

# 2024 Annual Investigation and Compliance Report

Investigation and Compliance

28 August 2024



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## **About the Accounting and Financial Reporting Council**

The Accounting and Financial Reporting Council (**AFRC**) is an independent body established under the Accounting and Financial Reporting Council Ordinance (**AFRCO**). As an independent regulator, the AFRC spearheads and leads the accounting profession to constantly raise the level of quality of professional accountants, and thus protects the public interest and promotes the healthy development of the accounting profession.

For more information about the statutory functions of the AFRC, please visit [www.afrc.org.hk](http://www.afrc.org.hk).

## Foreword

Accurate and reliable financial statements are the backbone of efficient capital markets. High-quality audits are a cornerstone that contributes to trust in the financial ecosystem. As the independent regulator of the accounting profession, the AFRC is committed to upholding audit quality through a multi-pronged and holistic regulatory approach to deter misconduct and prevent audit quality risks from escalating. This oversight safeguards the integrity of the financial system and enhances investor confidence.

To strengthen Hong Kong's position as a leading international financial centre, the AFRC continually underscores the importance of establishing a culture focused on quality financial reporting and auditing. We lead the accounting profession in constantly raising the level of quality among professional accountants by driving behavioural change, and maintaining a high standard of professionalism and integrity, thereby protecting the public interest.

### Purpose of the report

This is our fourth Annual Investigation and Compliance Report, covering the year ended 31 March 2024. The purpose of this report is to enhance the market's awareness of our findings and observations identified from our investigation and enquiry cases, and to offer guidance to the accounting profession to prevent recurrence of the misconduct and accounting non-compliance identified.

While the AFRC spares no efforts in taking regulatory actions against wrongdoings, it recognises the importance of fostering good practices within the accounting profession. Proactive preventive measures, such as engaging and educating the accounting profession, nurture the profession to improve the quality of financial reporting and audit, and promote the healthy development of the financial ecosystem.

## Regulatory Synergy: upholding financial reporting quality

This financial year is marked by significant breakthroughs in regulatory collaboration. Along with the growing complexities of financial crimes, which often entail the manipulation of financial statements to disguise illicit gains, the AFRC has become a strategic ally to other regulators and law enforcement agencies (**LEAs**) in combating financial crimes.

During the year, we conducted the first tripartite joint operation with the Securities and Futures Commission (**SFC**) and the Independent Commission Against Corruption (**ICAC**) against suspected misconduct and corporate fraud concerning two Hong Kong-listed companies. We also issued a landmark joint statement with the SFC on our common regulatory concern regarding an observable increase in cases of listed companies granting dubious loans.

Our regulatory collaboration efforts were also reflected in the case referrals from our counterparts. Referrals from regulators/LEAs have grown in proportion, accounting for 45% and 19% of the total number of complaints received concerning Public Interest Entity (**PIE**) auditors /PIEs and professional persons respectively.

The regulatory synergy created through effective cooperation in regulation and enforcement has significantly bolstered our capabilities to deter professional misconduct and accounting non-compliance in the financial statements of listed entities. This, in turn, has assisted us in building public trust in the financial reporting quality of listed entities and their auditors.

## Operation Review

The financial year ended 31 March 2024 has been a busy yet fruitful year for the Investigation and Compliance Department. We received a high number of pursuable complaints with an increase of 2.7% as compared to the previous year. The high level of complaints reflected growing confidence in our oversight of the accounting profession.

We continued to adopt a proportionality approach to prioritise resources and protect the public interest. By refining our complaint-handling procedures, we enhanced our efficiency in complaints assessments, ensuring that actions taken are proportionate to the issues identified and that timely and appropriate regulatory actions could be taken.

In parallel with our reactive approach, we undertook proactive market surveillance to detect possible misconduct and non-compliance with accounting requirements in the financial statements of listed entities. Employing a risk-based approach with selection criteria targeting the prevalent risk areas in financial reporting, we selected 130 sets of financial statements of listed entities for review under our Financial Statements Review Programme (**FSRP**), which resulted in the initiation of seven investigations and two enquiries. During the year, we re-engineered our 2024/25 FSRP to incorporate elements of “education” to promote good financial reporting practices and “thought leadership” to influence the mindset and change the behaviours of stakeholders.

In the reporting period, the number of investigations initiated increased by 7%. Of which, the number of investigations concerning professional persons significantly increased by 158%, following our full year’s operation after the expansion of remit.

Amidst a high level of caseload, we have adopted initiatives in operational optimisation. We prioritised our resources to handle cases involving significant public interest, and concluded five and two investigations against PIE auditors and professional persons respectively. We referred six concluded investigations to the Discipline Department for consideration of disciplinary actions, and concluded one investigation with the issuance of a compliance advice letter.

The concluded investigations revealed three main areas of misconduct (i) failure to act diligently and exercise due professional care; (ii) failure to exercise professional judgment and maintain professional skepticism; and (iii) non-compliance with laws and regulations.

In the past year, 46 PIE investigations and 14 enquiries had been newly initiated. Amongst the initiated investigations concerning PIE auditors, the most common areas of potential misconduct included (i) failure to obtain sufficient appropriate audit evidence; (ii) failure to exercise professional judgment and maintain professional skepticism; and (iii) failure to properly perform engagement quality control review.

As for potential accounting non-compliance, the top areas of concern included (i) revenue recognition; (ii) impairment assessment and fair value measurement; and (iii) fraudulent financial transactions and reporting.

In respect of misconduct of professional persons, the predominant areas of potential misconduct continued to be non-compliance with the Code of Ethics for Professional Accountants (**CoE**) and the assurance standards. We have also seen a notable increase in cases concerning potential failures to comply with the provisions in the AFRCO.

### **Vision of developing the accounting profession with all stakeholders**

The development of the accounting profession hinges on the collective efforts of all stakeholders, including auditors, accountants, the public, and the AFRC. Their combined and active contributions are vital for the profession's success.

As the financial landscape undergoes profound transformation and faces new challenges, the AFRC places great emphasis on a culture of lifelong learning, which is key to ensuring the accounting profession remains relevant through reskilling and upskilling. The report offers guidance on how key stakeholders can contribute to the profession's development, emphasising the responsibilities of auditors and preparers of financial statements in avoiding misconduct and accounting non-compliance. We encourage everyone to refer to this guidance and collaborate to grow the accounting profession together.

We all have a key role in maintaining trust and confidence in the market. Let us recognise the pivotal role that all stakeholders play in shaping a robust and dynamic accounting profession. By fostering collaboration, embracing continuous learning, and enhancing professional expertise, we can collectively ensure the long-term success and integrity of the accounting profession.

**Investigation and Compliance Department**

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# Section 1

## Overview

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### I Introduction

1. The financial year 2023/24 was a year full of challenges for the global business environment. With the economic circumstances of high interest rates, inflationary pressure, and credit crunch, enterprises are impacted by rising costs, alterations in contract and pricing terms, and changes in credit risks.
2. The economic turbulence creates significant financial reporting and audit implications in various aspects such as revenue recognition and valuation of assets. Public confidence in the credibility of the financial statements becomes vulnerable, and ensuring the accounting profession upholds professional standards becomes of paramount importance.

#### **Our role and mission**

3. As a financial regulator, we are committed to administering an investigation and enquiry regime that fosters high standards of professional conduct in the accounting profession, enhances the quality of financial reporting and audit, delivers fair and robust investigation outcomes to deter misconduct and non-compliance.
4. The investigation and enquiry functions aim to support the AFRC's mission to enhance public confidence in Hong Kong's capital markets through safeguarding the integrity of financial reporting and audit, and promote sustainable development of the accounting profession.

#### **Purpose of this report**

5. This report provides:
  - (a) An overview of our remit and powers, our processes, and the oversight mechanism of the investigation and enquiry functions (**Section 1 Part II**), and our key operations statistics (**Section 1 Part III**);



- (b) An overview of the full-year results of our operations in complaints handling, proactive review of financial statements under the FSRP, investigations and enquiries (**Section 2**);
  - (c) An overview of key findings and observations on misconduct and non-compliance identified from concluded and newly initiated investigation and enquiry cases (**Section 3**); and
  - (d) Our guidance for the accounting profession to mitigate the risks of committing similar misconduct and accounting non-compliance, and our guidance for the public to facilitate the AFRC in detecting misconduct and non-compliance (**Section 4**).
6. By sharing our findings and observations, we aim to inform the market about significant irregularities and non-compliance. This transparency reinforces trust in the regulatory and enforcement processes, holds organisations and individuals accountable, and sends a strong deterrent message discouraging others from engaging in similar misconduct.
  7. We believe this report will bring insights to different stakeholders within the financial ecosystem and create positive ripple effects. By highlighting the consequences of misconduct and non-compliance, it encourages positive behavioural change and promotes higher standards of audit quality and financial reporting. This approach not only strengthens confidence in the regulatory system but also promotes the development of the accounting profession and brings benefits to the capital market.
  8. We expect the audit profession and preparers of financial statements of listed entities to understand the AFRC's powers and our work processes, and timely and fully cooperate with our investigations and enquiries. They are also expected to pay attention to the audit deficiencies and accounting non-compliance identified, and take appropriate actions to prevent or detect similar misconduct and/or non-compliance.
  9. The public are also encouraged to understand the AFRC's work and purview, and lodge quality complaints to assist us in detecting misconduct and/or non-compliance effectively.

## II Our process

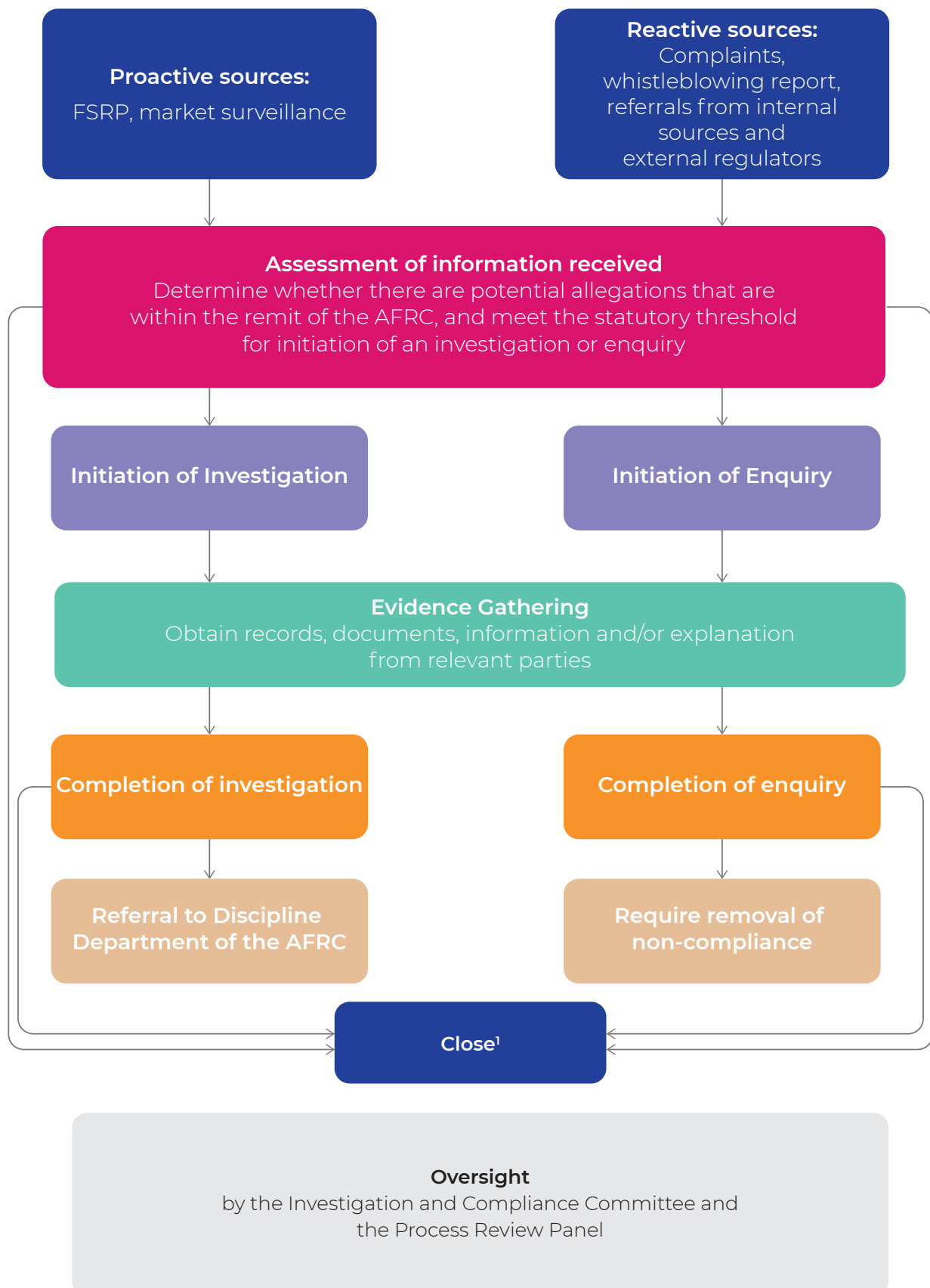
10. Since the implementation of the new regulatory regime on 1 October 2022, the AFRC has the statutory powers to:
  - (a) Investigate possible misconduct committed by PIE auditors and their registered responsible persons;
  - (b) Investigate possible misconduct committed by professional persons, i.e. Certified Public Accountants (**CPAs**) and practice units; and
  - (c) Enquire into possible non-compliance with accounting requirements in the financial reports of PIEs.

