

# 2023 Annual Investigation and Compliance Report

Investigation and Compliance

4 September 2023



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## **About the AFRC**

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

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

## Glossary

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<b>Term</b>	<b>Meaning</b>
AIB	Audit Investigation Board
AFRC	Accounting and Financial Reporting Council
AFRCO	Accounting and Financial Reporting Council Ordinance
Amendment Ordinance 2021	Financial Reporting Council (Amendment) Ordinance 2021
AWP	Audit working papers
Category A firms	PIE auditor with over 100 PIE clients
Category B firms	PIE auditor with 10 to 100 PIE clients
Category C firms	PIE auditor with less than 10 PIE clients
CoE	Code of Ethics for Professional Accountants
CPA	A person registered as a certified public accountant by virtue of section 22 of the PAO
EQCR	Engagement Quality Control Review
FRC	Financial Reporting Council
FRCO	Financial Reporting Council Ordinance
FRRC	Financial Reporting Review Committee
FSRP	Financial Statements Review Programme
HKAS	Hong Kong Accounting Standards
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
HKPF	Hong Kong Police Force
HKSA	Hong Kong Standards on Auditing
HKSQC	Hong Kong Standard on Quality Control
ICAC	Independent Commission Against Corruption
ICC	Investigation and Compliance Committee
LEA	Law enforcement agency
MOF	Ministry of Finance of the People's Republic of China
MoU	Memorandum of Understanding

<b>Term</b>	<b>Meaning</b>
PAO	Professional Accountants Ordinance
PIE	Public Interest Entities
PIE auditor	A registered PIE auditor or a recognised PIE auditor as defined under the AFRCO
Professional Persons	A CPA or a practice unit as defined under the AFRCO
PRP	Process Review Panel
RBA	Resolution by Agreement offered based on the powers of the Council of the HKICPA outlined in the PAO
SEB	Supervision and Evaluation Bureau of the MOF
SEHK	The Stock Exchange of Hong Kong Limited
SFC	Securities and Futures Commission

## Foreword

We are pleased to share with the public our third Annual Investigation and Compliance Report, covering the year ended 31 March 2023. This Report provides an overview of the operations of complaints handling, investigation, and enquiry functions of the AFRC, highlights the more common examples of practice irregularities, non-compliance in listed entity financial statements, and misconduct of their auditors and CPAs that we have found or investigated during our investigations and enquiries, and a look forward at our plans for the coming year.

### Further reform and expanded remit

The year 2022/2023 was a challenging yet fruitful year for the Investigation and Compliance Department of the AFRC.

For decades, the accounting profession in Hong Kong has been subject to self-regulation by the HKICPA. By virtue of the Financial Reporting Council (Amendment) Ordinance 2021 (**Amendment Ordinance 2021**), the AFRC became the full-fledged independent regulatory and oversight body of the accounting profession on 1 October 2022. On top of its existing regulatory powers in relation to PIE auditors, the AFRC is now vested with expanded statutory functions to cover all CPAs and practice units (collectively, **professional persons**). This momentous change heralds a new era of the regulatory regime of the accounting profession and the AFRC, which now has a dual role: as a regulator, and as a market facilitator.

Investigation and enquiry are fundamental and essential functions of the AFRC's regulatory and oversight framework. Since the establishment of the then FRC in December 2006, we have been vested with the powers of investigation and enquiry to conduct investigations into potential misconduct by PIE auditors and enquiry into potential non-compliance with accounting requirements by PIEs in their financial statements. Given the expanded duties, we now have the statutory powers to conduct investigations into professional irregularities of professional persons (i.e. all CPAs and practice units).

In line with our expanded remit under the further reform, we have significantly expanded our team with a diverse range of talents, including professional staff who are richly experienced in handling complaints and investigations related to CPA and CPA practices, and staff with regulatory and forensic accounting experiences.

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 audits, delivers fair and robust investigation outcomes to deter misconduct and non-compliance, and protects investors' interests.

## **Operations overview**

It has been a busy year for the Investigation and Compliance Department with a substantial 83% increase in pursuable complaints received during the year. In terms of reactive approach, we encourage the public and whistleblowers to report misconduct, accounting or practice irregularities, and respond to complaints, whistleblower reports, and referrals by other regulators. The number of complaints received from the public about potential misconduct or non-compliance concerning PIE auditors continued to increase; besides, we have also started to receive complaints against professional persons since 1 October 2022. The above trend and statistics indicate more public awareness and confidence in the AFRC to take regulatory action as the independent audit and accounting regulator.

The number of financial statements we proactively reviewed under the Financial Statements Review Programme (**FSRP**) increased by 73% this year. As a proactive approach, we monitor announcements made by listed entities and other public sources of information and comments on financial reports and audits of listed entities, and identify financial statements for review under the FSRP using a risk-based approach.

Referrals for investigations from the inspection function have also significantly grown in number and scope this year.

Fair, transparent, and robust investigations are one of the key regulatory tools to protect the public interest, deter misconduct and shape the behaviour of the accounting and auditing profession. Formal investigation or enquiry is commenced after careful consideration of a range of factors, including the seriousness of the potential misconduct/non-compliance, public interest benefit, and the availability and sufficiency of evidence. The number of investigations being initiated this year increased by 88%, some of which concern complex issues with significant public interest.

During the year, we have concluded five investigations against professional persons, three investigations against PIE auditors and two enquiries. We demonstrated the standards we uphold and delivered important messages for the market, whilst continuing our efforts to tackle ageing cases in parallel with a strategic focus to investigate high-impact cases.

In December 2022, we published clear Complaint Guidelines with interactive public complaint and whistleblower forms on our website to encourage high-quality reporting of potential misconduct and non-compliance. Besides, the Investigation and Compliance Department maintains effective collaboration with the Inspection and Discipline Departments to implement a seamless and holistic regulatory regime. High uptake and swift initiation of investigations from internal referrals demonstrates joined-up effort across the AFRC to improve audit and financial-reporting standards and quality. Early collaboration with the Discipline Department increases efficiency and effectiveness in the conduct of subsequent disciplinary action.

Since the 2021/2022 financial year, we have been taking the initiative to increase our follow up on the potential accounting non-compliance found in our complaints and financial statements review cases by initiating and conducting more enquiries with our powers under the AFRCO. We aim to identify financial reporting non-compliance to hold financial statements preparer accountable, and to require the relevant listed entities to take appropriate actions to rectify the identified relevant non-compliance, including but not limited to making proper disclosures to the public. In the 2022/2023 financial year, we completed two enquiry

cases and have been actively performing follow-up actions with the listed entities concerned, directed at rectification of the financial reporting non-compliance.

### **Potential and actual non-compliance in listed entity financial statements**

Delivery of high-quality financial statements is first and foremost the responsibility of the boards, audit committees, managements, and professionally qualified accountants of listed entities (i.e. financial statements preparers).

This year, the more common areas of financial reporting non-compliance include (i) revenue recognition, (ii) recognition and measurement of financial instruments, (iii) impairment assessment, and (iv) going concern assessment and disclosures. We have also seen an increase in potential fraudulent financial transactions and reporting.

### **Potential and actual misconduct by listed entity auditors and professional persons**

Auditors are responsible for providing reasonable assurance about whether the financial statements are prepared in accordance with the applicable financial reporting framework and are free from material misstatements. The professional competence and independence of the engagement team, and the effectiveness of the auditors' quality controls are of equal importance in upholding high-quality financial statements audit.

This year, we identified from the PIE auditor cases that the persistent key areas of actual or potential misconduct by PIE auditors involve (i) failure to perform engagement quality control review (**EQCR**) adequately, (ii) failure to obtain sufficient appropriate audit evidence, (iii) failure to exercise appropriate professional skepticism and professional judgment, (iv) inadequate audit work on accounting estimates, and (v) improper forming of audit opinion and reporting on financial statements.



In respect of misconduct of professional persons, our investigative work on professional person cases shows that the more common types of misconduct concern non-compliance with fundamental requirements of auditing and assurance standards, such as obtaining sufficient appropriate audit evidence, quality controls, independence and other ethical requirements, and integrity and professional misconduct.

From our recently-initiated investigations and enquiries, we have observed a significant increase in potential non-compliance with HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and potential audit deficiencies in relation to recognition and measurement of financial guarantee and financial liabilities.

### **Looking to the future**

The AFRC plays a pivotal role within the financial regulatory system by upholding audit and financial reporting quality and regulating the conduct of accountants and auditors, who are gatekeepers of financial reporting quality in Hong Kong. The Investigation and Compliance Department spares no effort on the shared mission of protecting the public interest and creating positive ripple impacts for the accounting profession by taking prioritized, proportionate, and risk-focused enquiries and investigations.

We will build on our capabilities and resources to deliver and continue to optimise our processes and procedures to enable us to discharge our expanded statutory duties efficiently and effectively. On the stakeholders' engagement front, we will disseminate enquiry and investigation findings to educate the market on common irregularities and non-compliance.

Handling high-profile cases with significant public interest and cases where audit working papers have been obtained from the Mainland are, amongst others, our priority areas. We will continue to reinforce our regulatory cooperation with local and Mainland regulators under the framework of our memoranda of understanding in order to achieve effective cross-sector and cross-border enforcement outcomes.

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# Section 1

## Introduction

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### 1.1 Purpose of this report

1.1.1 2022/23 is the first year since the AFRC was transformed to become the independent regulator of the accounting profession. This report, on one hand, provides an overview of the operations of investigation and enquiry functions of the AFRC, including our expanded remit covering all practising CPAs, firms of practising CPAs, and corporate practices under the new regulatory regime. On the other hand, it is the third annual investigation and compliance report which sets out the full-year results of our findings and observations on misconduct, audit irregularities and financial reporting non-compliance arising from our complaints assessment, proactive review of financial statements under the FSRP, investigations, and enquiries.

1.1.2 This report includes:

- (a) An overview of the remit and powers, the work processes, co-operation with other regulators, and the oversight mechanism of the investigation and enquiry functions (section 2);
- (b) An overview of sources of cases dealt with via our proactive market monitoring and reactive complaints handling mechanisms, and key operation statistics (section 3);
- (c) An overview of the processes and key operation statistics of the investigation and enquiry functions (section 4);

- (d) An overview of key findings and observations on misconduct (section 5), and financial reporting non-compliance (section 6). We also include in this report our expectations of CPAs, listed entity auditors, directors, and audit committees in respect of our investigation and enquiry findings and observations on emerging issues; and
- (e) Highlights of key aspects of our plans to further enhance our efficiency and effectiveness in discharging the investigation and enquiry functions, increase stakeholders' engagement, and maintain close collaboration with local and Mainland regulators in the coming year (section 7).

## 1.2 Key operations statistics

### Key Figures For 2022-23



<sup>1</sup> These include investigation reports that we have provided the named persons in the reports an opportunity of being heard pursuant to section 35(4) of the FRCO.

The below table lists out 5-year operational statistics for complaints, investigations and enquiries and financial statements reviews for the year 2022/2023, with comparatives for the year 2021/2022, 18-month-period from October 2019 to March 2021 (due to a change of the financial year-end to 31 March after the regulatory reform in 2019), nine-month-period from January to September 2019 (due to regulatory reform in 2019), and the year ended 31 December 2018.

