

AFRC Quarterly Report

17 January 2023



Overview

During the third quarter of the financial year 2022-23, the AFRC has taken a number of initiatives to enhance audit quality and quality of financial reporting in order to effectively discharge our regulatory responsibility.

Apart from publishing detailed performance reports that shed light on key findings and recommendations in relation to our regulatory functions, we also engaged with different stakeholders to expound our regulatory principles, procedures and expectations, in particular those related to our expanded responsibilities.

Understanding the thoughts, attitude and behaviour of practitioners is an essential prerequisite to effective regulation of the accounting profession. To this end, we conducted two surveys – one to understand how well PIE audit committees and their auditors follow our Guidelines for Effective Audit Committees published in December 2021, and the other one to ascertain the implementation progress of the new and revised quality management standards that came into effect on 15 December 2022.

We also closely monitored the latest trends and developments of the profession and took appropriate and swift action to remind practitioners the importance of audit quality so as to protect public interest. Our proactive approach included issuing an open letter on late auditor resignation and appointment and sending a new bulletin entitled “Audit Focus” to remind PIE auditors of the key areas they should focus when performing year end audit.

The AFRC also organised and supported various stakeholder engagement activities and webinars to ensure practitioners understand our regulatory principles, practices and observations arising from our regulatory work.

Regulatory reports to enhance improvement in audit quality

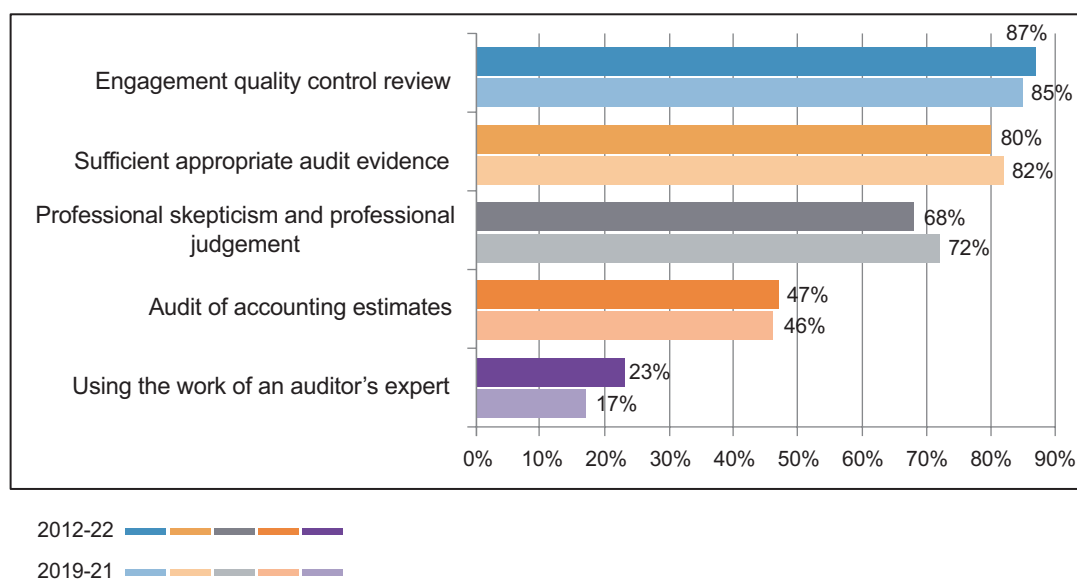
2022 Investigation and Compliance Report

On 20 October 2022, AFRC published the [2022 Annual Investigation and Compliance Report](#) covering an overview of the work of the investigation and enquiry functions for the 12 months from 1 April 2021 to 31 March 2022 (the report period).

The report provides insights on common areas of misconduct of listed entity auditors and financial reporting non-compliance in financial statements of listed entities identified in our investigative and enquiry work and our expectations of the auditors and financial statements preparers.