### **Deploying resources with the principle of proportionality**

11. 2023/24 is the first full year since the implementation of further regulatory reform in 2022, in which our investigation power expands to cover professional persons. We apply the principle of proportionality and deploy our resources in cases with high public interest.
12. To gather intelligence of potential misconduct and accounting non-compliance in listed entities' financial statements, we adopt a combination of proactive and reactive strategies.
  - (a) Proactively, we carry out market surveillance and select financial statements of PIEs for review using a risk-based approach under our FSRP. We focus our resources on financial statements that are prone to higher risks of material misstatements in financial reporting and auditing irregularities.
  - (b) Reactively, we receive complaints relating to PIEs and/or PIE auditors, and professional persons from internal and external sources. We establish an efficient process to handle cases with less public interest, and prioritise our resources on cases with higher public interest.

13. In determining whether to initiate an investigation and/or an enquiry, we consider factors including the severity of the issues, the benefits to the public interest, as well as the sufficiency of evidence to substantiate the allegations. Allegations of less serious in nature may not be followed up. We may also close cases with other actions for the benefits of the public interest, such as referring to other regulators/LEAs.
14. For the ongoing investigations and enquiries, we prioritise the handling of high-profile cases and cases with high public interest. Investigation findings involving potential significant misconduct are referred to our Discipline Department for consideration of disciplinary actions. For enquiries identified with material accounting non-compliance, listed entities are required to remove the non-compliance in a specified manner and timeframe.
15. An overview of our process of handling reports about potential misconduct or non-compliance, investigations and enquiries, is set out in the flow chart below.

### Overview of our process



<sup>1</sup> Cases may be closed with or without other actions. Other actions may include referring the case to other appropriate authorities if the matter falls within their remit, or issuing advice letters to PIE auditors, professional persons and/or PIEs.

## Oversights

16. Our investigation and enquiry functions are overseen by the Investigation and Compliance Committee (**INCC**) and the Process Review Panel (**PRP**) of the AFRC. The oversight ensures the reasonableness of the decisions made for individual cases, and the upholding of procedural fairness within the decision-making process.
17. The INCC is set up by the AFRC Board with an advisory role on matters concerning the investigation and enquiry functions. It conducts annual reviews of the performance of the complaint handling, financial statements review, investigation and enquiry handling functions. The INCC selects concluded cases and reviews both the procedures and reasonableness of the decisions made for the cases under review.
18. The PRP, as an independent non-statutory panel established by the Chief Executive of the Hong Kong Special Administrative Region, reviews and considers if individual cases have been dealt with consistently, and that all actions and decisions taken are in line with internal procedures and guidelines.
19. In the most recent reviews by the INCC and PRP, the oversight bodies concluded that all cases reviewed were handled in accordance with the internal procedures. The INCC also concluded that the decisions to close the cases selected for review were deemed reasonable. The PRP annual reports can be found on the website of the AFRC.

### III Key operations statistics

#### Key Figures for 2023-2024



<sup>2</sup> These include the ongoing investigations which we have provided investigation reports to the named persons in the reports for an opportunity of being heard.

## Section 2

# Operational Performance

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### I Overview

1. The AFRC is at the forefront of combating professional misconduct and accounting non-compliance. During the financial year, we handled 261 pursuable complaints, proactively selected 130 financial statements for review, and handled 223 investigations and 45 enquiries.
2. In this section, we provide a summary of our operational highlights (**Section 2 Part II**), a review of our work in relation to the assessment of complaints (**Section 2 Part III**), review of financial statements under the FSRP (**Section 2 Part IV**), and the conduct of investigations and enquiries (**Section 2 Part V**).

### II Operational highlights

#### Creating synergy through regulatory collaboration

3. Amidst a rapidly evolving financial environment, financial crimes have become progressively complex. The complexities often stem from the collusion between internal and external parties, and exploitation of loopholes in financial reporting to conceal the illicit activities. Regulatory collaboration among regulators and LEAs of different jurisdictions becomes indispensable in bringing all perpetrators to justice.
4. As financial crimes often entail the manipulation of financial statements to disguise illicit gains, or cover up asset misappropriation, being a regulator of the gatekeepers of financial statements, **the AFRC acts as a strategic ally to other regulators and LEAs** in combating these crimes.
5. Amongst the collaboration efforts during the year,
  - (a) We partnered with the SFC and the ICAC and conducted our **first tripartite joint operation** against suspected misconduct and corporate fraud involving two listed companies. The joint operation involved a search of 16 premises, including the offices of three PIE auditors, with participation from over 50 AFRC officers.

### *Tripartite joint operation with the SFC and the ICAC*



[Press release](#) on the AFRC, ICAC and SFC first tripartite operation against suspected misconduct and corporate fraud dated 19 October 2023

- (b) In July 2023, we also issued a landmark **joint statement** with the SFC. This statement outlines our observations in relation to loans, advances, prepayments and similar arrangements made by listed entities, and reminds the companies, audit committees, and auditors of the standards and practices that they should adhere to.

### *Joint statement with the SFC*



**Joint statement of the Securities and Futures Commission (SFC) and the Accounting and Financial Reporting Council (AFRC) in relation to loans, advances, prepayments and similar arrangements made by listed issuers**

[Joint statement](#) with the SFC in relation to loans, advances, prepayments and similar arrangements made by listed issuers on 13 July 2023



6. In addition, we have formed a strong alliance with local regulators and LEAs through **sharing of intelligence and expertise**. This facilitates swift referrals of potential misconduct, fosters an exchange of expertise and insights with our counterparts, and equips ourselves to navigate emerging challenges with resilience and agility.
7. Regulatory collaboration creates **synergy** that significantly bolsters our capabilities to deter professional misconduct and uphold financial reporting quality. It builds public confidence in the financial market, and becomes indispensable in today's complex financial landscape. It will continue to be our strategic focus.

### **Streamlining processes to enhance efficiency**

8. In response to the increased caseloads following the expansion of regulatory power, we adopted a **proportionality approach** to prioritise resources in order to focus on cases with greater impact on the public. During the year:
  - (a) We refined our complaint-handling procedures, to ensure resource allocation aligned with the public interest significance. This initiative has significantly enhanced our efficiency and enabled us to take appropriate regulatory actions in a timely manner; and
  - (b) We implemented operational optimisation initiatives and enhanced collaborations among internal functions to enhance our efficiency in processing investigations and enquiries. With these initiatives, we concluded seven investigations, including five PIE cases. 10 PIE investigations were also at finalising stages.
9. Enhancing the efficiency in handling cases with significant public interest and high-profile cases will continue to be our top priority in the coming year.

## **Creating positive ripple impacts for the accounting profession**

10. Since 1 October 2022, we have referred 12 concluded investigations to the Discipline Department for consideration of disciplinary actions. Five cases have been fully assessed by the financial year end, and most of which have resulted in disciplinary actions against the PIE auditors and professional persons. The results of our regulatory actions send a strong deterrent message against misconduct and drive positive behavioural change.
11. Apart from taking regulatory actions, we communicated with the market about significant observations of misconduct and accounting non-compliance, and re-engineered our 2024/25 FSRP for promoting good financial reporting and auditing practices. The dual approach of taking robust regulatory actions and promoting good practices will continue to create positive ripple impacts for the accounting profession.

## **III Complaints**

### **Overview**

12. The AFRC encourages complaints from members of the public, reports from whistleblowers, and referrals from other regulators/LEAs. They provide valuable intelligence on potential misconduct by audit firms and CPAs and non-compliance with relevant accounting standards in the financial statements of listed entities.
13. Upon receipt of allegations of potential misconduct or accounting non-compliance, the AFRC assesses whether the allegations are within our remit (i.e. pursuable). If the allegations fall outside our remit, we may direct the informants or refer the matter directly to relevant regulatory bodies, as appropriate.

14. Every pursuable allegation is evaluated to determine if they meet the statutory threshold for initiation of an investigation or enquiry. Factors considered include the severity of the potential misconduct/non-compliance, the public interest benefit, and the availability and sufficiency of evidence. Pursuable matters with insufficient evidence to substantiate or issues of less serious in nature will be closed with no follow-up action. Other follow-up actions, such as referrals to other regulators, may also be considered where appropriate.
15. During the year, we handled 261 pursuable complaints. We completed the assessment of 197 cases, including 133 completed without initiation of investigations or enquiries. 64 cases were still being evaluated.

**Table 1: Movement in complaints**

	PIEs and/or PIE auditors		Professional persons		Total	
	2023/24	2022/23	2023/24	2022/23	2023/24	2022/23
In progress at beginning of the year	<b>47</b>	68	<b>24</b>	–	<b>71</b>	68
Pursuable complaints received	<b>78</b>	114	<b>112</b>	71	<b>190</b>	185
Completed <sup>3</sup>	<b>(46)</b>	(85)	<b>(87)</b>	(37)	<b>(133)</b>	(122)
Initiated investigation and/or enquiry	<b>(38)</b>	(50)	<b>(26)</b>	(10)	<b>(64)</b>	(60)
In progress at end of the year	<b>41</b>	47	<b>23</b>	24	<b>64</b>	71

<sup>3</sup> Include complaints closed without further action, with advice letters issued or referrals to other departments for follow-up.