**Table 1: Five-year operations statistics**

	Apr 2022 to Mar 2023	Apr 2021 to Mar 2022	Oct 2019 to Mar 2021 (18 months)	Jan to Sep 19 (9 months)	2018
<b>Reports of matters</b>					
Opening (pursuable <sup>2</sup> )	68	29	23	11	14
Reports <sup>3</sup> received <sup>4</sup>	185	101	67	48	35
Cases <sup>5</sup> initiated	(60)	(31)	(19)	(6)	(9)
Advice letter issued	(3)	(3)	(2)	-	-
Referred to specified enforcement agencies	(2)	-	-	(1)	(2)
Closed without further action	(117)	(28)	(40)	(29)	(27)
Closing (pursuable)	71	68	29	23	11
<b>Investigations</b>					
Opening (In progress)	82	58	42	43	40
Initiated	72	32	23	11	19
Advice letter issued	(1)	-	-	-	-
Referred to the HKICPA	-	(7)	(7)	(12)	(16)
Referred for disciplinary actions	(6)	-	-	-	-
Closed without further action	(1)	(1)	-	-	-
Closing (In progress)	146	82	58	42	43
<b>Enquiries</b>					
Opening (In progress)	16	3	1	3	2
Initiated	17	14	2	1	2
Non-compliance removed	-	(1)	-	(2)	(1)
Non-compliance not yet removed <sup>6</sup>	(2)	-	-	(1)	-
Closing (In progress)	31	16	3	1	3
<b>Financial statements reviews</b>					
Opening (In progress)	27	30	39	31	25
Financial statements selected for review	130	75	62	47	50
Cases <sup>5</sup> initiated	(11)	(2)	(4)	(5)	(9)
Advice letter issued	(9)	(16)	(37)	(10)	(21)
Closed without further action	(69)	(60)	(30)	(24)	(14)
Closing (In progress)	68	27	30	39	31

<sup>2</sup> Reports are not pursuable if the subject matter of the reports is outside the remit of the FRC/AFRC.

<sup>3</sup> These include complaints received from members of the public, whistleblower reports and referrals from other regulators.

<sup>4</sup> Excluded 723, 163 and 50 pursuable complaints of a vexatious, abusive or unreasonably persistent nature for the years 2022-23, 2021-22 and 2018 respectively which were not taken further.

<sup>5</sup> A case initiated means a complaint case/financial statements review case for which the assessment resulted in the initiation of an enquiry, an investigation, or both.

<sup>6</sup> The AFRC issued notice to remove the non-compliance, however the subject entity was subsequently delisted and the non-compliance has not yet been removed; or the subject entities were still in the process of assessing the impact of the relevant non-compliance and the required disclosures.

## Section 2

# Overview of operations

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### 2.1 Introduction

- 2.1.1 The AFRC has the statutory power to investigate possible misconduct committed by PIE auditors or reporting accountants and to enquire into possible non-compliance with accounting requirements in the financial reports of PIEs.
- 2.1.2 With the commencement of the Amendment Ordinance 2021 on 1 October 2022, the regulatory powers of the AFRC, including the powers to investigate, have been expanded to cover professional persons, i.e. certified public accountants and practice units.
- 2.1.3 The FRCO as in force immediately before 1 October 2019 continues to apply to investigations of PIE engagements completed before 1 October 2019.
- 2.1.4 Both investigation and enquiry are important AFRC regulatory functions:
- (a) Investigations ensure that potential misconduct on the part of PIE auditors and their registered responsible persons and professional persons detected through our reactive and proactive monitoring activities (see diagram in paragraph 2.3.1) are responded to on a timely basis and adequately so that appropriate follow-up action can be taken. Such follow-up action may include the imposition of sanctions or referral to other regulators or law enforcement agencies for conduct falling within their remit.

- (b) Enquiries ensure that potential non-compliance with financial reporting requirements in the financial reports of PIEs identified are rectified on a timely basis and appropriately so that investors and other stakeholders are not misled by misstatements contained in the financial reports of PIEs.

2.1.5 Details of the remit and powers of the investigation and enquiry functions are available on the AFRC's website (see paragraph 2.3.1).

## **2.2 Acquiring information about potential misconduct or non-compliance**

2.2.1 The AFRC aims to acquire information about potential misconduct or non-compliance through conducting market surveillance and market monitoring activities. The AFRC may do so:

- (a) Reactively, through market surveillance activities that scan for complaints, and through reports and referrals of misconduct or non-compliance from:
  - (i) members of the public;
  - (ii) whistleblowers; and
  - (iii) other regulators; or
- (b) Proactively, through our risk-based market monitoring activities, i.e.:
  - (i) inspections; and
  - (ii) reviews of financial statements of PIEs under the FSRP (see section 3.3).



2.2.2 The AFRC provides a platform for members of the public and whistleblowers to make complaints or provide information about possible misconduct or non-compliance they are aware of.

The platform has:

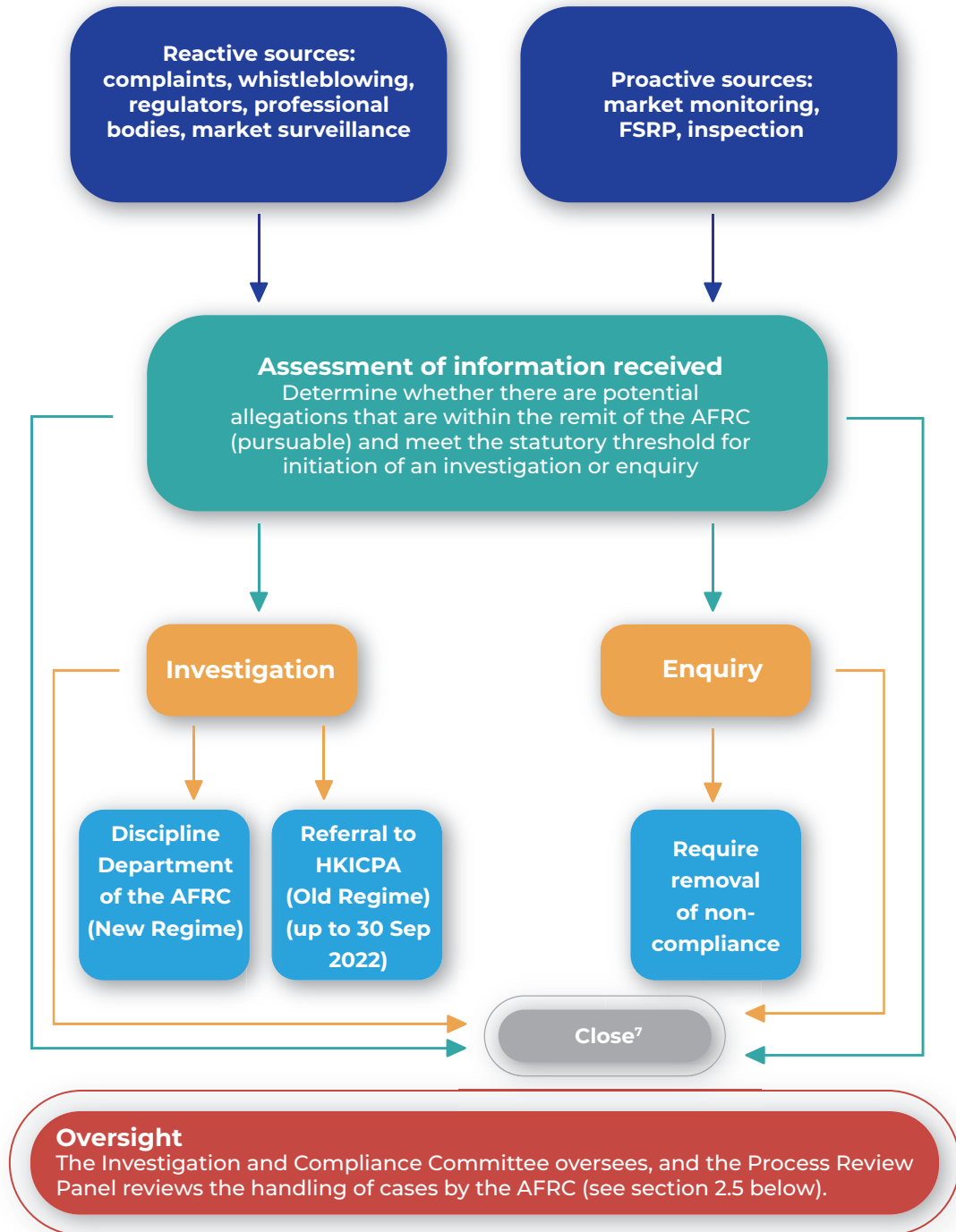
- A guideline to complainants;
- An online Complaint Form; and
- An online Whistleblowing Form

## 2.3 Our process

2.3.1 A high-level overview of our process of handling complaints and other reports about potential misconduct or non-compliance, investigations or enquiries, is set out in the flow chart below. Details of the AFRC's remit and powers are set out in the following policy statements which are available on the AFRC's website:

- *Investigation Policy Statement for PIE Auditors, Non-PIE Auditors and Registered Responsible Persons*
- *Investigation Policy Statement for Professional Persons*
- *Investigation Policy Statement (in relation to audits or the preparation of specified reports completed for listed entities before 1 October 2019)*
- *Enquiry Policy Statement for Listed Entities*

## Overview of our process



<sup>7</sup> Cases would be closed by the AFRC under the following circumstances:

- when the potential allegations fall outside the remit of the AFRC; or
- when the evidence acquired does not meet the statutory thresholds.

However, the AFRC may refer the case to other appropriate authorities if it falls within their remit, and may issue a letter of advice to the PIE and/or its auditor to highlight certain issues identified based on evidence obtained to suggest improvements for the preparation of future financial statements or the performance of future audits.

## **AFRC's disciplinary functions**

- 2.3.2 Up to 30 September 2022, for completed investigations involving audits of PIE engagements completed before 1 October 2019 (**Old Regime**), the investigation findings were referred to the HKICPA for consideration of appropriate follow-up actions.
- 2.3.3 Since 1 October 2022, the AFRC has assumed the investigation and discipline of all CPAs registered with the HKICPA, CPAs (practising) and practice units. Accordingly, investigation findings involving audits under the Old Regime are now considered by the AFRC's Discipline Department.

## **2.4 Cooperation with other regulators**

- 2.4.1 We collaborate closely with local and Mainland authorities on regulatory initiatives under the framework of MoU in order to achieve effective cross-sector and cross-border enforcement outcomes.

### **Hong Kong**

- 2.4.2 Misconduct and relevant non-compliance in the financial markets might simultaneously involve offences under regulations within the jurisdiction of different regulators and LEAs.
- 2.4.3 Over the years, the AFRC has been fostering effective collaboration with other regulatory and professional bodies and LEAs in Hong Kong, including the HKPF, ICAC, SFC, SEHK, and the HKICPA. We share a common goal of safeguarding the interests of investors and other stakeholders in the markets. The close cooperative relationships that have been established are reinforced under the framework of MoU which facilitates regular liaison meetings, proper exchanges of knowledge and information of common interests, intelligence and investigation findings, swift case referrals for investigation and enforcement actions, and effective use of full-spectrum enforcement tools available to combat misconduct.

- 2.4.4 In September 2022, the AFRC entered into a MoU with the Commercial Crime Bureau of the HKPF to enable full collaboration and co-operation in combating commercial crime and illicit activities in relation to financial reporting and audit quality in Hong Kong.
- 2.4.5 In November 2022, the AFRC gave presentations at the Hong Kong Police training sessions. In December 2022, we shared our experiences in investigating audit and financial reporting irregularities and non-compliance with accounting requirements at the inaugural ICAC Financial Investigation Specialist Training.
- 2.4.6 In July 2023, the AFRC and SFC issued their first *joint statement* in relation to loans, advances, prepayments and similar arrangements made by listed issuers. We shared our ongoing concern on potential fraudulent transactions conducted by listed issuers in which dubious loans and advances were granted with little or no commercial rationale, and without proper risk assessment, due diligence or documentation. We also shared our expectations on the management of the Company, audit committee and auditors.