The five key common areas of potential or actual auditing irregularities remain the same as those in our last report, which are set out in Chart 1 below:

Chart 1: Key areas of auditing irregularities



The more common areas of financial reporting where we identified potential or actual non-compliance continue to relate to areas where preparers are required to make significant judgements or estimates, such as:

- (i) fair value measurement;
- (ii) impairment of financial and non-financial assets including cash generating units;
- (iii) classification of financial instruments; and
- (iv) going concern assessment and reporting.

Auditors should take note of the key findings and observations in relation to auditing irregularities and take appropriate actions to make the necessary improvements to ensure that a robust audit approach is in place to deliver high quality audits. Given their respective roles in ensuring good corporate governance, the board and management of listed entities and their audit committees should also seriously consider our findings and recommendations to avoid these matters arising in their financial reporting processes and audits.



Dr Kelvin Wong, Chairman (second from the left), Mr Marek Grabowski, CEO (second from the right), Ms Wincey Lam, Head of Investigation and Compliance (left), and Mrs Linda Biek, Head of Investigation and Compliance (right) of the AFRC present to media the 2022 Annual Investigation and Compliance Report.

2022 Interim Inspection Report

On 15 November 2022, we published our [2022 Interim Inspection Report](#), setting out the results from our interim inspections of PIE engagements and systems of quality control of PIE auditors, our review of the remediation plans submitted by PIE auditors subject to our 2021 inspections and key reminders for 2022 year-end audit.

Many of the deficiencies identified were related to PIE engagements completed by Category B and C which had not been inspected in the first two years of our three-year inspection cycle. Common deficiencies included:

- (i) lack of adequate exercise of professional skepticism;
- (ii) insufficient evaluation of management's application of accounting standards for revenue recognition and expected credit loss; and
- (iii) insufficient testing of journal entries and other adjustments.

Other issues that called for concerns included auditor violations of the independence rule under the Code of Ethics for Professional Accountants and firmwide quality controls over client and engagement acceptance and continuance, particularly whether the firms had critically assessed their competence and capabilities to perform a quality audit before accepting or continuing an appointment.

The report also sets out our expectations of the respective duty of PIE auditors, directors and audit committees in upholding audit quality ahead of the imminent busy audit season.

Following the issue of the report, we organised three webinars for PIE auditors and members of professional bodies in December 2022. They were attended by over 750 professionals who gained in-depth understanding of the interim inspection results and our expectations.



Dr Kelvin Wong, Chairman (second from the left), Mr Marek Grabowski, CEO (second from the right), Ms Mary Leung, Head of Policy, Registration and Oversight (left), and Ms Janey Lai, Head of Inspection (right) of the AFRC present to media the 2022 Interim Inspection Report and 2022 Oversight Report.

Report on oversight of HKICPA Regulatory Functions

We published the [2022 Oversight Report](#) of the performance by the HKICPA of its specified regulatory functions relating to PIEs and their auditors (Specified Functions) from 1 April 2021 to 31 March 2022 (the Assessment Year). In contributing to the enhancement of the in-scope Specified Functions of the HKICPA, two new findings and corresponding recommendations relating to governance and standards setting were made in this assessment.

This is the third year of oversight and we have assessed the follow-up actions taken by the HKICPA on our recommendations arising from the assessment covering the period from 1 April 2020 to 31 March 2021. Four out of eight of our recommendations relating to governance and standards setting were satisfactorily completed while considerable progress has been made for the remaining four recommendations relating to governance, setting of CPD requirements and CPD compliance audit according to the agreed plan. We will continue to communicate with the HKICPA to ensure satisfactory completion of the follow-up actions for these recommendations.

Given the expanded roles of the AFRC, our oversight and assessment of the HKICPA's performance cover the following areas:

- a. ascertaining the qualification for registration as certificated public accountants (**CPAs**) by conducting examinations;
- b. registering CPAs;
- c. arranging for mutual or reciprocal recognition of accountants;
- d. setting CPD requirements for CPAs;
- e. issuing or specifying standards on professional ethics, and accounting, auditing and assurance practices for CPAs; and
- f. providing training for qualifying as, and the CPD of, CPAs.