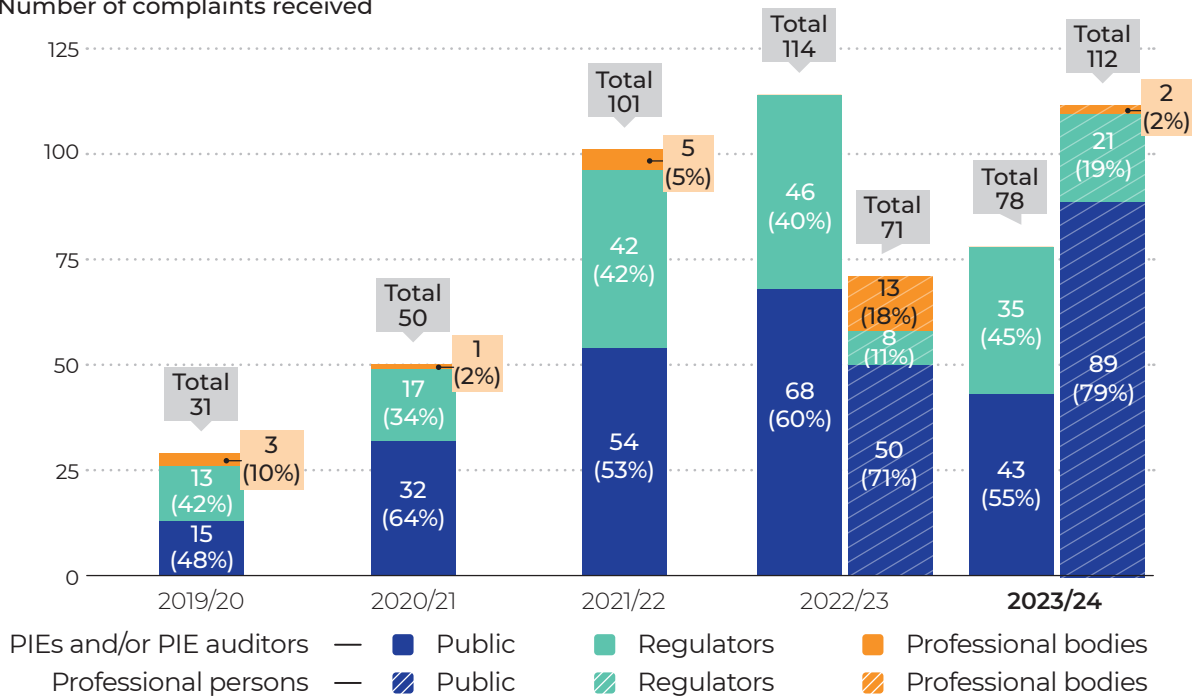
16. The pursuable complaints received in 2023/24 were at a persistently high level (2023/24: 190; 2022/23: 185). To manage the caseload, we refined our complaint-handling process. The initiative enabled us to significantly enhance our efficiency, and effectively handle the expanded caseload.

### Our role in the realm of financial reporting and auditing

- 17. Among the pursuable complaints, referrals from regulators/LEAs were gaining significance. They contributed 45% and 19% of pursuable complaints received relating to PIEs and professional persons respectively, as compared to 40% and 11% in 2022/23.
- 18. These referrals were primarily related to accounting issues of listed entities and concerns about the adequacy of audit work performed by auditors. They were referred to the AFRC, **which had the authority to undertake appropriate regulatory actions against the potential misconduct or non-compliance identified.**

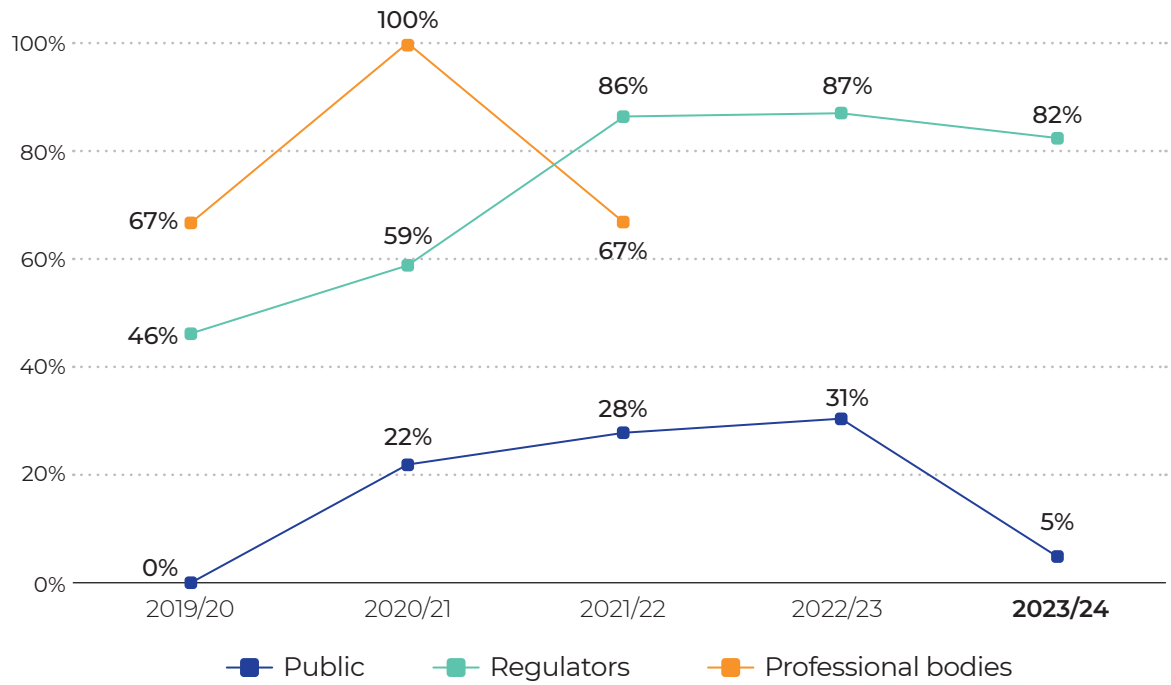
**Chart 1: Source of complaints received**

Number of complaints received

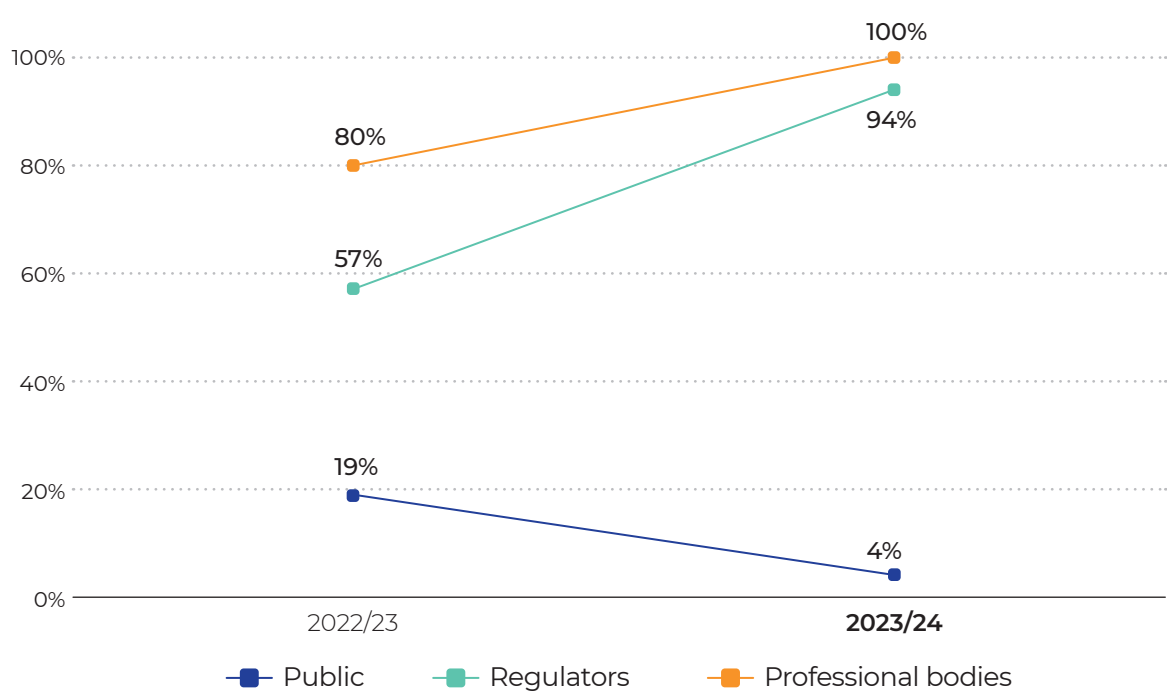


- 19. It is worth noting that the majority of the referrals from regulators/LEAs had led to the initiation of investigations and/or enquiries. For both complaints concerning PIEs and professional persons, the rates of initiating investigations and/or enquiries exceeded 80%.
- 20. The high initiation rates reflected that our collaboration with counterparts extended beyond referrals. With intelligence sharing, the allegations of regulators' referrals are generally more substantiated with evidence, resulting in more effective detection of potential misconduct/accounting non-compliance.

**Chart 2: Initiation rate of investigations and/or enquiries by source of complaints relating to PIE auditors**



**Chart 3: Initiation rate of investigations and/or enquiries by source of complaints relating to professional persons**



### Quality complaints lead to effective actions

21. Over the years, there has been an observable increase in pursuable complaints received from external sources such as the public and other regulators/LEAs. This signified **their growing confidence in our oversight** of the conduct of the accounting profession and the financial reporting quality of PIEs.
22. Compared to the referrals from regulators/LEAs, the initiation rate of investigations and/or enquiries from complaints lodged by the public was relatively lower. This was primarily due to the absence of clear allegation and sufficient supporting evidence provided by the informants.
23. While the AFRC welcomes the continuous effort of the public in communicating their concerns with us, we can only follow up on allegations **with precise allegations and substantiations**. These enable us to **take effective regulatory actions against potential misconduct and non-compliance**. Individuals seeking to file a complaint with us are encouraged to refer to Section 4 Part III, which provides useful guidance on how to submit allegations and information for our review and assessment.

## IV Financial Statements Review Programme

### Overview

24. In parallel with our reactive approach to obtain intelligence on potential misconduct and accounting non-compliance, we adopt a proactive approach to monitor the quality of financial reporting and auditing.
25. Our FSRP, as part of our market surveillance activities, is a non-statutory initiative aimed at detecting potential misconduct/non-compliance through review of financial statements of PIEs. The scope of review focuses on evaluation of compliance with financial reporting standards, auditing and assurance standards, and other relevant financial reporting guidelines.
26. We employ a risk-based approach to select financial statements for review, with criteria being reviewed and set annually, and revised in response to subsequent changes in the economic and regulatory environment.

27. The following table sets out the selection criteria adopted in the 2023/24 and 2022/23 review cycles.

**Table 2: Criteria for selection of financial statements for review**

Criteria for selection	2023/24	2022/23
Auditors who take up PIE audit engagement for the first time	✓	✓
Changes in auditors due to unresolved audit issues with an unmodified opinion issued by the successor auditor	✓	✓
Fair value measurement and disclosures of financial instruments, which require significant judgment and estimation	✓	✗
Impairment assessment of assets	✓	✗
Late auditor resignation	✓	✓
Market events such as media reports or announcements	✓	✓
Modified auditors' opinion	✓	✓
New business/significant changes in business activities, financial position and results	✓	✓
Prior year adjustments for reasons other than change in accounting policy or the adoption of newly introduced financial reporting standards	✓	✓
Specific industries	✗	✓

### Our Review

28. During the year, we selected 130 sets of financial statements for review. Our FSRP resulted in the initiation of seven investigations and two enquiries.
29. In the 2023/24 review cycle, we introduced two new criteria, namely (i) fair value measurement and disclosures of financial instruments which require significant judgment and estimation, and (ii) impairment assessment of assets. These criteria addressed the prevalent areas of the financial reporting risks where preparers are required to make significant management judgment and estimates.