### **Mainland China**

- 2.4.7 Hong Kong plays a unique role as a connector between the Mainland and global financial markets. Mainland enterprises listed in the SEHK (comprising of H-share companies, Red Chip companies, and Non-H share Mainland private enterprises) represent a significant proportion of all listed entities in Hong Kong (around 54% by number and 77% by market capitalization as of 31 December 2022). For effective regulation of the financial reporting and audits of these listed entities, it is important to develop a strategic relationship with Mainland authorities, in particular the SEB of the MoF of the People's Republic of China.
- 2.4.8 Under the arrangement of the MoU between the SEB and the AFRC, we have successfully gained access to audit working papers located in the Mainland for our investigations with the assistance of the SEB through an effective mechanism and clear procedures.

- 2.4.9 During the year, we maintain close and frequent working-level communication with the SEB to discuss how the efficiency in obtaining access to audit working papers located in the Mainland and the subsequent clearance could be further enhanced.
- 2.4.10 Details and progress of the requests for assistance of the SEB in relation to investigations are set out in paragraphs 4.2.9 to 4.2.12 of this report.

## 2.5 Oversight

- 2.5.1 Independent committee and panel provide external checks and balances on our investigation and compliance functions to ensure the upholding of natural justice and procedural fairness in the decision-making process and proper use of regulatory powers.

### Investigation and Compliance Committee

- 2.5.2 The ICC is a committee set up by the AFRC under the AFRCO comprising AFRC Board members and Honorary Advisers. The ICC advises the AFRC Board on matters concerning the investigation and enquiry functions and related activities to acquire, assess and obtain information about potential allegations of misconduct or non-compliance. It also provides advice on the development of strategies, guidelines, and procedures and in setting selection criteria for the FSRP.
- 2.5.3 In addition, the ICC performs an annual review (both procedural and substantive) of the performance of the handling processes for the reactive and proactive sources of allegations. The ICC uses a set of selection criteria that it determines annually to select completed cases for review (**ICC Review Programme**). The ICC reports its findings and recommendations to the AFRC Board.
- 2.5.4 The scope of the ICC Review Programme covers the following:
- (i) **Procedural review** — Compliance with internal procedures in handling the completed cases as contained in the operations manual; and

- (ii) **Substantive review** — Reasonableness of the justification for closing the case without further action with reference to financial reporting standards, auditing and assurance standards, other relevant financial reporting guidelines, and statutory disclosure requirements.

2.5.5 The ICC has completed its third review cycle under the ICC Review Programme covering the period from 1 April 2022 to 31 March 2023. The ICC selected 28 (14%) out of 199 completed cases of complaints, whistleblower reports, referrals and financial statements reviews that were closed with or without other actions taken. The ICC concluded that all the selected cases had been handled in accordance with the operations manual and the decisions to close the cases without initiating an investigation or enquiry were reasonable.

#### **Process Review Panel**

2.5.6 The PRP of the AFRC is an independent non-statutory panel established by the Chief Executive of the HKSAR in 2008 to review cases handled by the AFRC and to consider whether actions taken by the AFRC are consistent with its internal procedures and guidelines.

2.5.7 The PRP completed its review of 10 out of 113 cases handled by the investigation and enquiry functions in 2021<sup>8</sup>. The PRP recognised the AFRC's efforts in discharging its regulatory functions in relation to PIE auditors and was satisfied that the AFRC had handled the cases selected for review in accordance with the internal procedures. The PRP also made recommendations to the AFRC to enhance the process of handling complaints and investigations.

2.5.8 In response to the recommendations, the Investigation and Compliance Department has updated its operational manuals to enhance its operational efficiency, held cross-departmental collaborative meetings to facilitate the handling of referrals among different functions internally, and coordinated with other regulators and law enforcement agencies in sharing information of common interest and exchanging feedback on case referrals.

<sup>8</sup> 2022 Annual Report of PRP for the Financial Reporting Council.

## Section 3

# Sources of our work

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### 3.1 Introduction

- 3.1.1 This section provides a review of our work of the year in relation to the assessment of complaints, reports, referrals, and review of financial statements under the FSRP about potential allegations of misconduct or non-compliance.
- 3.1.2 During the year, there was a substantial increase (83%, see table 2 below) in the number of reports received about potential misconduct of auditors and professional persons or potential non-compliance with financial reporting requirements by listed entities. The number of complaints made by the public increased from 54 in 2021/2022 to 118 this year (including 68 complaints filed against PIE auditors and 50 complaints filed against professional persons during the period between 1 October 2022 and 31 March 2023).
- 3.1.3 For referrals, the Inspection Department is now the largest source which referred 36 cases (including 33 and 3 referrals concerning PIE auditors and professional persons respectively) in the year compared with 16 referrals concerning PIE auditors in the previous year, and accounted for 51% of the total number of referrals received. These referrals predominantly arose from inspections of individual audit engagements.
- 3.1.4 This year, we worked to optimise our process and procedures to enhance the efficiency and effectiveness of the complaints handling, including:
- a) Prioritizing our resources to handle potential allegations with significant public interest;

- b) Simplifying the steps in the assessment of complaints and financial statements reviews to enhance the efficiency and effectiveness of the processes; and
- c) Publishing a clear Complaint Guidelines with interactive public complaint form and whistleblower report on our website to encourage high-quality external reporting of potential misconduct and non-compliance.

## 3.2 Complaints

### Overview

- 3.2.1 The AFRC encourages complaints from members of the public, reports from whistleblowers, and referrals from other regulatory bodies (i.e. informants) which provide information about potential misconduct of a CPA registered with the HKICPA or a practice unit and practising CPA registered with or recognised by the AFRC, and non-compliance with the relevant accounting standards in the financial statements of a listed entity.
- 3.2.2 When the information received from the informants does not relate to allegations of potential misconduct or non-compliance that fall within the remit of the AFRC, it is not pursuable by the AFRC and we may direct the informants to other relevant regulatory bodies or refer the matter to such bodies directly.
- 3.2.3 Every pursuable allegation of potential misconduct or non-compliance identified from the aforesaid channels or from our FSRP is evaluated to determine whether to initiate an investigation or an enquiry. Pursuable matters are closed with no follow-up action when, based on our evaluation, the evidence obtained does not show that the relevant party may have engaged in material misconduct or non-compliance.
- 3.2.4 During the year, we handled 253 complaints and referrals, including 68 brought forward from the previous year and 185 pursuable complaints and referrals received in the year. We completed the assessment of 182 reports relating to pursuable allegations, of which 122 were closed without initiation of investigations or enquiries. As at 31 March 2023, 71 reports were still being evaluated.



**Table 2: Movements in reports by informants**

	PIE auditors		Professional persons	
	Apr 2022 to Mar 2023	Apr 2021 to Mar 2022	Apr 2022 to Mar 2023	Apr 2021 to Mar 2022
Brought forward	68	29	–	–
Reports received	115	114	80	–
Non-pursuable matters <sup>9</sup>	(1)	(13)	(9)	–
Reports of pursuable allegations received <sup>10</sup>	114	101	71	–
Completed <sup>11</sup>	(85)	(31)	(37)	–
Initiated investigations or enquiries	(50)	(31)	(10)	–
<b>In progress at the end of the year</b>	<b>47</b>	<b>68</b>	<b>24</b>	<b>–</b>

3.2.5 While the number of complaints received experienced a rapid growth of 83% this year, the number of complaints closed without initiating investigations or enquiries raised even more significantly (294%, see completed cases<sup>11</sup> in Table 2 above). It should be noted that a clear and concise explanation of the allegation with supportable evidence is essential when assessing whether a complaint should be pursued further. The AFRC may not have sufficient grounds to pursue the matter if there is a lack of such information and evidence.

<sup>9</sup> The subject matters of these reports are outside the remit of the AFRC.

<sup>10</sup> Excluded 723 (2021/2022: 163) pursuable complaints of a vexatious, abusive or unreasonably persistent nature which were not taken further.

<sup>11</sup> Include complaints closed without further action, with advice letters issued or referred to other LEAs.

### **Evidence provided by informants**

3.2.6 An assessment is conducted based on the intelligence acquired from the informant and all publicly available information, which may include the relevant financial statements. In addition, the AFRC may seek to acquire further information proactively from other sources. However, when the information provided by an informant is not sufficient to meet the statutory thresholds for initiating an investigation or enquiry into potential allegations of misconduct or non-compliance, the AFRC may not be able to pursue the potential allegations.

3.2.7 Therefore, it is important that an informant provides accurate information that is sufficient for the AFRC to identify and assess the potential allegations of misconduct or non-compliance. The information should include:

- a) The name and contact information of the CPA, practice unit and its registered responsible persons, recognised PIE auditors, and/or the listed entity, that are relevant in the circumstances;
- b) Specific details of the conditions, events or circumstances indicating the potential misconduct or non-compliance including, where relevant, details of the dates and parties involved; and
- c) Copies of any relevant documents providing evidence in support of the allegations.

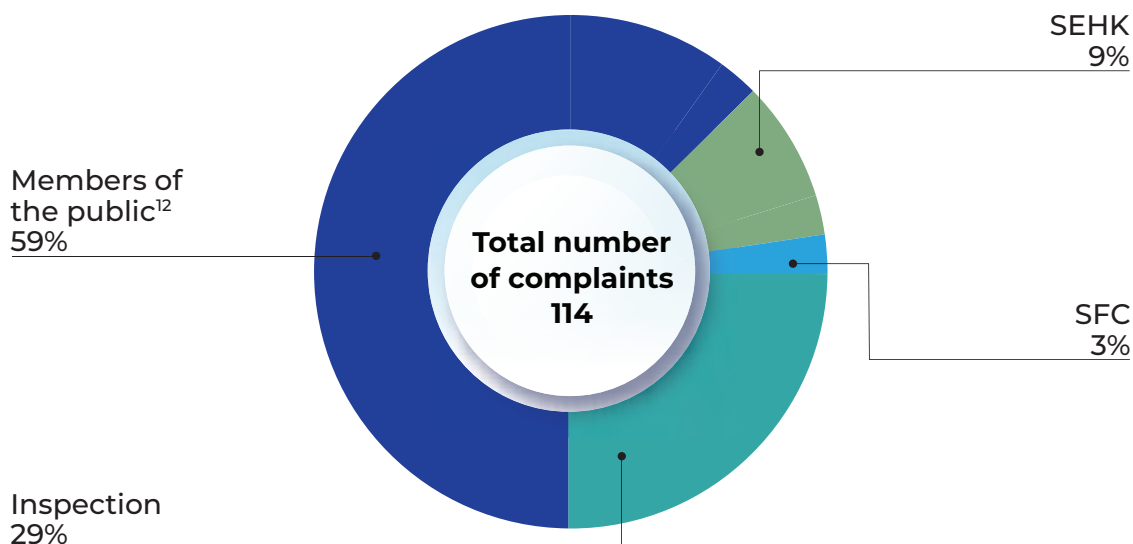
3.2.8 We accept information sources that are anonymous and the AFRCO (section 52) provides statutory protection for the informants, including confidentiality of their identity if disclosed. However, informants are advised to provide contact details to enable the AFRC to follow up or clarify information received or to obtain further information if considered necessary. Anonymous complaints may severely constrain our ability to pursue the allegations if further information is needed.