The AFRC is committed to performing effective oversight of HKICPA's performance of these functions in the new chapter of the oversight relationship between AFRC and HKICPA, and we look forward to working closely with HKICPA in raising the standards of accounting profession and contributing to its sustainable development.

Proactive approach to uphold audit quality

Open letter on late changes in auditor appointments

The AFRC has been proactively monitoring the situation regarding changes in auditors of listed entities. In particular, we are concerned with the surge in the number of PIE auditors resigning just one month before or even after the end of the reporting period of a listed entity. A change in auditor before the end of their term of appointment may indicate issues in the financial statements of the listed entity or difficulties encountered in conducting the audit. Audit quality may be compromised when the incoming auditors do not have sufficient time to plan and conduct a proper audit to meet the listed entity's deadline for the announcement of audited results.

Our analysis of the late changes in PIE auditors appointments, covering the period from 1 December 2021 to 31 August 2022, showed that in around 60% of these cases, the listed entity made a generic statement that the resignations were due to the outgoing auditors' inability to agree the audit fee with the listed entity, and around 30% were due to unresolved audit issues. In addition, the analysis revealed that the majority of the late PIE auditor appointments for listed entities with significant operations in Mainland China or overseas were taken by PIE auditors whose experience and resources appeared disproportionate to these audits.

In view of our observations and concerns, we issued an [open letter](#) on 27 October 2022 to remind the auditors of their respective roles and responsibility in upholding the quality of financial reporting and audit quality and our expectations of them. Also, it is vital that the PIE auditors maintain a close and effective dialogue with audit committees of listed entities in resolving any contentious audit matters. This way, public interest can be protected in a pre-emptive manner.

Audit Focus – 2022 Financial Year End Audits Reminders

On 22 December 2022, we issued the [Audit Focus](#) to remind all auditors on key audit issues and areas they should pay attention to and to set out our expectations to auditors in the preparation for 2022 audit.

The Audit Focus reminds auditors the importance of ongoing communication with their clients to understand significant changes in their operations. They should regularly re-assess the audit risk and revise the audit strategy when appropriate to uphold audit quality.

Under the current volatile economic environment, auditors need to consider the impacts of key areas to their audit, such as impairment assessment, revenue recognition, going concern assessment and potential fraud risk. In addition, auditors should pay attention to the following areas in executing year-end audit:

- (i) Auditors' independence;
- (ii) Direct supervision and on-site review;
- (iii) Professional skepticism and challenge status quo;
- (iv) Audit focus on going concern, significant accounting estimates and use of work of auditor's expert;
- (v) Documentation as audit work evidence to support audit conclusions reached at the time of the audit;
- (vi) Effective communication with management and those charged with governance; and
- (vii) Late changes of appointment

Surveys to understand how well our Guidelines and new quality management standards are implemented

Follow-up survey on the implementation of Guidelines for Effective Audit Committees – Selection, Appointment and Reappointment

In November 2022, the AFRC launched an online survey to better understand how well the [Guidelines for Effective Audit Committee – Selection, Appointment and Reappointment](#) published in December 2021 have been implemented by listed entities in Hong Kong. The survey seeks to identify and provide useful insights of the practical realities in auditor appointments from the perspective of audit committees and PIE auditors, the challenges audit committees face in evaluating auditor performance, as well as the challenges auditors face in maintaining audit quality. The results of this survey will be published in a report in March 2023.

Once the report is published, AFRC will engage with stakeholders and highlight relevant messages and insights through a series of engagements.

Follow-up survey on the implementation progress of the new and revised quality management standards

In early 2022, the Inspection Department conducted an initial survey to understand the progress of PIE auditors in adopting the requirements of the new and revised quality management standards (the **new QMSs**) which came into force on 15 December 2022. We conducted a follow-up survey in September 2022 with PIE auditors. On 10 November 2022, we published the [results of the follow-up survey](#) on their implementation progress for the new QMSs. The follow-up survey results also highlight the key challenges encountered by different categories of firms, as well as good practices and reminders for firms at the final stage of the implementation journey.

The survey results not only enabled PIE auditors to benchmark their progress against that of their peers so that necessary actions could be taken to uphold their audit quality but also allowed us to understand the readiness of the market practitioners.

