sanctions and consider that it would achieve effective regulatory outcomes. They also raised a number of comments and feedback regarding some specific proposals. We considered their feedback and made appropriate amendments to the draft documents to address some comments and to further clarify the intent and practical aspects of our proposed policies and processes.

The relevant disciplinary process applicable to PIE auditors and registered responsible persons came 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.

We firmly believe they will facilitate the efficient and effective discharge of our disciplinary function in a transparent and fair manner, and the achievement of our aim of enhancing the quality of the accounting profession and the standards of corporate reporting and audits.



## (ii) Other Developments

Three pieces of subsidiary legislation relating to the FRC (Amendment) Ordinance 2021 (Amendment Ordinance) were published in the Gazette on 6 May 2022 and tabled before the Legislative Council (LegCo) for negative vetting on 11 May 2022.

The first is the Commencement Notice for the Amendment Ordinance. It seeks to appoint 1 October 2022 as the commencement date except for the provisions relating to the new statutory Advisory Committee and the Government's power to make transitional and saving provisions. These provisions will commence on 4 July 2022.

The second piece of subsidiary legislation is a Regulation on transitional and saving provisions and consequential amendments. The third is a notice amending Schedule 3B of the Amendment Ordinance to update the fees payable from 1 October 2023 for registration and licensing activities.

A LegCo Subcommittee for the vetting of the subsidiary legislation was formed and held two meetings on 24 and 30 May 2022. At the first meeting, the Financial Services and the Treasury Bureau (FSTB) responded to questions and comments from legislators. The questions mainly related to:

- (a) The statutory Advisory Committee;
- (b) The development of the accountancy profession; and
- (c) The period of exemption from registration and licensing fees for the profession.

A clause-by-clause examination of the subsidiary legislation also began at the first meeting and was completed at the second meeting on 30 May 2022. There was no proposal by legislators to amend the subsidiary legislation.

With respect to the statutory Advisory Committee, LegCo members were particularly interested in the composition of the Committee and whether sufficient industry knowledge would be brought to bear in the interactions between the Committee and the FRC Board.

FSTB confirmed that the statutory Advisory Committee would have a broad membership with significant practitioner representation. As for the FRC Board, it currently comprises 12 members with diverse backgrounds (42% are former accounting practitioners, 42% with a business or finance background and 16% are lawyers). This enables it to perform its statutory functions with complete independence from current practitioners yet with a deep and broad understanding of the profession and the business environment in which they provide services. It is further supported by a staff currently comprising 57% accounting practitioners and 13% lawyers, with the remaining 30% providing support services.

## Implementation of the New and Revised Quality Management Standards

New and revised quality management standards (the New QMSs) will come into force on 15 December 2022. We are monitoring the progress of listed entity auditors in implementing the transition to the New QMSs. On 31 March 2022, we published the [results of our survey](#) on the progress being made by listed entity auditors in this respect.

The results of the survey highlighted the expected impact of the New QMSs on firms, the status of implementation and the key challenges to be addressed by them by different categories of firms. The survey results enable listed entity auditors of different sizes and nature to benchmark their own progress against that of their peers.

The survey results show that 48% of the PIE Auditors had already developed implementation plans, 40% were still developing them and the remaining 12% had yet to start as of mid-January 2022. PIE Auditors identified staff and information technology resources and designing responses to address their quality risks as the most significant challenges they faced in implementation.

The survey results also facilitated our oversight of the performance of the HKICPA in relation to the provision of sufficient timely training and appropriate reference materials to the audit profession. We will conduct a further survey of all listed entity auditors in September 2022 to ascertain their readiness to implement the New QMSs by 15 December and will publish the results.

# 2021 Annual Inspection Report

On 23 June 2022, we published our [2021 annual inspection report](#), which included the full year results of our inspections of listed entity engagements and systems of quality control completed in 2021. The report provides market-wide information on deficiencies and the common causes of these deficiencies. Listed entity auditors should consider and take action to prevent them from occurring in their future audits. The report also highlighted factors contributing to high quality audits and good practices we observed. Listed entity auditors should consider and implement these, where applicable, to improve their audit quality.

The report also sets out the actions we expect auditors to take to address our findings. By explaining our perspective and setting out our expectations, we aim to influence and shape the behaviours of listed entity auditors to further enhance audit quality.