**Our sources**

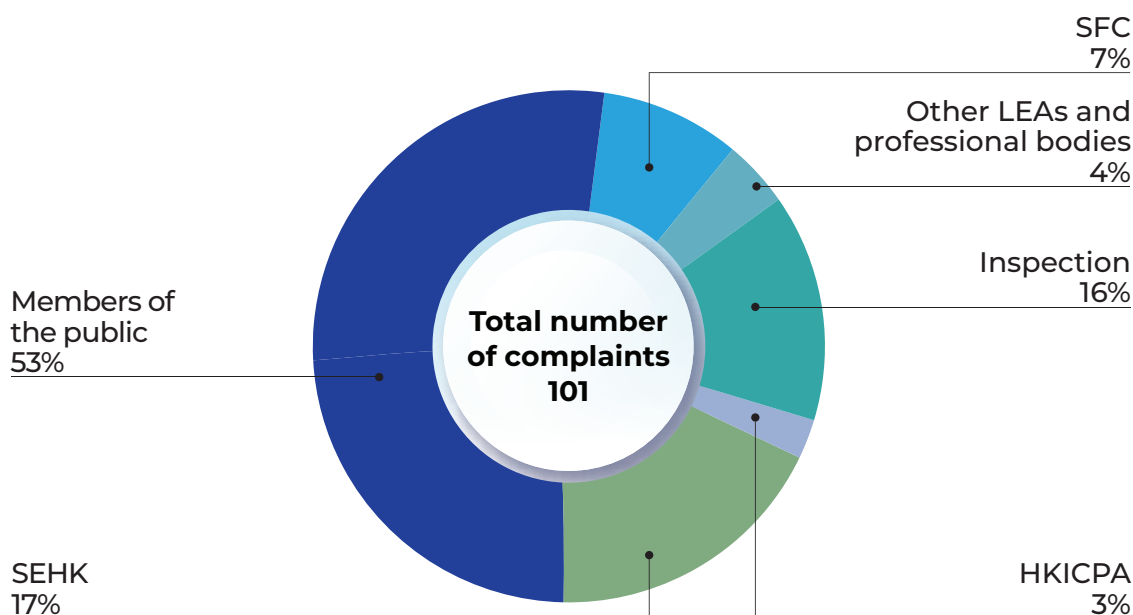
**Chart 1: Sources of pursuable complaints**

**(a) PIE**

**2022-23**



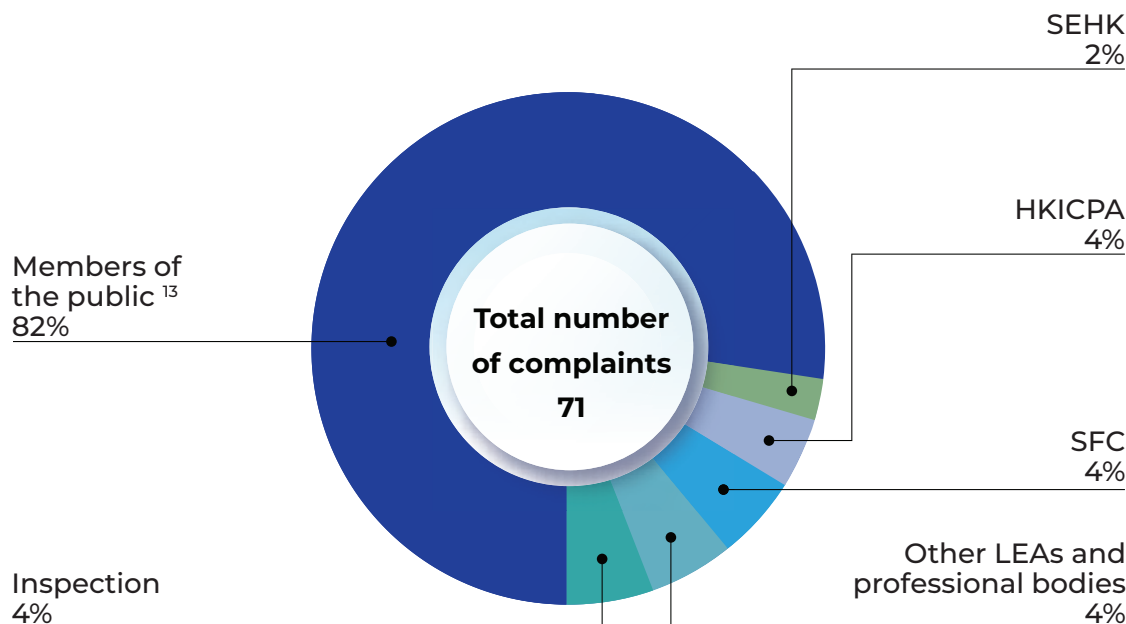
**2021-22**



<sup>12</sup> Included 3 cases that originated from public complaints to the HKICPA. These cases were subsequently referred to and followed up by the AFRC according to section 72 of the Accounting and Financial Reporting Council (Transitional and Saving Provisions and Consequential Amendments) Regulation for continued processing upon AFRC's assumption of the regulatory functions under the AFRCO.

## (b) Professional persons

**2022-23**



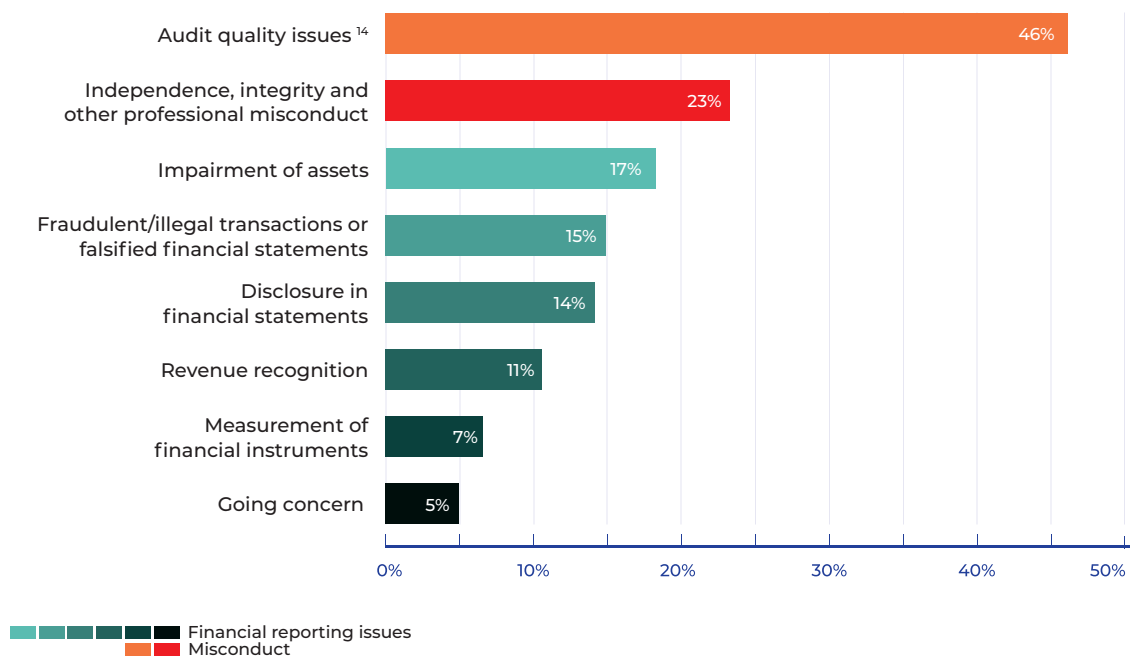
3.2.9 During the year, we received 68 complaints against PIE auditors from the members of the public (including 11 complaints received from whistleblowers), representing an increase by 26% from 2021/2022. Such an increase reflects that the AFRC successfully raises the awareness of the public on the quality of financial reporting and auditing of PIE.

3.2.10 While the overall complaints received from sources of referrals were relatively stable compared with the prior year, it is noted that regulators and other LEAs and professional bodies refer more complaints concerning professional persons to us during the year due to the expanded statutory functions of the AFRC after the further reform.

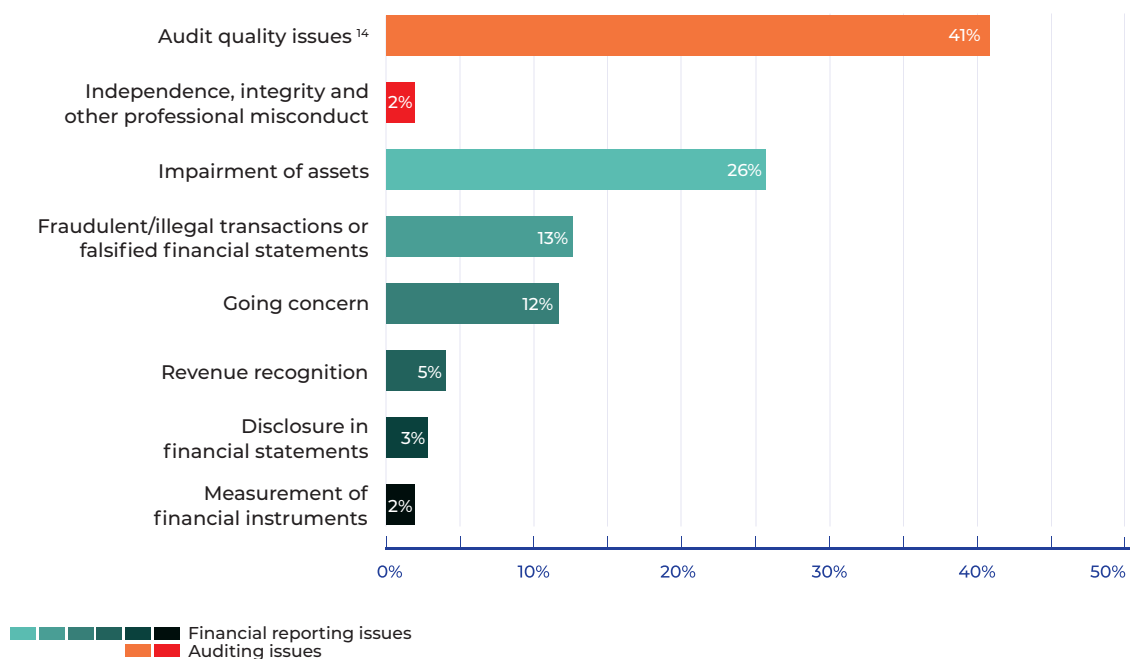
<sup>13</sup> Included 8 cases that originated from public complaints to the HKICPA. These cases were subsequently referred to and followed up by the AFRC according to section 72 of the Accounting and Financial Reporting Council (Transitional and Saving Provisions and Consequential Amendments) Regulation for continued processing upon AFRC's assumption of the regulatory functions under the AFRCO.

**Chart 2: Nature of Complaints**

**2022-2023**

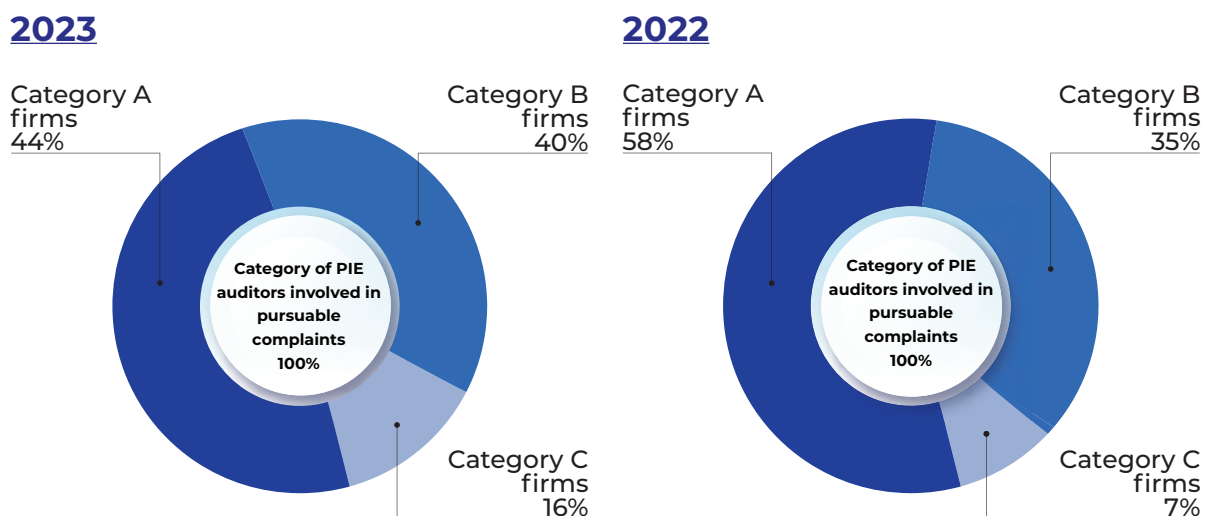


**2021-2022**



<sup>14</sup> Include complaints in relation to the sufficiency of audit evidence, engagement quality control review procedures or system and deficiencies in audit procedures.