30. Various criteria were also continued to be used for selection, including but not limited to:
- (a) Financial statements with adjustment correcting prior period errors, which may indicate possible misstatements in prior period's financial statements and/or that the audit opinion(s) given in prior period(s) may not have been appropriate; and
  - (b) Late auditor resignation, as audit quality may be compromised when the incoming auditors have limited time to plan and conduct a proper audit under time constraints.
31. In reviewing the financial statements of companies with issues of late auditor resignation, we are particularly concerned about any potential audit deficiencies and the incoming auditor's work in respect of unresolved audit issues identified by the outgoing auditor.

Auditors, company directors and audit committees are advised to make reference to the [follow-up open letter on auditor changes](#) issued by the AFRC for our expectations of them in the events of auditor changes.

32. **Fraudulent financial transactions and reporting** was one of our significant observations from the FSRP this year. The issues identified related to revenue manipulation, related party transactions, and dubious prepayments, deposits, and advances.

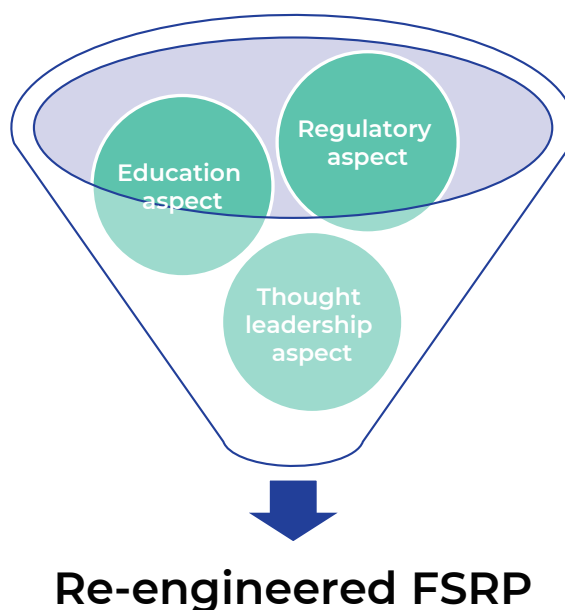
We strongly encourage auditors, company directors, and audit committees to make reference to our [joint statement with the SFC](#) concerning dubious loans for our expectations of them for addressing potential fraud risks.

### **FSRP Re-engineering**

33. In today's complex business landscape, the accounting profession, especially for the smaller accounting practices which possess relatively limited resources, may encounter challenges in identifying good practices for financial reporting and auditing.



34. As a regulator of the accounting profession, we believe in the power of education in enhancing the quality of financial reporting and auditing. During the year, we re-engineered our FSRP initiative. Apart from the existing function to identifying potential misconduct/non-compliance, we add in elements of “**education**” for promoting good financial reporting practices and “**thought leadership**” for influencing the mindset and changing the behaviour of stakeholders.



35. Under the re-engineered FSRP, financial statements are selected under a combination of risk-based approach and thematic approach.
- (a) **Risk-based approach:** Financial statements are selected based on a set of specific risk criteria, targeting to identify possible accounting non-compliance by PIEs and/or misconduct by PIE auditors. The risk criteria will be reviewed annually to respond to the changes of market condition and professional standards.
- (b) **Thematic approach:** Financial statements of companies from the **Hang Seng Index constituents** will be selected for review, primarily focusing on identifying good practices of presentation and disclosures in the financial statements.

The thematic reviews will examine specific areas corresponding to emerging trends or issues, with our key observations and good practices identified to be shared with the market.

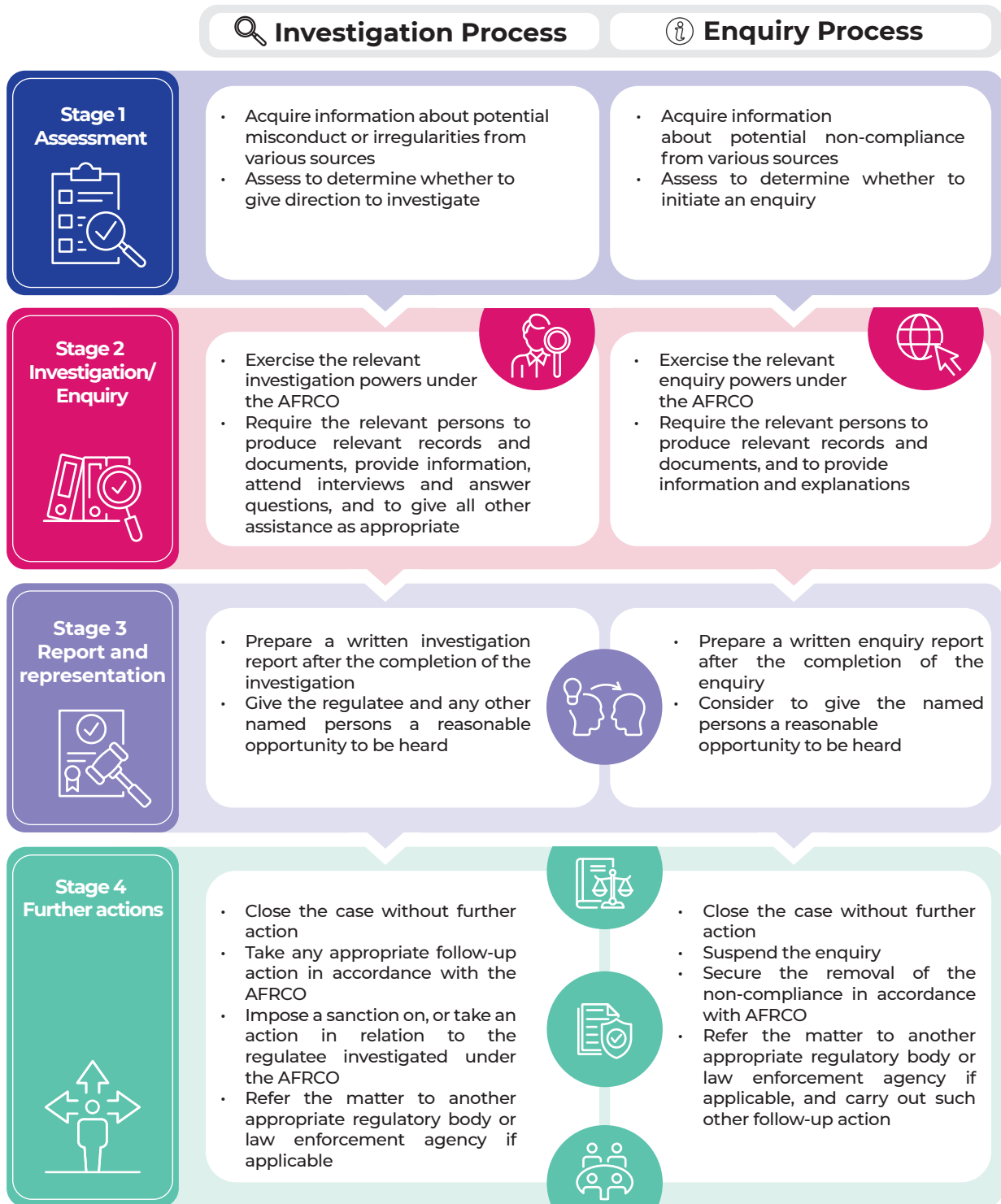
36. The re-engineered FSRP will be effective from the 2024/25 review cycle. The dual approach provides guidance on good financial reporting practices, and continues to monitor potential misconduct/accounting non-compliance. We expect it to bring valuable insights to drive the accounting profession to integrate best practices into their work.

## V Investigations and Enquiries

### Overview

37. Investigations or enquiries are initiated when there is prima facie evidence of possible misconduct by PIE auditors and professional persons, or potential accounting non-compliance in the financial reports of listed entities.
38. When an investigation or an enquiry is initiated, the PIE auditor, professional person and/or the listed entity concerned will be notified. The AFRC will commence the evidence gathering process, and issue requirements pursuant to the AFRCO.
39. Recipients of the requirements may be required to produce records and documents, give explanations or information in relation to the matters under the investigations and/or enquiries, and provide all other assistance in connection with the investigations. For investigations in relation to PIE auditors, investigators may require relevant persons to attend before the investigators to answer questions.
40. Potential misconduct and/or accounting non-compliance are carefully evaluated based on the evidence collected. Investigation findings that may warrant disciplinary actions are referred to our Discipline Department. For enquiry cases, listed entities may be required to remove the non-compliance in a specified manner and timeframe.

41. The diagram below depicts the overall investigation and enquiry processes:



## Our progress

42. For the year 2023/24, 223 investigations have been handled, including 146 investigations brought forward from the previous period, and 77 initiated within the year. Among the newly initiated investigations, 46 were against PIE auditors (2022/23: 60), representing a decrease of 23% while 31 were against professional persons (2022/23: 12), representing an increase of 158%. The significant increase in investigations concerning professional persons reflects the full-year operation following the expansion of our remit.
43. We concluded seven investigations this year, including five cases relating to PIE auditors and two cases relating to professional persons. Six of which were referred to our Discipline Department for consideration of appropriate disciplinary actions. The remaining case was closed with the issuance of a compliance advice letter to the PIE auditor concerned.
44. For enquiries, the number of cases handled increased to 45, including 31 cases carried over from the previous year, and 14 cases newly initiated. The increase was attributable to our strategic collaboration with other financial regulators, where 43% of the enquiries initiated this year were originated from referrals from other regulators.
45. Our progress of investigations and enquiries during the year is set out in the table below.

**Table 3: Movements in investigations and enquiries**

	Investigation				Enquiry	
	PIE auditors		Professional persons		2023/24	2022/23
	2023/24	2022/23	2023/24	2022/23	2023/24	2022/23
In progress at the beginning of the year	139	82	7	–	31	16
Initiated during the year	46	60	31	12	14	17
Handled during the year	185	142	38	12	45	33
Completed	(5)	(3)	(2)	(5)	–	(2)
<b>In progress at the end of the year</b>	<b>180</b>	<b>139</b>	<b>36</b>	<b>7</b>	<b>45</b>	<b>31</b>

## Our initiatives

46. The AFRC is well aware of the importance of taking regulatory and disciplinary actions in a timely manner. This protects the public interest as well as the interests of the persons under investigations/enquiries. To enhance our efficiency, we have adopted operational optimisation initiatives, which include:
- (a) **Prioritisation:** Prioritise resources in handling cases with significant public interest, high-profile cases and backlog cases.
  - (b) **Proportionality:** Allocate resources to match with the severity and complexity of cases. Implement regulatory actions proportionate to the degree of the risk of harm caused by the non-compliance/misconduct.
  - (c) **Specialisation:** Establish specialised teams to handle cases with similar allegations or issues based on team members' expertise, minimising the learning curve of team members.
  - (d) **Enhancement of the efficiency of evidence gathering process:**
    - (i) Develop and implement standardised protocols for evidence collection and documentation to ensure consistency and reliability;
    - (ii) Adopt a more robust policy for managing time extension requests from recipients of requirements for investigations/enquiries; and
    - (iii) Foster collaboration with internal and external counterparts to strengthen the evidence-gathering process.
47. The results from the above initiatives are forthcoming, with significant progress being made. Three more investigations have been concluded after the year end and nine investigations are at the finalising stage. We will continue to discharge our responsibilities efficiently and effectively.