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.

## Highlights of the report

In 2021, we completed 50 engagement inspections (2020: 37), 17 inspections of the systems of quality control of listed entity audit firms (2020: 18) and 4 narrow-focus inspections (2020: nil) with a similar level of resources.

We are glad to see that many firms were responsive and proactive in improving their audits. There is a year-on-year improvement in overall audit quality. The proportion of inspected engagements rated “Good” or “Limited improvements required” was 32% (2020: 27%).

## **Category A firms<sup>1</sup>**

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%).

This indicates that the Category A firms, as a group, are taking robust and effective action to improve their audit quality in response to our inspections in 2020. This should provide the investing public and the wider public with increasing confidence in the quality of financial reporting and audits of listed entities.

## **Engagement inspections**

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%).

In contrast, 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%).

## **Inspections of systems of quality control**

An effective system of quality control drives consistent, high quality audits. 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 systems of quality control. Our aim was to identify common areas of 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.

<sup>1</sup> Auditors with more than 100 listed entity audits



The common deficiencies of the systems of quality control of auditors with less than 100 listed entity audits (Category B and C firms) 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.

## Late Auditor Resignations and Removals

A change in auditor before the end of their term of appointment may indicate issues identified in the financial statements of the listed entity or difficulties encountered in conducting the audit. We have been monitoring the number of and reasons for late changes in auditor appointments closely.

For listed entities with a 31 December financial year-end, 59 auditors had resigned or were removed from their appointment after the end of the reporting period of 2021 (2020: 46). This included auditors of over 20 PRC property developers and property management companies who resigned because of unresolved audit issues.



This raise concern over the quality of these audits as audit quality is generally lower for companies that engage new auditors close to or after their year-end dates.

Listed entity auditors have to recognise that they serve a public interest and therefore they have to be committed to perform quality audits. Firms should only accept their client relationships and engagements when their engagement teams are competent to perform the audit engagements and have the necessary capabilities, including time and resources. We would not hesitate to take actions against firms which failed to do so.

## **FRC Annual Report for FY2021-22 published**

As a transparent and accountable financial regulator, our Annual Report serves to keep the public informed about how we have implemented our regulatory approach to achieve effective outcomes. On 24 June 2022, we published our [Annual Report for FY2021-22](#). This sets out our progress and accomplishments in fulfilling our mission of upholding the quality of financial reporting to protect the public interest. The report also describes our relentless preparation for the further reform of the accounting profession which will commence in the 4th quarter of 2022.

## **Third Summer Internship Programme**

The FRC is running its 3rd FRC Summer Internship Programme for 8 weeks from 4 July 2022 to 26 August 2022. This programme gives students the opportunity to understand the operations of the FRC and participate in a group project to present their ideas and insights on a current topic. This year, the project will address “What role should the FRC play in relation to promoting high-quality sustainability (ESG) reporting by companies?”

We have received 102 applications from the local universities from which 9 interns will be selected to participate in the Programme. The interns will be attached to each of our departments during the programme. This will enable them to gain hands-on experience of the FRC’s daily operations that will facilitate their future career planning. They will also be provided with a series of well-structured training sessions and the opportunity to share learning experiences, participate in activities across different departments and make small group presentation.

## Collection of Levies

From 1 January 2022, the FRC started to collect levies to fund its operations. Levies are payable by sellers and purchasers in securities transactions (transaction levy), entities listed in Hong Kong (PIE levy) and PIE auditors (PIE auditor levy).

The transaction and PIE levies are being collected on behalf of the FRC by the Hong Kong Exchanges and Clearing Limited since January 2022. The PIE auditor levy is being collected from recognised PIE auditors by the FRC and from registered PIE auditors by the HKICPA on behalf of the FRC. It is payable by reference to payments of the auditor's remuneration for PIE engagements that are made directly by the PIE to the PIE auditor. This requires detailed information to be provided by all PIE auditors.

The information gathering and collection process for the PIE auditor levy was initiated in parallel by the FRC and HKICPA on 6 May 2022. A single set of instructions, tools and briefing webinar were provided to all PIE auditors. For PIE auditors with significant numbers of PIE engagements, we have allowed all reasonable requests for additional time to gather the information.

## Contacts

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