**Chart 3: Category of PIE auditors<sup>15</sup> in pursuable complaints**



### 3.3 Financial Statements Review Programme

#### Overview

- 3.3.1 Our FSRP is a non-statutory initiative, which is part of our risk-based market monitoring activities, to monitor the quality of financial reporting by PIEs. The AFRC launched the FSRP in 2011 with the objective of proactively reviewing the financial statements of PIEs to identify possible misconduct by PIE auditors or non-compliance with accounting requirements by PIEs.
- 3.3.2 The scope of a review includes considering whether there is any non-compliance with financial reporting standards, auditing and assurance standards, and other relevant financial reporting guidelines (such as accounting requirements under the Listing Rules of the SEHK).
- 3.3.3 A risk-based approach is adopted to identify and select financial statements for review based on various criteria, which are reviewed and set annually and may be updated in response to subsequent changes in the current economic and regulatory environment.

<sup>15</sup> PIE auditors are categorised into four types: Category A firms (with >100 PIE clients), Category B firms (with 10 to 100 PIE clients), Category C firms (with less than 10 PIE clients) and Overseas firms (i.e. non-Hong Kong firms). As at 31 March 2023, there are 2,603 PIEs in the market (As at 31 March 2022: 2,573 PIEs). The PIE audit market shares by number of audit engagements of Category A, Category B and Category C firms as at 31 March 2023 are 58%, 35% and 2% respectively (As at 31 March 2022: 64%, 28% and 3% respectively).

**Table 3: Financial statements selected for review**

<b>Criteria of Selection</b>	<b>2022 Cycle</b>
<p><b>Significant changes</b></p> <p>Companies undertaking new business activities or having significant changes in business activities, financial position and results. These changes may give rise to increased risk of material misstatements in financial statements based on our experience of previous cycles</p>	<b>35%</b>
<p><b>PRC property development or education sector</b></p> <p>Listed entities in the PRC property development or education sectors which have been impacted by the changes in Mainland China regulatory environment</p>	<b>30%</b>
<p><b>Market events</b></p> <p>Financial statements with alleged non-compliance with accounting requirements and/or auditing irregularities based on media reports/companies subject to intervention by SEHK (e.g. to require the appointment of forensic accountant) — identified through our monitoring of market events, which indicate potential non-compliance and/or misconduct</p>	<b>11%</b>
<p><b>Auditors who take up PIE audit engagement for the first time</b></p> <p>Auditors who take up listed entities' audit engagement for the first time may not be able to identify material misstatements and/or fraud due to the lack of experience</p>	<b>8%</b>
<p><b>Companies with late auditor resignation</b></p> <p>Resignation or removal of auditors which may indicate the existence of unresolved audit issues</p>	<b>6%</b>
<p><b>Prior year adjustments</b></p> <p>Financial statements with significant prior period adjustments other than those reflecting a change in accounting policy or resulting from an adoption of newly introduced financial reporting standards, which may indicate possible misstatements in a prior period's financial statements and/or that the audit opinion(s) given in prior period(s) may not have been appropriate</p>	<b>5%</b>

Criteria of Selection	2022 Cycle
<b>Resignation of auditors</b> Resignation of auditor due to unresolved audit issues and successor auditor issued an unmodified audit opinion	3%
<b>Modified auditor's report</b> Financial statements with a modified auditor's report where there are indications of auditing irregularities in prior year's audit, or that the financial statements may be materially misstated	2%

### Key operations statistics about the FSRP

3.3.4 Our progress of review of financial statements under FSRP during the year is set out in Table 4 below.

**Table 4: Movements in financial statement reviews**

	Apr 2022 to Mar 2023	Apr 2021 to Mar 2022
Brought forward	27	30
Financial statements selected for review	130	75
Completed with no follow-up action <sup>16</sup>	(78)	(76)
Initiated investigations or enquiries	(11)	(2)
<b>In progress at the end of the year</b>	<b>68</b>	<b>27</b>

3.3.5 Out of the eleven cases of financial statements review which resulted in the initiation of investigations and enquiries in the current year, five of them were selected for our review due to auditor resignations with unresolved issues and late auditor resignations, with the rest of them being selected for our review due to adverse market reports, issuance of modified opinion by the auditors and significant change in financial results of the listed entities. Our financial statements review result highlighted the increased risks of relevant non-compliance and auditing irregularities that involved auditor resignations with unresolved issues and late auditor resignations.

<sup>16</sup> Include reviews for which advice letters were issued or were closed without further action.



Because of the aforesaid findings from the FSRP and the result of work performed by our Inspection Department concerning the auditor's client and engagement acceptance policies and procedures and system of quality control, we expect auditors and management of listed entities to be alert to the additional risks involved in auditor resignations with unresolved issues and late auditor resignation cases, and strictly comply with the relevant standards and guidelines. We would like to draw the attention of auditors, as well as company directors and audit committee, to our detailed analysis, concerns and expectation as documented in the AFRC's publications as listed below:

- *Open letter regarding late auditor resignations (October 2022)*
- *Follow-up open letter on auditor changes (January 2023)*
- *2022 Annual Inspection Report (July 2023)*

3.3.6 Given the importance of this proactive monitoring initiative, we have initiated a revamp of the FSRP in 2021 to enhance its effectiveness in identifying potential misconduct and non-compliance. The enhanced FSRP aims to create a deterrent for such behaviour and an incentive for listed entities to prepare high-quality financial reports and for their auditors to perform high-quality audits.

3.3.7 The revamp includes increasing the number of financial statements selected for review; reassessing the selection criteria (based on the probability of misstatement in the financial statements and the impact of the misstatement); introducing rotation and random sampling to the existing risk-based selection approach; and introducing a focused scope for reviews of financial statements selected under certain selection criteria.

3.3.8 In view of the resources available, the revamped FSRP is to be adopted gradually over a period of five years. For the 2022 cycle, the number of financial statements selected for review was increased to 130 (i.e. an increase of 73%) and such number will be maintained for the 2023 cycle.

## Section 4

# Investigations & Enquiries

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### 4.1 Introduction

- 4.1.1 This section provides a review of our work of the year in relation to the initiation and conduct of investigations and enquiries.
- 4.1.2 Formal investigation or enquiry of a matter is undertaken with due regard to a range of factors, including the severity of the misconduct/non-compliance, public interest benefit, and availability and sufficiency of evidence.
- 4.1.3 During the year, the surge in the total number of complaints and referrals received led to a significant increase in the number of investigations initiated this year (see Table 5 below) as compared to the year 2021/2022. For PIE auditors, we have initiated 60 investigations as compared with 32 in the previous year, an increase of 88%. The substantial increase in the number of PIE investigations was due to increased referrals both internally from Departments within the AFRC and externally from local regulators who were able to provide accurate and complete information. Since 1 October 2022, we have also initiated 12 investigations against professional persons.
- 4.1.4 Some of the complaints, reports and referrals received and handled during the year were more complex in nature with significant public interest. A number of investigations initiated during the year involved multiple auditing and financial reporting issues, potential fraudulent transactions, or complicated and industry-specific accounting matters (see Charts 5 and 6 in sections 5 and 6 below).

- 4.1.5 Up till 30 September 2022, findings of investigation cases involving audits of listed entities completed before 1 October 2019 were referred to the HKICPA for consideration of appropriate follow-up actions (see Table 7 below). Upon commencement of the AFRCO on 1 October 2022, all investigation findings where disciplinary action is required are referred to the AFRC's Discipline Department.
- 4.1.6 For cases where there may be non-compliance with accounting requirements by a listed entity, we may initiate an enquiry, which may be conducted either by the staff of the Investigation and Compliance Department or a FRRRC.
- 4.1.7 During the year, the number of enquiries handled has increased to 33 as compared with 17 in the previous year due to our proactive effort in the year in holding financial statements preparers accountable for financial reporting non-compliance.
- 4.1.8 For enquiries where we conclude that there is non-compliance, we may require the listed entity concerned to remove the non-compliance in the specified manner and within a specified period.
- 4.1.9 The AFRC is well aware of the importance of timely investigative and disciplinary actions. Therefore, we continue to optimise processes and procedures and enhance the efficiency and effectiveness of the investigation and enquiry functions, including:
- a) The collection of cogent evidence is the key to a robust investigation process. Early collaboration with the Discipline Department would enhance the evidence-gathering process, facilitate the conduct of timely investigation, and deliver fair enforcement outcomes;
  - b) Utilisation of e-Discovery forensic tool to aid evidence examination;

- c) Delegation of powers to the department in handling more straight-forward cases, e.g. enquiries into less complex financial reporting issues are conducted by the staff of the AFRC instead of a FRRC; and
- d) Prioritizing our resources to handle investigations with significant public interest.

## 4.2 Process of Investigations

### Overview

- 4.2.1 Fair, transparent, and robust investigations are one of the key regulatory tools to protect the public interest, deter misconduct and shape the behaviour of the accounting profession.
- 4.2.2 When potential misconduct by PIE auditors is identified through evaluation of matters reported or reviews of financial statements under the FSRP, the AFRC may initiate an investigation into the possible misconduct under the AFRCO.
- 4.2.3 The diagram below depicts the overall investigation process:

## Investigation Process

### Assessment and direction to investigate

- acquire information about potential misconduct or irregularities from various sources
- assess to determine whether to give direction to investigate

Stage 1

### Conduct investigation

- exercise the relevant investigation powers under the AFRCO
- require the relevant persons to produce relevant records and documents, provide information, attend interviews and answer questions, and to give all other assistance as appropriate. Applications for an extension to comply with a requirement will only be granted if made on reasonable grounds

Stage 2

### Draft investigation report and Representations

- prepare a written investigation report after the completion of the investigation
- give the Regulatee and any other named persons a reasonable opportunity to be heard

Stage 3

### Further actions

- close the case without further action; if the potential allegations of misconduct or non-compliance with accounting requirements is not substantiated by the evidence obtained;
- take any appropriate follow-up action in accordance with the AFRCO;
- impose a sanction on, or take an action in relation to, the Regulatee investigated under the AFRCO; or
- refer the matter to another appropriate regulatory body or law enforcement agency if applicable.

Stage 4

## Key operations statistics about investigations

4.2.4 During the year, the AFRC handled 82 investigations brought forward from the previous year and 72 new investigations, including 60 and 12 investigations concerning PIE auditors and professional persons initiated during the year respectively. Among the new investigations initiated, there are a number of investigations in relation to listed entities and matters with significant public interest which we had publicly announced the initiation of such investigations. During the year, we finalised 10 investigations and completed 8 investigations, 3 of which identified auditing irregularities related to audits completed prior to 1 October 2019 (i.e. under the Old Regime).