### **Compliance brings in effective regulatory outcome**

48. Timely and effective compliance lays the foundation of fair, robust, and evidence-based regulatory outcomes. During the evidence gathering process, the AFRC issues requirements to relevant parties to collect evidence, and recipients are provided with a reasonable timeframe to comply with the requirements.
49. To enhance the efficiency of the evidence-gathering process, we have adopted a more robust policy for handling requests for time extension to comply with requirements. Requests will only be granted if they are made on reasonable grounds, submitted in a timely manner, and demonstrated that substantial efforts have been made to meet the original deadlines before submitting the requests.
50. Recipients of the requirements are expected to undertake immediate and thorough planning upon receipt of the requirements and inform the AFRC, without delay and with reasons, when they become aware that they cannot meet the requirements by the deadlines. They are reminded of their legal obligations and their public duty to cooperate fully with the AFRC.

## Section 3

# Findings and Observations

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### I Overview

1. This section highlights (i) the key findings of the misconduct identified in concluded investigations, whether referred to our Discipline Department or resolved through other follow-up actions; and (ii) our observations on potential misconduct or accounting non-compliance identified from investigations and/or enquiries initiated during the year.
2. Through this section, we seek to communicate the AFRC's expectations to the accounting profession, discourage the recurrence of misconduct, and notify the market of emerging concerns or trends of non-compliance identified during the year.

### II Findings from concluded investigations

3. The concluded investigations of this year revealed that some PIE auditors failed to act diligently and exercise due care; or failed to exercise appropriate professional judgment and skepticism. Instances of breaches of relevant laws and regulations by PIE auditors and professional persons were also identified.

#### Failure to act diligently and exercise due professional care

##### Findings

4. One of the key findings identified from the concluded investigations was auditors' **failure to act diligently and exercise due professional care**. In two PIE investigations, it was found that the respective PIE auditors failed to exercise due care when performing certain key audit procedures.

5. In one case, a PIE auditor and an engagement partner (**EP**) were found to have signed off an auditor's report that omitted certain information and wordings as required by HKSA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements* and HKSA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*. The omissions, though caused during the printing process, should have been caught by the PIE auditor and the EP, who were expected to diligently verify documents before signing, particularly the auditor's report which is heavily relied upon extensively.
6. In another case, a PIE auditor failed to identify its audit client's non-compliance with the Companies Ordinance (**CO**) as the PIE distributed dividends in the absence of distributable profits for three consecutive years. The non-compliance with the CO by the PIE should have been obvious to the PIE auditor and the failure to detect such non-compliance may constitute a breach of HKSA 250 (Clarified) *Consideration of Laws and Regulations in an Audit of Financial Statements*. Had the PIE auditor acted diligently, the non-compliance by the PIE would have been rectified earlier.



#### Reminders to auditors

7. An audit is intended to enhance the credibility of the financial statements. Auditors are expected to demonstrate professionalism and act diligently and in accordance with applicable professional standards, laws and regulations.
8. Audit firms and EPs should take proactive steps to ensure that their staff uphold the relevant requirements under professional standards throughout the audits. For instance:
  - (a) Audit firms should **ingrain the requirement of exercising diligence and due care into daily operations** as a fundamental aspect of the firms' culture and quality management system; and
  - (b) EPs should **foster an environment for engagement that emphasises the exercise of diligence and due care**, ensure that the assignment of tasks could bring in effective supervision and review of the audit work performed, and promote a culture where engagement team members feel comfortable raising concerns without fear of reprisal.



9. Engagement teams, particularly the EP, are reminded to maintain professional competence and due care in accordance with the CoE. EPs should also refer to HKSA 220 (Revised) *Quality Management for an Audit of Financial Statements* concerning the responsibilities of an EP for an audit of financial statements.



An audit firm without the mindset of diligence and due care imbedded is a castle built on quicksand, where every step threatens to sink its credibility.

### Failure to exercise professional judgment and maintain professional skepticism

#### Findings

10. HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* requires auditors to exercise professional judgment and maintain professional skepticism in planning and performing an audit of financial statements and recognise circumstances that may exist that cause the financial statements to be materially misstated. The failure to exercise professional judgment and maintain professional skepticism has been a recurring area of concern.
11. We found a PIE auditor failed to **alert audit evidence contradicting management’s assessment of the company’s service concession arrangements**. Management assessed that its service concession arrangements did not fall under the scope of HK(IFRIC) Interpretation 12 *Service Concession Arrangements* and recognised the infrastructure of these concession arrangements as the company’s fixed assets, while the agreements and legal opinions indicated otherwise. Despite the existence of contradicting evidence, the PIE auditor concurred with management’s view without critically challenging the assessment set forth by management.
12. As a result of the auditor’s failure to (i) critically challenge management’s assessment; and (ii) exercise professional judgment in evaluating the appropriateness of the accounting treatment of the service concession arrangements, the mistaken view taken by the management that caused the financial statements to be materially misstated was not timely identified and rectified.



### Reminders to auditors

13. Auditors are reminded to thoroughly review the audit evidence for inconsistencies with management's assessment. When contradictory evidence exists, they should seek further clarification from management and obtain independent sources of information and should not only rely on management's assessment without critical evaluation.
14. The current economic downturn may pressurise management to adopt an aggressive approach, such as unreasonable accounting estimates, for a favourable financial performance. Auditors are reminded to exercise heightened professional skepticism and professional judgment, **especially in areas where management's judgment plays a significant role**, such as accounting for complex transactions or accounting estimates and assumptions used for asset impairment assessments.



Where the fog of management's judgment thickens, the light of skepticism must shine brightest.

### Non-compliance with laws and regulations



### Findings

15. In various concluded investigations relating to both PIE auditors and professional persons, we also note an alarming finding relating to practice units' non-compliance with the relevant laws and regulations. We found various practice units failed to comply with the AFRCO, or specifically, the requirements issued by the AFRC pursuant to the AFRCO. Examples include:
  - (a) Practice units' failure to complete corrective actions to remediate deficiencies identified during the AFRC's inspections within the required specified timeframes; and
  - (b) Practice units' failure to produce documents as required by the AFRC for the latter to exercise its regulatory function.

- 16. Reasons given by practice units for their non-compliance, such as “busy schedule” or “mishandling of correspondence by administrative staff”, are unacceptable under any circumstances and indicate a **concerning lack of basic awareness to comply with relevant laws and regulations across all levels within the practice units.**
- 17. This lack of basic compliance awareness also undermines the quality of practice units’ audit work, as demonstrated in paragraph 6 of this section that an oversight by an EP resulted in his/her failure to discover the PIE’s non-compliance with the CO for three consecutive years.

 *Reminders to auditors*

- 18. A well-functioning and prosperous market requires strict and consistent compliance with laws and regulations by all participants and stakeholders. Market participants are always attracted to a professional, law-abiding and actively regulated market. Both the AFRC and the accounting professionals play important roles in maintaining a disciplined market, which helps fostering a sustainable development of the accounting profession.
- 19. Compliance with laws and regulations is a fundamental responsibility for all professional accountants. It is essential that accounting professionals have a thorough understanding of, and strictly adhere to relevant laws and regulations at all times. The AFRC views non-compliance as a serious issue and unequivocally condemns any lax attitude towards compliance with laws and regulations. We will not hesitate to hold firms and their personnel accountable by taking robust enforcement actions.
- 20. Practice units are expected to embed a commitment to compliance within the firm’s culture. Practice units should ensure that all members of the firm, whether administrative or professional staff, cultivate a compliance mindset.

.....  
: Plant the seeds of compliance culture and be rewarded with a  
: sustainable practice.  
.....



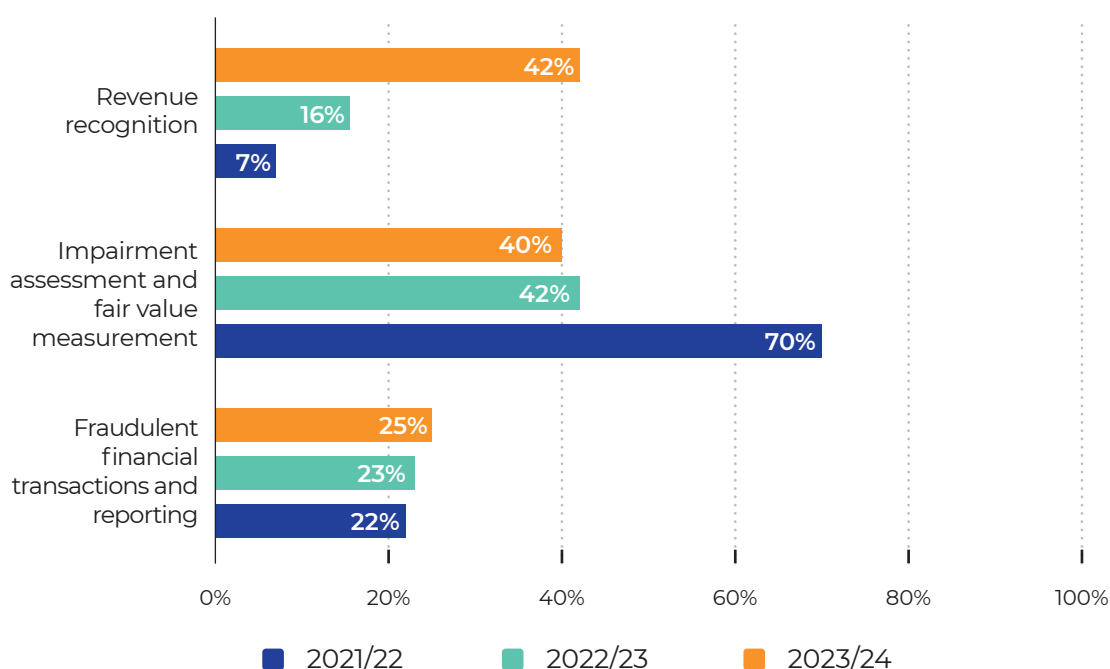
### III Observations from newly initiated investigations and enquiries

21. During the year, we initiated 77 investigations and 14 enquiries based on complaints, referrals, or reviews of financial statements from our FSRP. From these newly initiated investigations and enquiries, we observed emerging trends and issues, which we would like to draw to the attention of auditors, directors and management of listed entities, and preparers of financial statements to promote future compliance.

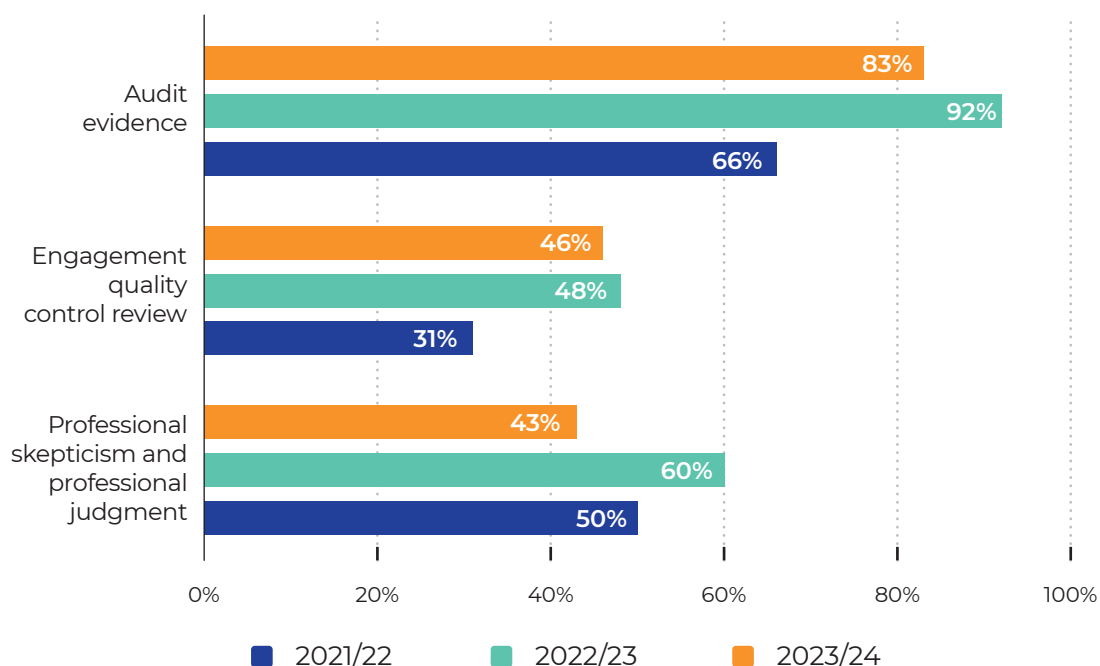
#### A. Observations in relation to PIE engagements

22. The charts below highlighted the key areas of potential accounting non-compliance and misconduct observed from 46 investigations and 14 enquiries initiated during the year.