In 2023, we will carry out inspections of the selected PIE auditors' new system of quality management based on the requirements of the new QMSs.

Stakeholder engagement to promote the development of the profession

To promote the healthy development of the accounting profession, the AFRC provides support and engages with different professional bodies of the profession from time to time.

On 26 November 2022, Ms Mary Leung, Head of Policy, Registration and Oversight, was invited to speak at the “2022 CPD Carnival Day”, organised by The Society of Chinese Accountants and Auditors (SCAA). The event was attended by over 9,000 participants.



Ms Mary Leung, Head of Policy, Registration and Oversight, presents at the 2022 CPD Carnival Day.

Under the topic “AFRC – who we are, what we do, and what it means for the profession”, Ms Leung provided an interactive introduction to the audience AFRC’s expanded regulatory functions and recent publications. She also discussed the issues and challenges facing the profession and AFRC’s forthcoming focus in contributing to the long term, healthy and sustainable development of the accounting profession. Effective communications with the industry and stakeholders is an ongoing commitment of the AFRC. To enhance audience engagement, participants were invited to take part in live polls on fun facts relating to the global development of audit regulation as well as on AFRC and its roles and functions. There was active participation with both the online and physical audience.

Registration and licensing

Effective from 1 October 2022, the AFRC takes on the new registration functions of practice units (i.e. the issuance of practising certificates and the registration of firms and corporate practice) and of local PIE auditors.

As an ongoing effort to improve the efficiency in registration and licensing and to make the transition of the new functions to AFRC a smooth one, the AFRC provided informative sharing and guidance materials with the industry and stakeholders.

To promote the understanding of registration and renewal requirements and procedures under the new regime by potential applicants and existing practice units and to help them better prepared for the first registration and renewal season with the AFRC, we delivered information sharing sessions and answered questions at three webinars held by three professional accounting bodies including The Hong Kong Association of Registered Public Interest Entity Auditors Limited (PIEAA), The Hong Kong Institute of Certified Public Accountants (HKICPA) and The Society of Chinese Accountants and Auditors (SCAA) during 26 September 2022 to 12 October 2022.

To ensure transparency over AFRC's registration and licensing procedures and requirements and to assist potential applicants and existing practice units in handling their registration and license applications and renewals, the AFRC has published comprehensive guidelines, application forms, fee schedule and submission deadlines for each type of registration and renewal applications on its [website](#) to facilitate potential applicants to submit the relevant applications to the AFRC.

New applications for registration of practice units and local PIE auditors

The AFRC processes new applications in batches and has set the submission deadlines for applications to be processed for the period 2022 to 2024. For applications to be processed by December 2022, applicants were required to make their submissions by 18 October 2022. We received a total of 69 new applications for registration of practice units, and 5 new applications for registration of local PIE auditors.

Renewal of registration of practice units and local PIE auditors

Practising certificates and the registration of firms and corporate practices expire on 31 December each year. 2023 renewal applications were required to be submitted to the AFRC between 1 November 2022 and 15 December 2022. Nearly 7,000, or over 96% of, practice units submitted their renewal applications to the AFRC by the deadline.

The registration of local PIE auditors expires on 31 December each year. 2023 renewal applications were required to be submitted to AFRC between 1 October 2022 and 16 November 2022. We received 73 renewal applications from local PIE auditors by the deadline. 72 have been approved and one is under process.

Online form and guidelines to enhance public protection

On 7 December 2022, the AFRC launched an [online complaint form](#) for lodging of complaints and published the [complaint guidelines](#) (Guidelines) to provide complainants and the general public with an overview of the complaint handling process. The Guidelines would help complainants understand the type of complaints that are within the AFRC's jurisdiction, the information required to substantiate a complaint, how the information is handled, and the type of communication to be expected from the AFRC.

The published Guidelines demonstrate AFRC's commitment to protecting the public interest, as reflected by its continued efforts towards efficient processing of cases and effective assessment of subject matters through consistency of case handling, enhanced transparency, and robust oversight.

Contacts

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