**Table 5: Movements in investigations**

	PIE auditors		Professional persons	
	Apr 2022	Apr 2021	Apr 2022	Apr 2021
	to	to	to	to
	Mar 2023	Mar 2022	Mar 2023	Mar 2022
In progress at the beginning of the year	82	58	–	–
Initiated in the year	60	32	12	–
Handled during the year	142	90	12	–
Completed during the year <sup>17</sup>	(3)	(8)	(5)	–
<b>In progress at the end of the year</b>	<b>139</b>	<b>82</b>	<b>7</b>	<b>–</b>
Old Regime	66	55	–	–
New Regime	73	27	7	–
	<b>139</b>	<b>82</b>	<b>7</b>	<b>–</b>

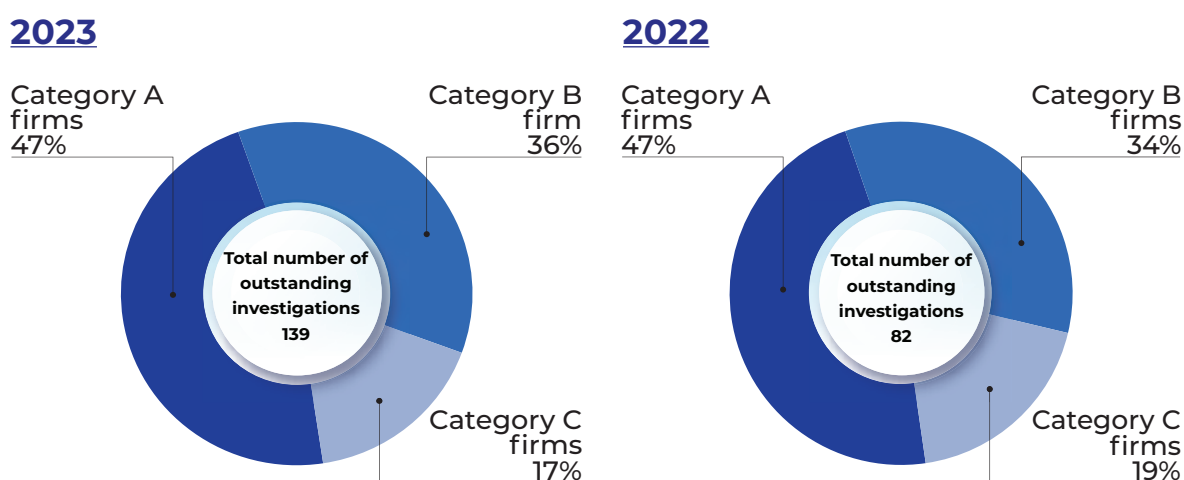
<sup>17</sup> Include investigations which were referred to HKICPA or closed without further action.

4.2.5 The allegations of potential misconduct in the 72 investigations initiated in the year relate to the following areas:

- (a) Breach of auditing and assurance standards;
- (b) Adequacy of audit work of accounting estimates;
- (c) Breach of independence and other ethical requirements;
- (d) Integrity-related and professional misconduct; and
- (e) Professional competence and due care.

4.2.6 During the year, 46%, 36% and 18% of our PIE-related investigations involved audits of Category A, B and C firms respectively (2022: 48%, 36% and 16%; 2021: 45%, 37% and 18%). The overall trend in the categories of firms subjected to our investigations is relatively constant. While the statistics alone are not conclusive, they may provide meaningful information for analysis. AFRC will continue to monitor the implications of the data on the quality of audit work performed by these three categories of firms, with reference to the PIE audit market share<sup>18</sup> and the findings from the investigations.

**Chart 4: Category of PIE auditors involved in investigations outstanding at the end of the year**



<sup>18</sup> As at 31 March 2023, there are 2,603 PIEs in the market (As at 31 March 2022: 2,573 PIEs). The PIE audit market shares by number of audit engagements of Category A, Category B and Category C firms as at 31 March 2023 are 58%, 35% and 2% respectively (As at 31 March 2022: 64%, 28% and 3% respectively).

**Table 6: Investigations outstanding at the end of the year by location of AWP\***

	As at 31 Mar 2023		As at 31 Mar 2022	
	AWP* located in		AWP* located in	
	HK	Mainland#	HK	Mainland#
<1 year	57	10	29	3
1-2 years	26	6	16	1
2-3 years	16	1	7	1
3-5 years	18	2	14	5
Over 5 years	3	7	3	3
	<b>120</b>	<b>26</b>	<b>69</b>	<b>13</b>

\* AWP refers to audit working papers

# Further details on the progress of these cases are set out in paragraphs 4.2.9 to 4.2.12 below

**Table 7: Regulatory outcome of referrals to the HKICPA**

	Apr 2022 to Sep 2022	Apr 2021 to Mar 2022
Resolution by agreement (RBA)	5	2
Disciplinary sanctions	3	5
	<b>8</b>	<b>7</b>

4.2.7 During the year and up to September 2022, the HKICPA took regulatory actions in response to eight investigations which we had completed and referred to them in earlier years as follows:

- (a) For the five cases completed through RBA, the relevant parties were publicly reprimanded, ordered to pay an administrative penalty and required to reimburse the costs of the AFRC and the HKICPA; and



- (b) For the three cases with disciplinary sanctions, there were significant allegations, and the relevant parties were publicly reprimanded, ordered to pay an administrative penalty ranging from HK\$50,000 to HK\$200,000 and required to reimburse the costs of the AFRC and the HKICPA. In one case, the practising certificate of the engagement director was ordered to be cancelled, with no issuance of a practising certificate to him for six months.

4.2.8 With effect from 1 October 2022, the disciplinary process for all investigation cases under both the Old Regime and the New Regime will be handled by the Discipline Department of the AFRC. As of 31 March 2023, six cases of completed investigation had been referred to the Discipline Department for consideration of disciplinary actions.

#### **Cross-boundary cooperation with SEB regarding audit working papers located in the Mainland**

4.2.9 Pursuant to the MoU signed with SEB in May 2019, we made 25 requests for assistance from the SEB in gaining access to audit working papers located in the Mainland, and as of 31 March 2023, we obtained the audit working papers located in the Mainland for 14 requests.

4.2.10 During the year, we made 8 requests for assistance from the SEB in gaining access to audit working papers for investigations.

4.2.11 The table below summarises the requests for assistance we filed with the MOF since the signing of the MoU and the number of cases where audit working papers were received.

**Table 8 — Requests for regulatory assistance from SEB**

	2022/23	2021/22	2020/21	2019/20	Total
No of requests for assistance filed with SEB	8	5	1	11	25
No of requests with audit working papers received	7	—	7	—	14

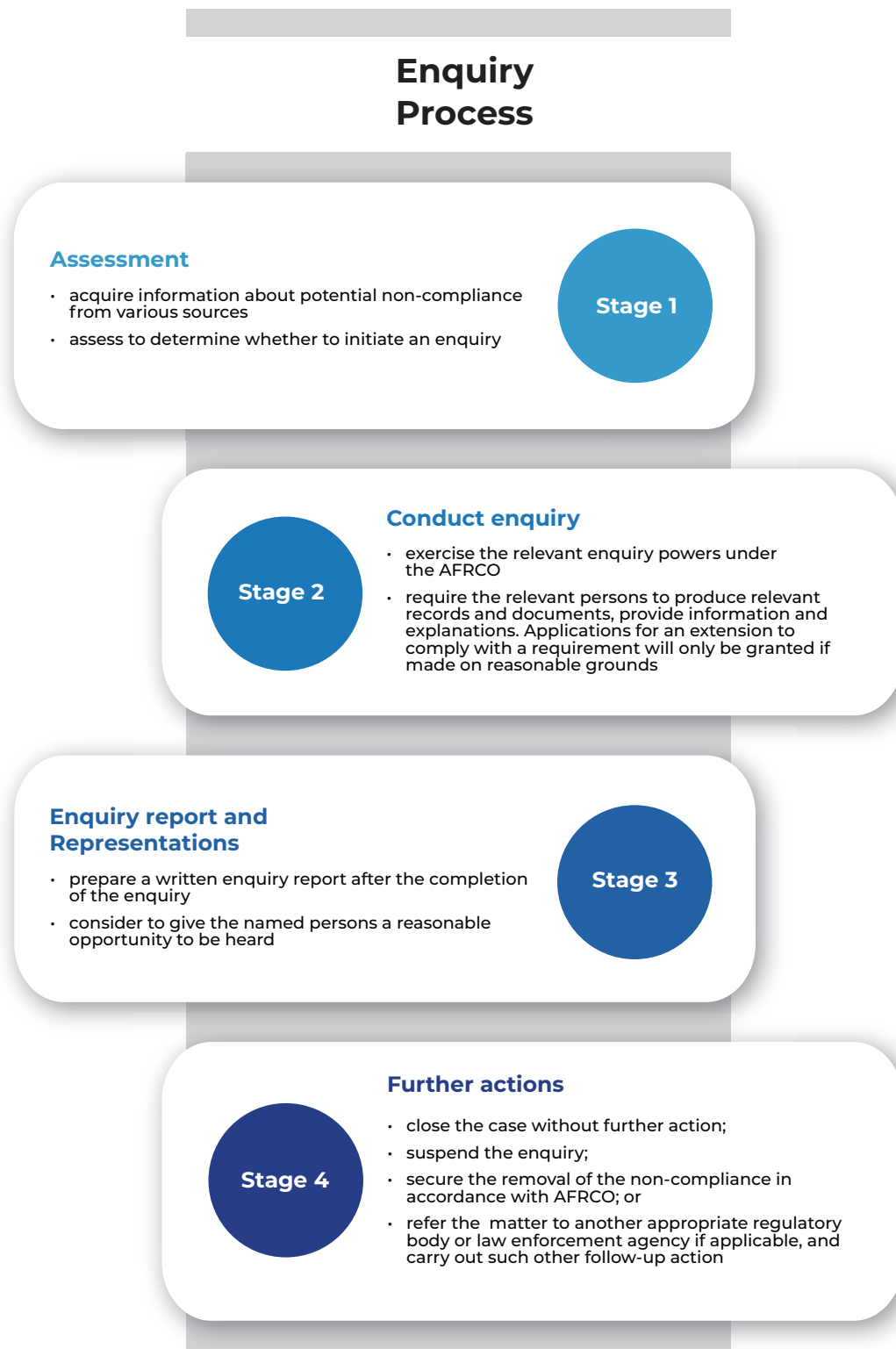
4.2.12 Building on the experience in obtaining access to audit working papers during the last three years, the AFRC and SEB continue to work closely together to explore ways to enhance the efficiency of the process and to strengthen cross-boundary collaboration on audit regulation.

### 4.3 Process of Enquiries

#### Overview

- 4.3.1 The AFRC may initiate an enquiry if it appears to the AFRC that there is or may be a question whether or not there is a relevant non-compliance in relation to a listed entity. A relevant non-compliance exists if a relevant financial report of a listed entity does not comply with a relevant requirement.
- 4.3.2 An enquiry may be conducted either by the Investigation and Compliance Department (i.e. AFRC staff) or an FRRC with delegated power from the AFRC Board.
- 4.3.3 The enquiry process assists to ensure that potential non-compliance with financial reporting requirements in the financial statements of listed entities is identified and rectified, so that investors and other stakeholders are not misled.

4.3.4 The diagram below depicts the overall enquiry process:



### Key operations statistics about enquiries

4.3.5 During the year, we handled 16 enquiries brought forward from the previous year and initiated 17 enquiries during the year. Two enquiries brought forward were completed during the year and notices were issued by the AFRC to the listed entities for the removal of the relevant non-compliance. There are 31 ongoing enquiries at the end of the year.