**Chart 4: Key areas of potential accounting non-compliance**



**Chart 5: Key areas of potential misconduct by PIE auditors**



23. The key areas of potential accounting non-compliance identified from the newly initiated cases remained to be revenue recognition, impairment assessment and fair value measurement, and fraudulent financial transactions and reporting (**Top 3 Potential Accounting Non-Compliance**). There has been a surge in cases in revenue recognition from 16% in 2022/23 to 42% in 2023/24, which outgrew the cases in relation to impairment assessment and fair value measurement.
  
24. Amongst the potential misconduct by PIE auditors, failures to (i) obtain sufficient appropriate audit evidence; (ii) properly perform engagement quality control review; and (iii) exercise professional judgment and maintain professional skepticism remained the top three concerns. To enhance financial reporting and audit quality, we summarised observations from cases involving the Top 3 Potential Accounting Non-Compliance to remind auditors on areas that they should beware of in the future.
  
25. Apart from the above, we also highlighted our observations from cases associated with late auditor resignation, which contributed over 20% of the investigations relating to PIE auditors initiated during the year.

## Revenue recognition

### ! Accounting issues

26. Revenue recognition could be complicated because the contractual terms may give rise to different performance obligations. After identifying the contract with customers, entities should **identify the performance obligations** in the contract as either (i) a distinct good or service; or (ii) a series of distinct goods and services as required under HKFRS 15 *Revenue from Contracts with Customers* (**HKFRS 15**).
27. The performance obligations, if determined inappropriately, would adversely affect the entire revenue recognition process, including allocation of transaction price and satisfaction of performance obligations. The issue is more profound for contracts involving multiple promises, such as a software developer providing one-stop service for its customers including development of a customised system, after-sales customer support, maintenance and warranties at a package price.
28. In one case, a software developer recognised revenue in full upon the delivery of the system without considering its performance obligations related to after-sales customer support, maintenance and warranties. This led to a series of challenges as to whether the amount and timing of revenue recognised by this software developer were appropriate. Accordingly, preparers of financial statements, if in doubt, are advised to discuss concerns over the identification of performance obligations arising from complex contracts with appropriate expert promptly.
29. There are also issues concerning **the measurement of the progress towards complete satisfaction of the performance obligation**, in particular, construction business where management use progress reports issued by surveyors to certify the construction progress. If the timing of the survey work does not align with the year-end date, whether the results of the survey could faithfully depict the entity's performance towards complete satisfaction of the performance obligation would be questionable.
30. Guidance on how to measure an entity's progress towards complete satisfaction of a performance obligation is detailed in HKFRS 15.

 *Reminders to auditors*

- 31. Auditors should obtain a thorough understanding of the contractual arrangements with management and assess the risks associated and design appropriate audit procedures to:
  - (a) Obtain **appropriate** evidence that supports the completion of the relevant performance obligations, such as the final acceptance note agreed and signed by the customers.
  - (b) Ensure the audit evidence **sufficiently** covers the reporting period concerned. Certification work performed before year-end date might call for additional audit procedures. For construction business that relies on certified progress reports as the key audit evidence to support work progress, auditors should advise management on the implication of timing for conducting the certification work.
  - (c) Maintain **professional skepticism** and pay attention to any contradictions amongst audit evidence obtained, such as revenue has been fully recognised while substantial amount of work remains outstanding.

.....  
: These are **NOT** industry specific issues because the identification and :  
: satisfaction of performance obligations are relevant to all entities :  
: applying HKFRS 15. :  
.....



## Impairment assessment and fair value measurement

### ! Accounting issues

32. Impairment assessment is a familiar topic to many preparers of financial statements because HKAS 36 *Impairment of Assets* (**HKAS 36**) applies to all non-financial assets except those specifically excluded.
33. One common issue observed relates to the **length of the forecast period** of the budgets or forecasts as management may consider a period of projection longer than five years can be justified. However, HKAS 36 limits the maximum period of cashflow forecast to five years unless management can demonstrate its ability, based on past experience, to forecast accurately over that longer period, which is generally not available.
34. Another observed issue concerns the **fair value measurement of financial assets and liabilities**. HKFRS 13 *Fair Value Measurement* (**HKFRS 13**) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date. Non-compliance with HKFRS 13 in relation to fair value determination is observed for some entities as they claimed that:
- (a) There have been no substantial changes or developments in the underlying assets/liabilities; or
  - (b) There is a lack of up-to-date financial information (one of the significant unobservable inputs used to measure fair value) on certain investments due to their minority stake.
35. However, explanations in paragraph 34 cannot justify the use of historical values to represent the prevailing fair value of the financial instruments, especially considering the adverse impact of COVID-19 on the global economic environment over the past couple of years. Management should have robust internal controls to monitor investment portfolios and perform valuation using a consistent methodology on the relevant measurement dates.



 *Reminders to auditors*

- 36. Auditors are often presented with management budgets or forecasts, or valuation reports prepared by management’s experts. These materials should be critically evaluated by:
  - (a) **Challenging the parameters and assumptions adopted**, such as comparing with historical data, benchmarking with metrics of industry peers, and performing retrospective review of management’s ability to prepare accurate forecasts for at least the same or longer period;
  - (b) **Considering the competence, capabilities, and objectivity of the expert**, including their qualification, work experience, technical expertise, and factors that might impair an expert’s objectivity such as fee dependence and long-term business relationship; and
  - (c) **Evaluating the appropriateness of the expert’s work**, including the purpose of the expert’s report and sources of information relied upon by the expert for preparation of the report.

Evidence is fact, not what management or its expert says.  
Turning a blind eye misses errors of all kind; questioning things you ought to be questioning put troubles behind.



**Engagement Quality Control Review**

- 37. We noted instances where the engagement quality control reviewers (**EQCRs**) might not have properly performed the engagement quality control review, e.g. the EQCR failed to perform an objective evaluation of the significant judgments made by the engagement team and the conclusion reached thereon before the issuance of the audit report.

38. Conducting an engagement quality control review in a timely manner during the audit engagement assists the engagement team in promptly resolving matters raised to the EQCR's satisfaction. Frequent communications between the engagement team and the EQCR throughout the audit engagement also assist in facilitating an effective and timely engagement quality control review.
39. The EP should cooperate with the EQCR, and discuss significant matters and judgments made in planning, performing and reporting on the engagement.
40. The EQCR is reminded to review engagement documentation relating to the significant judgments made by the engagement team and evaluate:
- (a) The basis for making those significant judgments;
  - (b) Whether the engagement documentation supports the conclusions reached; and
  - (c) Whether the conclusions reached are appropriate.



.....  
: The need for a quality audit review rises in tandem with the level of  
: judgment involved. EP and EQCR are key gatekeepers of audit  
: quality and play an instrumental role in upholding the integrity and  
: reliability of the audit process.  
: .....

## Fraudulent financial transactions and reporting

### Accounting issues

41. Fraud has a pervasive effect on financial statements and it is usually not confined to any specific financial line items. The potential fraud-related accounting non-compliance from the newly initiated cases includes (i) **recognition and disclosure of financial guarantees and/or contingent liabilities**; and (ii) **concealment of dubious prepayments, deposits, and advances through manipulation of accounting records**.
42. It is the primary responsibility of management to establish a proper control environment and maintain policies and procedures for internal controls to safeguard the company's assets, prevent and detect fraud and errors, and ensure the accuracy of the company's financial reports. These internal controls should also ensure compliance with all applicable laws and regulations by the company.
43. Audit committee of listed entities, as the cornerstone of the governance process, also has a vital role in overseeing the company's implementation of effective internal control and risk management systems so that it is more probable to identify specific business and financial reporting risks.

### Reminders to auditors

44. While those charged with governance and management are primarily responsible for fraud prevention and detection, auditors are responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatements, whether caused by fraud or error. Auditors are required to design and implement procedures to identify and assess the risks of material misstatement due to fraud and to respond appropriately to fraud and potential fraud identified during the audit.
45. The unique position of management to perpetrate fraud by overriding controls, in an unpredictable manner, to manipulate accounting records represents a significant risk. Auditors should design and implement procedures responsive to risk related to management override of controls, such as performing journal entries testing that aims at identifying those transactions outside normal course of business or unauthorised journal entries recorded to cover up misappropriation of assets or inflate profits.

46. A common yet fundamental observation concerning the performance of journal entries testing is the failure to evaluate the completeness of population from which journal entries were selected for testing. The absence of such evaluation can undermine the reliability of the test results, compromise the conclusions, and defeat the objective of the test.
47. Most importantly, as the gatekeepers to quality financial reporting, auditors should maintain a skeptical mindset and attention to irregularities, such as contradicting audit evidence and circumstances indicating possible fraud, during the course of audit.
48. The above-listed items are not exhaustive and auditors should always refer to HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* for comprehensive guidance.



An auditor is a watchdog, not a bloodhound, however, a skeptical mindset and robust audit procedures would always be the tools to potentially uncover and combat management fraud.

### Late auditor resignation

#### Implications

49. During the year, 11 investigation and enquiry cases initiated were relevant to late auditor resignation. Companies usually cited audit fee disagreement or auditor rotation for the sake of good corporate governance as the reason for the auditor's last-minute departure. The AFRC has concerns whether these explanations are used to disguise the true reasons for the resignation. Withholding critical information leading to the auditors' resignation obstructs information flow to other market participants and adversely affect the creditworthiness of the capital market.

50. We noted that some of the listed entities were able to announce their audited results within a short period and that appeared to be disproportionate to the complexity of the audits. The tight time constraints imposed on incoming auditors indicate the engagements may have been poorly considered and planned, thus putting the audit quality at risk.
51. For cases initiated during the year, it is observed that the client acceptance and audit planning were often poorly performed, particularly in areas that the outgoing auditors identified as unresolved audit issues. Because of the last-minute appointment, incoming auditors also appeared to struggle with the deployment of appropriate resources to complete the audits.



### *Reminders to auditors*

52. Our expectations of **outgoing auditors** include:
- (a) Set out the precise circumstances leading to the resignation including the nature and significance of all disagreements in the resignation letter;
  - (b) Assess whether the matters reported in the resignation letter have been brought to the attention of the stakeholders; and
  - (c) When being approached by incoming auditors, disclose without delay the unresolved matters through a letter of professional clearance with the same level of detail as in the letter of resignation.