**Table 9: Movements in enquiries**

Handled by	Apr 2022 to Mar 2023		Apr 2021 to Mar 2022	
	FRRC	AFRC staff	FRRC	AFRC staff
In progress at the beginning of the year	2	14	2	1
Initiated in the year	2	15	-	14
Handled during the year	4	29	2	15
Completed	(2)	-	-	(1)
<b>In progress at the end of the year</b>	<b>2</b>	<b>29</b>	<b>2</b>	<b>14</b>

4.3.6 The 17 enquiries initiated during the year mainly related to the following financial reporting areas:

- (a) Revenue recognition;
- (b) Impairment assessment/fair value measurement of non-financial assets;
- (c) Recognition and measurement of financial instruments;
- (d) Going concern assessment and disclosures; and
- (e) Potential fraudulent financial transactions and reporting.

## Section 5

# Findings and observations on misconduct

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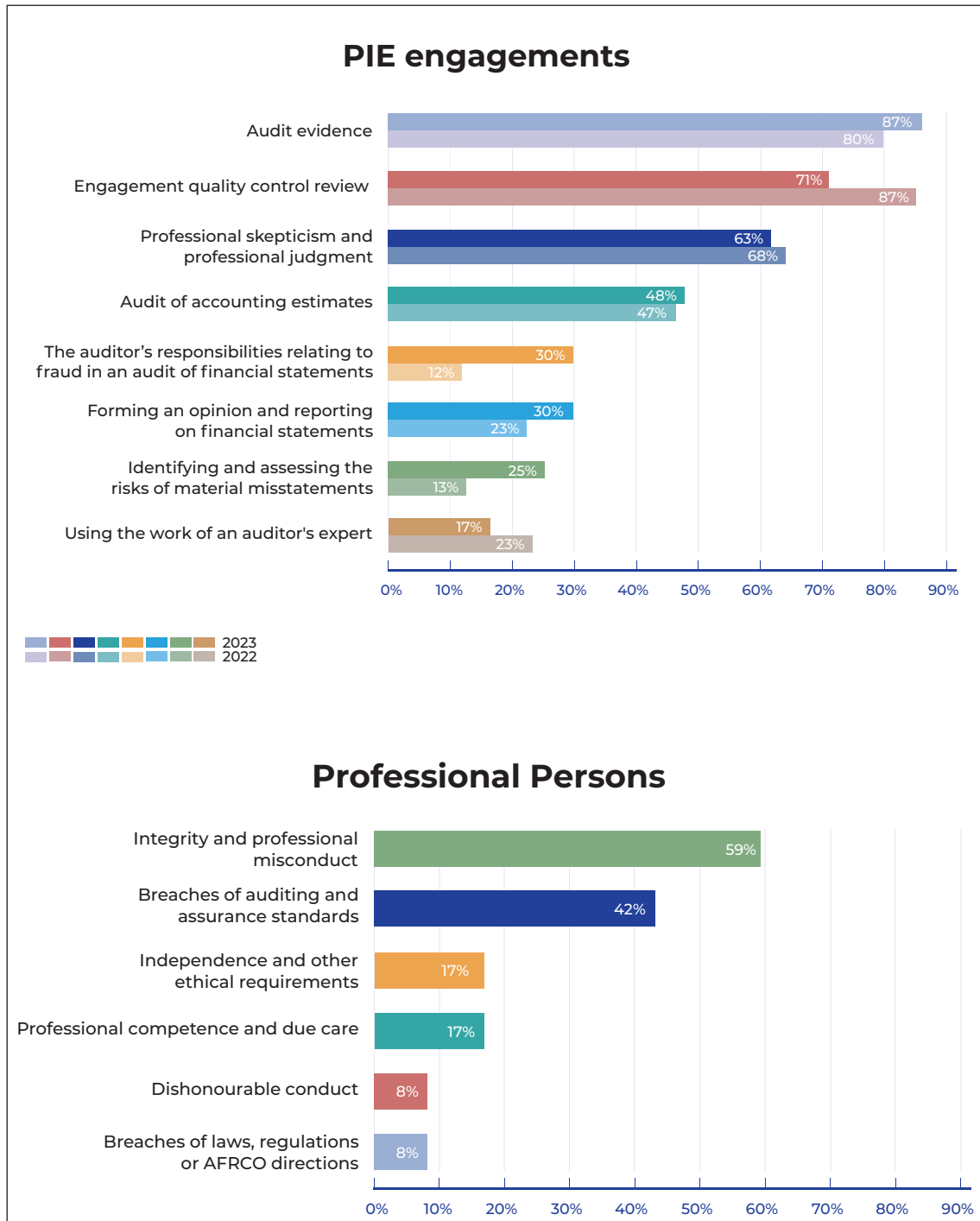
### 5.1 Introduction

5.1.1 Misconduct can be committed by both PIE auditors/registered responsible persons and professional persons. In the context of this report:

- Misconduct in relation to a PIE engagement mainly refers to an act done or an omission made by a PIE Auditor and its registered responsible persons that amounted to a practice irregularity within the meaning of section 4 of the AFRCO, or auditing irregularities within the meaning of section 4 of the FRCO as in force prior to 1 October 2019.
- Misconduct in relation to Professional Persons mainly refers to an act done or an omission made by a professional person that amounted to a professional irregularity within the meaning of section 3B of the AFRCO.

5.1.2 The charts below show the most common areas where misconduct were identified or observed based on 154 investigations, including 18 finalised or concluded investigations, and the 136 ongoing investigations handled during the year.

**Chart 5: Key areas of misconduct**



5.1.3 The key common areas of findings of misconduct in our finalised or concluded investigation cases are summarised in section 5.2 below. While the most common findings remain the same as those for the previous year, we observed that the potential misconduct of our newly-initiated investigation cases started to include significantly

more allegations on auditors' responsibilities relating to fraud in audits of financial statements and assessments of its risk of material misstatement. In addition, issues on audit evidence and accounting estimates and integrity-related matters on professional persons also gained significance.

- 5.1.4 In view of our observations, we remind auditors in section 5.3 below their responsibilities and requirements in relation to frauds which is a common area of focus in our recent investigation cases.
- 5.1.5 The AFRC expanded its investigation function to cover the potential misconduct of professional persons only as from 1 October 2022, and for this reason, no comparative information is available in this regard. During the year, we handled 12 investigations in relation to potential misconduct of professional persons. The key common areas of findings for these misconduct included integrity issues, professional issues including non-compliance with independence, ethical and competence and due care requirements, and non-compliance with auditing and assurance standards. We have not yet identified significant potential misconduct of CPA, other than CPA practices, based on our investigations.

## 5.2 Findings

### Misconduct in relation to PIE engagements

- 5.2.1 HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing (HKSA 200)* sets out the overall objectives of the auditor which are to:
- (a) obtain reasonable assurance to enable the auditor to express an opinion about whether the financial statements are prepared materially in accordance with an applicable financial reporting framework; and
  - (b) report on the financial statements, and communicate the auditor's findings.

Our investigations into PIE engagements often found the auditors involved did not possess a competent understanding of the

relevant financial reporting framework, and also failed to obtain reasonable assurance on the relevant matters by failing to maintain professional skepticism, and over-relying on the representations and information provided by the management and management's experts. For example, the aforesaid issues had been found in two of our investigations into PIE engagements. We have included the relevant misconduct in this section below, and explained the relevant matters of non-compliance in section 6.

### **Audit Evidence**

- 5.2.2 HKSA 500 *Audit Evidence (HKSA 500)* requires an auditor to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. Evidence must be relevant to the audit assertions that the auditor is testing. The quality of the audit evidence obtained by the auditor depends on its relevance and reliability (i.e. appropriateness) in addition to its sufficiency.
- 5.2.3 When forming an opinion on the financial statements, the auditor is required to conclude as to whether reasonable assurance has been obtained about whether the financial statements are free from material misstatement, whether due to fraud or error. Such a conclusion should take into account whether sufficient appropriate audit evidence has been obtained, and whether such evidence corroborates or contradicts management's assertions in the financial statements. Failure to obtain sufficient appropriate audit evidence would result in failing to obtain reasonable assurance and therefore failing to meet the overall objectives of an auditor and may result in the auditor giving an inappropriate audit opinion on the financial statements.
- 5.2.4 More assurance is ordinarily obtained by consistent audit evidence from different sources or of different natures than from considering items of audit evidence individually. Information from sources independent of the entity generally provides more reliable evidence than that obtained internally or from the entity.
- 5.2.5 The following are instances where the auditors failed to obtain sufficient appropriate audit evidence:



### Audit procedures on revenue from sales of goods

- (a) The auditor selected all sales invoices issued in the last week of the year as samples for revenue cutoff testing because of their expectation that the delivery of relevant goods would take 7 days at the most after the invoice was issued. However, such expectation was improperly made because as shown in other audit documentation, the auditor was well aware that the deliveries of some goods took more than 7 days and there were sales transactions in which receipts of goods were not acknowledged by the reporting entity's customers. It was also found that the auditor did not check the relevant goods delivery notes when conducting the sales cutoff testing;
- (b) When performing a test of details on sales transactions, the auditor adopted the sales transactions in the first and last months of the year as the population of the testing without justifying how they could represent the sales transactions in other months during the year. In addition, it was also found that the auditor used goods delivery notes as audit evidence to support the occurrence of the sales transactions selected in the test. However, these goods delivery notes were internally-generated documents and actually could not evidence that the relevant goods were accepted by the customers.

### Valuation-related matters

- (c) In an investigation, the auditor was found to rely on valuation reports prepared by two management's experts to determine the fair value of capitalisation shares issued. However, the valuation reports contain remarks that entity-specific valuation adjustment have been taken into account in the estimation of the fair value, which does not comply with the definition of fair value under HKFRS 13 *Fair Value Measurement* (**HKFRS 13**), the applicable financial reporting standard.

## External confirmations

- 5.2.6 Obtaining external confirmations is an important part of the audit process as it provides independent evidence to support the financial statement assertions made by the management. HKSA 505 *External Confirmations (HKSA 505)* guides auditors on obtaining audit evidence through external confirmations from third parties to corroborate the information provided by the entity.
- 5.2.7 Auditors are required to plan and design confirmation procedures, evaluate the responses obtained, and deal with non-responses and inconsistencies. HKSA 505 also requires auditors to assess the reliability of the information obtained through external confirmations, and to perform additional procedures if necessary.
- 5.2.8 In an investigation, we found that the auditor failed to comply with the requirements in HKSA 505 in conducting external confirmations. In such instance, the auditor arranged confirmations to the entity's customers and in a returned customer confirmation, the customer reported discrepancies in its balance with the entity and that some invoices documented in the confirmation form were not recorded in its book. However, the auditor considered that the customer had confirmed the balance without discrepancy and did not follow up on the exceptions.

## Engagement Quality Control Review

- 5.2.9 Engagement quality control review is a quality control procedure required for audits of listed entities' financial statements or other audit engagements that the audit firm has determined that such control review is required, in accordance with HKSA 220 *Quality Control for an Audit of Financial Statements*.
- 5.2.10 The purpose of an engagement quality control review in an audit is to serve as an objective evaluation, on or before the date of the auditor's report, of the work performed and decisions made by the engagement team in formulating the auditor's report. The reviewer, not being a member of the engagement team, must have sufficient and appropriate experience and authority to perform such evaluation, which includes:

- (a) discussion of significant matters;
- (b) review of the financial statements, the auditor's report, and the relevant audit documentation relating to significant judgments; and
- (c) evaluation of the conclusions and the appropriateness of the auditor's report.