53. We expect the **incoming auditors** to possess a comprehensive understanding of and analyse the audit implications surrounding the circumstances that led to the resignation of the outgoing auditors. Prior to accepting a new client engagement, incoming auditors should:
- (a) Evaluate the audit implications of the circumstances leading to the outgoing auditors' resignation and critically assess whether those matters indicate any potential management integrity issues that may have an impact on their acceptance decisions as incoming auditors;
  - (b) Critically assess their competence and capabilities to perform a quality audit, considering factors such as skills, industry expertise, time and resources commensurate with the client's size and business complexity; and understanding of relevant regulatory and reporting requirements;
  - (c) If they intend to rely on component auditors for significant parts of the audit, assess if they can ensure the component auditors' compliance with professional standards and regulatory requirements applicable to group audits, and involve themselves in the work of the component auditors to the extent necessary to obtain sufficient appropriate evidence;
  - (d) Maintain professional skepticism throughout the audit, even under tight time constraints; and
  - (e) Uphold audit quality without compromise with respect to the proposed fee level.
54. Since our open letter expressing concerns over auditor changes in 2022, significant improvements, such as a substantial reduction in the reported number of late auditor changes and enhanced disclosure on details about auditors' resignation have been observed in announcements of the respective listed entities.

55. While the results have been encouraging, we remind audit committees of the listed entities to continue to fulfil their responsibilities in monitoring the effectiveness of the audit process relating to the financial statements. In the events of the change of auditors, we expect that:

- (a) Audit committees of the listed entities should continue to play an important role in corporate governance and they should procure the listed entities to ensure announcements in connection with the change of auditors are informative without any ambiguity; and
- (b) Audit firms should establish procedures and policies in client and engagement acceptance following the relevant professional standards, with a regular review programme in place to ensure that these established policies and procedures are properly followed.

Untold truth for resignation causes information asymmetry and harms market integrity; tight deadlines lead to poor audit planning and disappointing audit quality.

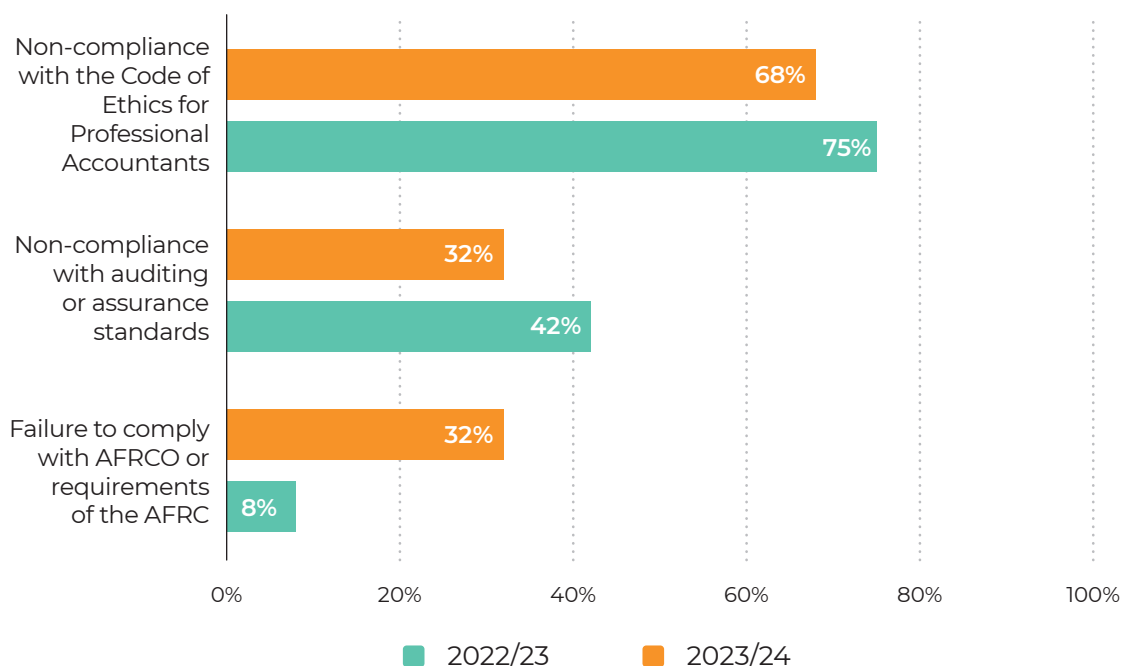
Listed issuers, outgoing, and incoming auditors should collaborate to resolve the issues and prevent future recurrence.



**B. Observations in relation to professional persons**

56. The chart below shows the key areas of potential misconduct in the 31 investigations initiated against professional persons during the year.

**Chart 6: Key areas of potential misconduct by professional persons**



57. The predominant potential misconduct continued to be non-compliance with the CoE and auditing and assurance standards. There was also a notable increase in cases concerning potential failures to comply with the AFRCO or requirements of the AFRC, as featured in 32% of our investigations initiated during the year (2022/23: 8%).

### **Non-compliance with the CoE**

58. We noted potential gaps in compliance with the principles of professional behaviour, professional competence and due care, and the Independence Standards as outlined in the CoE. Specifically, we observed potential issues concerning compliance with the registration requirements relating to PIE engagements, conduct of listed entities' officers, and concerns regarding independence by professional persons.

#### *Compliance with the registration requirements relating to PIE engagements*

59. The AFRCO stipulates that PIE engagements can only be undertaken and carried out by local PIE auditors registered with the AFRC or overseas PIE auditors recognised by the AFRC. In addition, there are specific registration requirements for individuals performing the roles as EPs or EQCRs of registered PIE auditors for PIE engagements, including:

- (a) Individuals undertaking activities as EPs or EQCRs for PIE engagements must be registered EPs or registered EQCRs of the registered PIE auditors; and
- (b) Registered PIE auditors must not authorise any person who is not a registered EP or a registered EQCR of the registered PIE auditors to carry out any activities as an EP or EQCR of the registered PIE auditors for PIE engagements.



60. The registration requirements for PIE engagements ensure that activities are conducted by fit and proper individuals. They serve the purpose of safeguarding the audit quality of PIE engagements. PIE auditors and individuals acting as EPs or EQCRs are reminded that non-compliance constitutes an offence and they should closely follow the [AFRC's Guide for the Registration of PIE Auditors](#).
61. During the year, we observed instances of non-compliance with the AFRCO where certain practitioners appeared to have carried out activities as EPs or EQCRs of the registered PIE auditors for PIE engagements at the time when they were not registered EPs or EQCRs of the registered PIE auditors. This also implied that the relevant registered PIE auditors might have breached the AFRCO by authorising unregistered persons to carry out activities as an EP or EQCR of registered PIE auditors for PIE engagements.
62. The above observations again illustrated that there seems to be a lack of basic awareness to comply with relevant laws and regulations by some practitioners, which we have mentioned in paragraphs 15 to 20 of this section.
63. Professional accountants are reminded that such non-compliance not only constitutes a violation of the fundamental principle of **professional behaviour** of the CoE which requires professional accountants to comply with relevant laws and regulations, but also carries potential legal consequences.

#### *Conduct of officers of listed entities*

64. With the AFRC's expanded authority to investigate misconduct by professional persons, we have started to take regulatory actions against professional accountants in business. Preparers of financial statements and officers of listed entities are particularly of concern as their misconduct can significantly affect stakeholders and market integrity.
65. We noted situations where the actions of listed entities' officers potentially caused the listed entities to breach the disclosure requirements under the Securities and Futures Ordinance (**SFO**). We also hold preparers of financial statements of listed entities accountable for preparing financial statements with non-compliance with accounting requirements.

66. Quality financial reporting requires commitment and sustained efforts from stakeholders including the board of directors, audit committees, and management. Professional accountants are expected to diligently apply their professional knowledge and take all reasonable measures to ensure the companies they act for comply with relevant laws and regulations.

### *Independence*

67. Compliance with independence requirements remains a major concern. We noted certain practitioners might have potentially disregarded the independence requirement, such as performing audits of financial statements for private companies in which the practitioner acted as officers.

68. Independence is fundamentally linked to objectivity and integrity. An independent audit enhances a company's credibility and fosters public trust in the accuracy of the results and the integrity of the accounting profession. Professional accountants are reminded to adhere to the Independence Standards under the CoE when performing audits, reviews, and other assurance engagements.

Compliance is a must, not an option. It is the cornerstone of public trust and supports your professional career. Non-compliance risks the loss of both.



### **Non-compliance with assurance standards**

69. Apart from audit services, practice units may provide other professional services, such as engagements to review of historical financial information, agreed-upon procedures engagements and investment circular reporting engagements. These engagements are occasionally provided to entities including listed companies and entities under other local regulators' supervision, and involve significant public interest.

70. We observed an increasing number of cases related to potential deficiencies in assurance engagements carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* for licensed corporations' compliance with the SFO. There are various instances indicating that the auditors might have failed to, amongst others:

- (a) Identify financial returns that were not correctly compiled in accordance with the Securities and Futures (Accounts and Audit) Rules; and
- (b) Perform sufficient procedures to test controls over renewal of standing authority and over Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules with reference to Practice Note 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries*.

These instances demonstrate auditors might not have sufficient understanding of the relevant regulatory requirements, or lack specialised expertise or resources to handle these assurance engagements.

71. **Professional accountants should consistently demonstrate competency and due care to their professional work, regardless of the nature of the engagements.** There are established standards that outline the responsibilities of auditors for review, assurance, and investment circular reporting engagements. In addition, there are practice notes providing guidance applicable to specific engagements. We urge audit firms to provide sufficient training and professional development to their staff to enable them to understand and apply the **established professional standards and practice notes** when carrying out these engagements.



Check if you are fit before you commit. Competence is the prerequisite for quality.

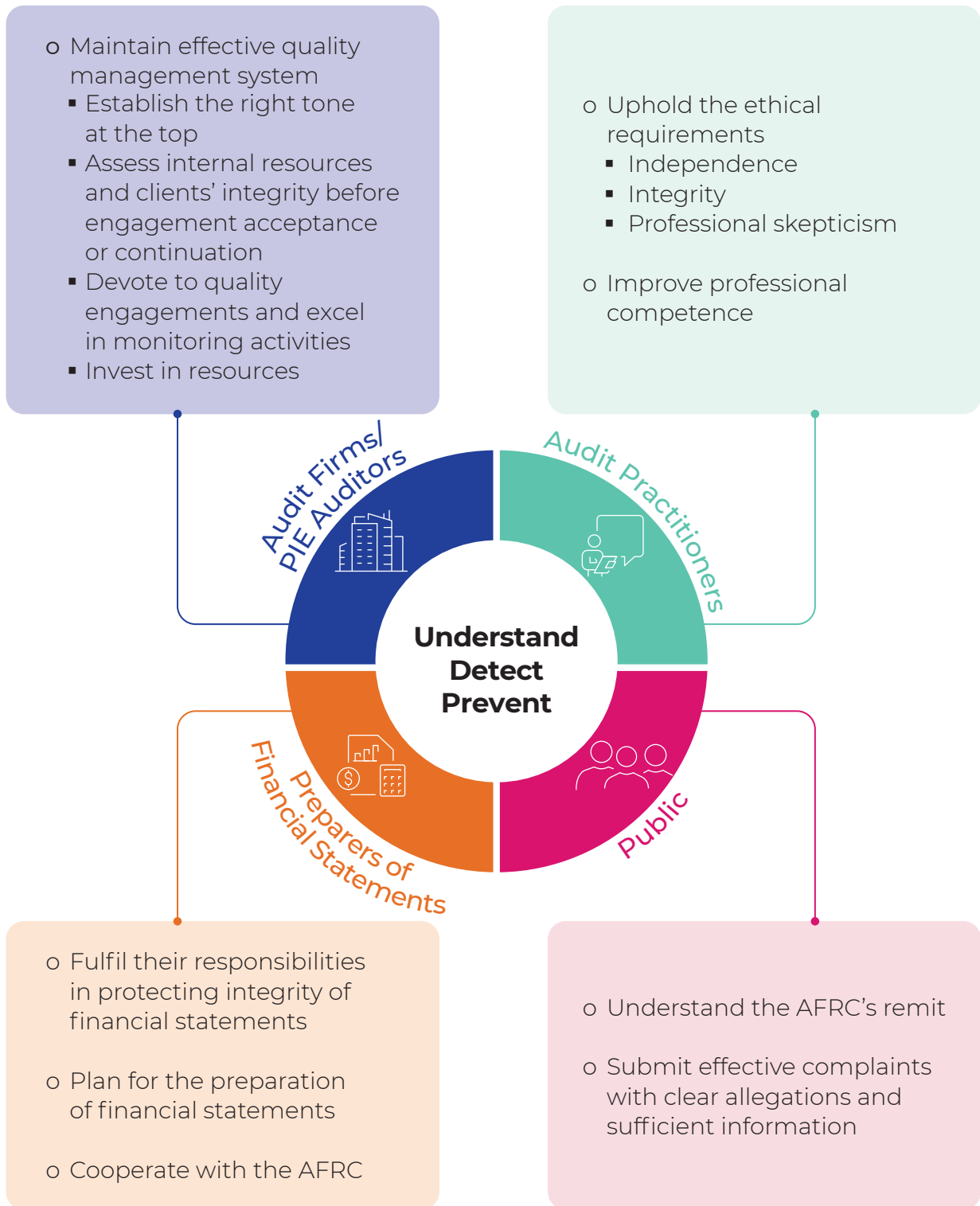
## Section 4

# Guidance for Stakeholders

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### I Overview

1. Quality financial reporting and independent external audits are crucial to market confidence and to the effective functioning of capital markets. The AFRC has a mission to uphold the quality of financial reporting of listed entities in Hong Kong, to enhance protection for investors and ensure the audit market in Hong Kong serves the interests of the investing public and the wider public interest.
2. While the AFRC addresses misconduct and accounting non-compliance through regulatory measures and effective engagement with auditors and CPAs, it recognises the importance of fostering good practices within the accounting profession. Proactively preventing wrongdoing is often more effective than addressing misconduct or non-compliance through investigations and enquiries.
3. To this end, we introduce guidance for the auditors and preparers of financial statements (**Section 4 Part II**) on our expectations of and recommendations for them to uphold audit and financial reporting quality.
4. We also appreciate the public continuously providing valuable information to us to detect potential misconduct/accounting non-compliance. To ensure effective actions could be taken against the allegations against audit firms and CPAs, we encourage individuals who wish to file a complaint with the AFRC to refer to the guidance for the public (**Section 4 Part III**) to understand how to lodge an effective complaint.



## II Guidance for auditors and preparers of financial statements



### Audit Firms / PIE Auditors are expected to:

#### Establish the right tone at the top:

5. Tone at the top is fundamental to promoting high-quality audits. Audit firm's leadership should establish the right tone at the top through their actions and behaviours, and engaging in clear, consistent and frequent actions and communications at all levels within the firm that:
  - (a) Compliance with all legal, professional and ethical standards is an essential component of audit work;
  - (b) Professionalism and audit quality should always be prioritised over commercial considerations; and
  - (c) Professional skepticism is prioritised and exercised at all times during an audit engagement.
6. Tone at the top can be reinforced by fostering a culture of communication and openness, promoting a culture of professional development and implementing performance evaluation and compensation systems that are duly tied to behaviours in upholding audit quality and performance based on it. Audit firm's leadership are encouraged to refer to AFRC's publication [\*Setting and Reinforcing Tone at the Top to Achieve Quality Audits\*](#) for further guidance.

**Assess internal resources and clients' integrity before engagement acceptance or continuance**

7. The quality of an audit links directly to the sufficiency of resources and the competence of the engagement team, including the time allocated to complete the audit. Audit firms are expected to:
  - (a) Establish robust policies and procedures to ensure that they have considered the nature and circumstances of the engagements before undertaking new engagements or continuing relationships;
  - (b) Conduct adequate customer due diligence to obtain information about the integrity and ethical values of the clients. Audit firms should consider declining or discontinuing client relationships when the clients lack integrity and ethical values; and
  - (c) Conduct assessments of the staff's competence and capabilities and the availability of appropriate resources to perform a quality audit.

**Devote to quality engagements and excel in monitoring activities**

8. The public interest is served by the consistent performance of quality engagements. Achieving quality engagements requires the audit firms and their personnel to comply with professional standards and applicable legal and regulatory requirements. Audit firms should endeavour to:
  - (a) Ensure EPs direct and supervise the engagement team effectively to enable team members to understand and fulfil their responsibilities in connection with the engagements and exercise appropriate professional judgment and professional skepticism;
  - (b) Emphasise the importance and benefit of consultations to resolve difficult and contentious matters at an early stage; and
  - (c) Elevate internal requirements relating to retention and maintenance of engagement documentation.

9. Audit firms should establish an effective monitoring process to identify and remediate deficiencies on a timely basis to facilitate proactive and continual improvement of engagement quality. Audit firms should ensure information from both internal (e.g. whistleblowing reports) and external (e.g. results of external inspections) sources are properly considered.

### **Invest in resources**

10. High-quality audits require the deployment of the right quantity and quality of resources. Audit firms should identify the resources needed, and obtain and allocate resources with appropriate competence, capabilities and commitment to engagements.
11. Audit firms should equip their staff with appropriate knowledge of professional standards and relevant legal and regulatory requirements, and develop their staff competence through training and continuing professional development (**CPD**). Audit firms should also design and implement human resources processes for hiring and retaining personnel with the appropriate capabilities and commitment to quality, and recognise the personnel's performance with rewards.
12. A well-developed professional staff is not an expense; it is an investment that yields dividends in the form of quality work. Investments in these resources enable the consistent performance of quality engagements.





## Audit Practitioners are required to:

### Observe independence requirements

13. Auditors play a pivotal role in providing credibility to financial statements and give public confidence in their truthfulness and fairness for making decisions. Audit practitioners should maintain independence in mind and appearance throughout engagements as this enables them to express a conclusion without bias, conflict of interest, or undue influence.
14. Audit practitioners should always be alert to circumstances that create or might create threats to independence. When such circumstances arise, audit practitioners should address the threats by eliminating the circumstances, applying safeguards or declining the specific professional activity to eliminate the threats or reduce them to an acceptable level.

### Maintain integrity

15. Audit practitioners should maintain integrity by being straightforward and honest in all professional and business relationships. They should avoid conflicts of interest and stand their ground when faced with pressure, potential adverse personal or organisational consequences.

### Exercise professional skepticism

16. As the gatekeepers of financial statements, auditors are always expected to challenge management's assertions and assumptions whenever necessary.
17. In an environment where listed entities are facing intensified financial pressure, audit practitioners should pay closer attention to areas susceptible to accounting manipulation and management override of controls, such as revenue recognition and fair value measurement, and apply robust methodologies to identify suspicious activities and detect material misstatements resulting from fraud or error.

### Assess and continuously improve professional competence

18. It is essential for audit practitioners to attain and maintain the professional knowledge and skills necessary to provide competent professional services, and act diligently and in accordance with applicable technical and professional standards. They are also reminded to comply with the CPD requirements to remain in good standing with the professional body.

As part of the audit firms' leadership, practitioners are also required to support the firms in fulfilling the AFRC's expectations.



### Preparers of Financial Statements are expected to undertake the following:

#### Protect the integrity of financial statements

19. The primary responsibility for high-quality financial reporting rests with the boards of directors, management and financial reporting officers of listed entities. Audit committees also play important roles in safeguarding the integrity of financial reporting.

##### *Board of Directors*

20. The current challenging global economy brings uncertainties to listed entities, making them more susceptible to fraudulent activities. The board of directors must protect the integrity of financial statements as part of their statutory duties. They should establish a proper control environment and maintain policies and procedures for internal controls to detect fraud and errors, thereby ensuring the accuracy of the companies' financial reports.
21. They should fully cooperate with and support audit committees in carrying out their oversight functions over financial reporting.

##### *Audit Committees*

22. Audit committees play a crucial role in monitoring the financial reporting processes and related internal control systems, reviewing financial information and overseeing the relationship with external auditors to ensure financial reporting quality. They should:
- (a) Maintain a constructive dialogue with external auditors throughout the entire process, from planning to completion. In-depth communications regarding identified risks, significant findings and observations made by the auditors should be conducted in a timely manner.
  - (b) In the event of a change of auditor, ensure that the disclosures relating to the auditor's resignation are complete and accurate, especially in relation to unresolved audit issues and disagreements with management.

They should also ensure that incoming auditors possess the necessary competence and capabilities to perform a high-quality audit and properly resolve outstanding audit issues.

**Plan for the preparation of financial statements**

23. Management of listed entities should engage in effective planning and allocate sufficient resources and competent personnel to assist in preparing the financial statements. They should ensure the financial statements are prepared in accordance with the applicable financial reporting standards, and exercise management judgment that is reasonable and supportable, while ensuring compliance with the relevant laws and regulations.

**Cooperate with the AFRC**

24. Listed entities may receive requirements from the AFRC to provide documents and information for investigations and enquiries, or written notices to remove accounting non-compliance from their financial reports. The board of directors are reminded to provide the required documents and information promptly and to adhere strictly to the deadlines specified in the AFRC's requirements or notices.

### III Guidance for the public



#### People who wish to lodge a complaint are encouraged to:

##### Understand the AFRC's remit

25. The AFRC acts in the public interest and for the benefit of the public as a whole. It is vested with the authority to conduct investigations into possible misconduct by audit firms and CPAs and to conduct enquiries into non-compliance with accounting standards or other requirements in the financial reports of listed entities.
26. The AFRC does not act for the benefit of individual complainants, and is not in a position to intervene in service quality issues, commercial disputes, private or criminal matters, or act as the financial or legal adviser of individual complainants.
27. Individuals who wish to lodge a complaint are encouraged to refer to our [Complaints Guidelines](#), and consider whether the subject of the complaint and the involved parties fall within our jurisdiction.

##### Clearly articulate allegations in the complaint and provide sufficient information to substantiate the allegations

28. The AFRC can only pursue allegations that are supported by explanations and evidence showing that the relevant party may have engaged in material misconduct or non-compliance.
29. Formal investigation and/or enquiry will only be undertaken if the nature and seriousness of the complaint require the AFRC's interference to protect the public interest.
30. Individuals who wish to lodge a complaint are encouraged to clearly articulate allegations in the complaint and provide sufficient information to substantiate the allegations to facilitate our complaint assessment.

## Glossary

Term	Meaning
AFRC	Accounting and Financial Reporting Council
AFRCO	Accounting and Financial Reporting Council Ordinance
CO	Companies Ordinance
CoE	Code of Ethics for Professional Accountants
CPAs	Certified public accountants
CPD	Continuing professional development
EP	Engagement partner
EQCR	Engagement quality control reviewer
FSRP	Financial Statements Review Programme
HKAS	Hong Kong Accounting Standard
HKAS 36	HKAS 36 <i>Impairment of Assets</i>
HKFRS	Hong Kong Financial Reporting Standard
HKFRS 13	HKFRS 13 <i>Fair Value Measurement</i>
HKFRS 15	HKFRS 15 <i>Revenue from Contracts with Customers</i>
HKSA	Hong Kong Standard on Auditing
ICAC	Independent Commission Against Corruption
INCC	Investigation and Compliance Committee
LEAs	Law enforcement agencies
PIE	Public Interest Entity
PRP	Process Review Panel
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance

## **Contacts**

**If you have any enquiries or comments, please feel free to contact us.**

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