5.2.11 In our investigations, we found that engagement quality control reviewers did not adequately review the audit working papers, critically challenge the nature and extent of audit procedures performed and evidence obtained during the audits and objectively evaluate the conclusion reached by the engagement teams.

5.2.12 Examples of deficiencies in engagement quality control review include:

- (a) The reviewer failed to properly discuss the assessment of and responses to the presumed significant risk of fraud in revenue recognition with the engagement team, and to review the relevant audit working papers.
- (b) The reviewer did not sufficiently challenge the decision of the engagement team in respect of valuations of convertible bonds and capitalisation shares issued, determination of recoverable amount of mining rights and identify non-compliance with financial reporting requirements in these matters.

5.2.13 Auditors should be aware of the new and revised quality management standards, namely, Hong Kong Standard on Quality Management 2 *Engagement Quality Reviews* (**HKSQM 2**) and Hong Kong Standard on Auditing 220 (Revised) *Quality Management for an Audit of Financial Statements* (**HKSA 220 (Revised)**), and the equivalent international standards issued by the International Auditing and Assurance Standards Board which became effective for audits and reviews of financial statements for periods beginning on or after 15 December 2022, and other assurance and related

services engagements beginning on or after 15 December 2022.

5.2.14 HKSQM 2 specifies requirements for (i) the appointment and eligibility of an engagement quality reviewer; (ii) the performance of an engagement quality review, including evaluating the exercise of professional skepticism, when applicable to the engagement, by the engagement team in relation to those significant judgments; and (iii) documentation of an engagement quality review. HKSA 220 (Revised) deals with the responsibilities of the auditor regarding quality management at the engagement level, and the related responsibilities of the engagement partner. Also, it enhances engagement partners' responsibilities for managing and achieving quality on audit engagements.

5.2.15 As both of the aforesaid quality management standards have already been effective and would be applicable to most of the 2023 audit and review engagements, we remind auditors to get familiarised with their requirements, to understand their firms' updated policies and procedures thoroughly, and to comply with them in all relevant engagements.

### **Professional Skepticism and Professional Judgment**

5.2.16 Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. It is part of the skill set of an auditor and is essential (together with professional judgment) to maintain audit quality. HKSA 200 requires auditors to exercise professional judgment in planning and performing audits, and to plan and perform audits with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Auditors should also exercise professional judgment in planning and performing an audit of financial statements, which can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of

the auditor's report.

5.2.17 In a completed investigation, we found that the Auditor failed to exercise professional judgment in applying the relevant accounting principles to measure capitalization shares which were issued to a creditor to extinguish a financial liability. HK(IFRIC) Int 19 *Extinguishing Financial Liabilities with Equity Instruments* (**HK(IFRIC)-Int 19**) was applicable for the aforesaid transaction and the capitalisation shares issued should be measured at their fair value as of the issuance date, with the difference between the fair value of the capitalisation shares issued and the carrying amount of the financial liability being extinguished recognised in profit or loss.

The investigation found that the listed entity considered that the fair value of the capitalisation shares (with a lockup-period adjustment) to be the same as the carrying amount of the financial liability extinguished and recognised no profit or loss as a result of the extinguishment, which the auditor concurred. However, as the lockup period was an entity-specific contractual term between the listed entity and its creditor, it should not be accounted for in determining the fair value of the capitalisation shares in accordance with HKFRS 13.

5.2.18 In another investigation, we found that the auditor accepted a valuation report prepared by a management's expert stating that the convertible bond issued by the entity was equal to its principal value. The entity also subsequently recognised a significant gain due to a decrease in the fair value of the liability portion of the convertible bond, which was indeed classified as a financial liability carried at amortised cost rather than fair value. The auditor accepted the two matters without exercising their professional judgment on whether they were appropriate for financial reporting purposes.

### **Audit of Accounting Estimates**

5.2.19 Accounting estimates involve significant judgments, assumptions and estimates. It is an area where audit deficiencies are often found, including accounting estimates in relation to (i) fair value measurement of financial instruments and biological assets; (ii)

acquisition-date fair value measurement of purchase considerations and assets acquired; and (iii) impairment assessments of assets.

5.2.20 HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* requires auditors to perform audit procedures and obtain sufficient appropriate audit evidence to evaluate the reasonableness of the accounting estimates. The determination of accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management. This can give rise to inherent uncertainty and considerable complexity in measurement, thereby increasing the risk of material misstatement.

5.2.21 For deficiencies in auditing accounting estimates, we found in our investigations that the relevant auditors failed to properly evaluate the reasonableness of the following accounting estimates:

- (a) The fair value of convertible bonds issued by the entity for an acquisition. Such fair value was inappropriately estimated to be the same as the principal amount and consideration for the acquisition, which was determined almost four years ago;
- (b) The fair value of the capitalisation shares, which was inappropriately estimated at below the shares' trading price in the market at the date of issuance; and
- (c) The fair value less costs of disposal of a mining right, which was calculated based on a discounted cash flow model by using the financial projections of the mine and contributory assets' charges provided by management without any supporting documents and evidence.

### **Using the Work of an Auditor's Expert**

5.2.22 In auditing accounting estimates, auditors may engage experts in a field other than accounting or auditing, to assist them in obtaining sufficient appropriate audit evidence. We continue to observe that auditors failed to adequately evaluate the work of their experts in accordance with HKSA 620 *Using the Work of an Auditor's Expert (HKSA 620)* when using their experts' work as audit evidence.

5.2.23 In addition to assessing the competence and objectivity of the auditor's expert, HKSA 620 requires evaluation of the adequacy of the expert's work for the auditor's purpose. Auditors are required to consider:

- (1) the source data, assumptions and methods used by the expert in their work and their consistency with prior periods; and
- (2) whether the results of the expert's work are consistent with the auditor's overall knowledge of the business and the results of other audit procedures performed. Such discussion should be properly documented in the audit file.

5.2.24 In an investigation, we found that an auditor directly relied on its expert's opinion on the fair value less costs of disposal of a mining right. However, the expert only relied on management's representation for the projected financial performance of the mining operations and did not obtain any evidence on the completeness and appropriateness of contributory assets charges that were adopted in the valuation. The auditor also did not perform further audit procedures to obtain sufficient appropriate evidence in respect of the aforesaid inputs in the valuation model.

## **Misconduct in relation to Professional Persons**

### **Integrity and professional misconduct**

5.2.25 Integrity is one of the fundamental principles set out in the CoE which requires professional accountants to be straightforward and honest in all professional and business relationships.

5.2.26 Integrity also involves truthfulness and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organisational consequences.

5.2.27 In an investigation, the practitioner was required to complete and submit certain documents to the practice reviewer to establish the practice unit's risk profile. The practitioner provided false or misleading information in the documents submitted by stating in them that the practice unit had established certain policies and had performed the necessary procedures for client screening, audit testing and review of audit work performed. But in fact the purported policies and procedures had not been established or performed. The practitioner was considered in breach of the fundamental principle of integrity under the Code of Ethics for Professional Accountants (**CoE**).

### **Breaches of auditing and assurance standards**

5.2.28 A professional person, who is not a PIE auditor, has committed a CPA misconduct if the person failed or neglected to observe, maintain, or otherwise apply a professional standard.

5.2.29 During our investigations, we noted that the instances of non-compliance with professional standards mainly related to the sufficiency of audit evidence and quality control for practice units.

#### **Audit Evidence**

5.2.30 Same as for a PIE auditor, a professional person should comply with the HKSA 500 (paragraph 5.2.2 above) to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence during the course of the audit.



5.2.31 The following are instances where the professional persons failed to design and obtain sufficient appropriate audit evidence in our investigations:

- (a) The auditor did not perform inventory count procedures and other audit procedures to ascertain the existence of inventories although there is a concern on the existence, ownership, accuracy and completeness of inventories as at the year-end date. Furthermore, the auditor did not perform any audit procedures to ascertain the valuation of the inventories.
- (b) The auditor only relied on the client's ledger and did not obtain audit confirmation or other external audit evidence to support trade receivables balances in the financial statements. There were also no audit procedures performed to evaluate the accuracy of the ageing analysis of trade receivables and the sufficiency of the provision for doubtful debts.
- (c) The auditor circularized audit confirmations in relation to a material amount due from related parties at the year-end date and checked client's books and records for its movements during the year. However, the auditor had not received the audit confirmations returned from relevant related parties when the auditor's report was signed off.
- (d) The auditor failed to carry out sufficient appropriate audit procedures, including audit tests on the relevant internal controls of the audit client, to support their acceptance of the completeness of turnover included in the financial statements.

### Quality control for practice units

5.2.32 The Hong Kong Standard on Quality Control was established to deal with a practice unit's responsibilities for its system of quality control for audits and reviews of financial statements, and other assurance and related services engagements.

5.2.33 A system of quality control consists of:

- (1) policies designed to ensure the practice unit and its personnel comply with professional standards and applicable legal and regulatory requirements and reports issued by the practice unit or engagement partners are appropriate in the circumstances; and
- (2) procedures that are necessary to implement and monitor compliance with those policies.

5.2.34 Practice units shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:

- (1) Leadership responsibilities for quality within the practice unit;
- (2) Relevant ethical requirements;
- (3) Acceptance and continuance of client relationships and specific engagements;
- (4) Human resources;
- (5) Engagement performance; and
- (6) Monitoring.

5.2.35 In our investigations, we found that some of the practice units did not establish and maintain a proper system of quality control for the practice.

5.2.36 The following are examples that indicate deficiencies in the quality control system in practice units:

- (a) No audit programme or audit checklist in conducting audit procedures.
- (b) No or minimal audit work done in a number of audit engagements within the practice unit.
- (c) The monitoring reviews carried out on the practice's quality control system and completed audit engagements did not comply with the relevant requirements.
- (d) Failure to address independence issues arising from audit engagement.

### **Independence and other ethical requirements**

5.2.37 Professional accountants are required to be independent when performing audits, reviews and other assurance engagements under the CoE. Independence comprises independence of mind and independence in appearance.

5.2.38 Independence of mind refers to the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism. Independence in appearance is being the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's, or an audit or assurance team member's integrity, objectivity or professional skepticism has been compromised.

5.2.39 Independence Standards under the CoE set out requirements on how to apply the conceptual framework to maintain independence when performing audits. Professional accountants and firms are required to comply with these standards in order to be independent when conducting such engagements.

5.2.40 In our investigations, we found that some practitioners disregarded the independence requirements that were applicable to them despite that they were aware of them.

5.2.41 Examples of practitioners' breach of independence requirements under the CoE in our investigations include audits of the financial statements of private companies in which:

- (a) the practitioner was a director and had financial interests.
- (b) the practitioner's close family members were directors and had financial interests.
- (c) the practitioner was the company secretary.

### **5.3 Observations: key areas of misconduct identified from initiated investigations**

#### **Fraudulent financial transactions and reporting – Identification of risk of material misstatements due to fraud**

5.3.1 We observed that potential fraudulent financial transactions and reporting has become a growing issue in our investigations and featured in 19% of our investigation cases initiated during the year (2021/2022: 3%).

5.3.2 Fraud usually has a significant impact on the accuracy and reliability of financial statements, and auditors should remain vigilant in detecting fraud during the audits of financial statements. Auditors should maintain strict compliance with the requirements of the relevant auditing standards, particularly HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (**HKSA 240**). In assessing the fraud risk, HKSA 240 requires auditors to:

- maintain professional skepticism throughout the audit;
- inquire management on matters including but not limited to their assessment of the risks that financial statements may be materially misstated due to fraud, processes to identify and respond to risks of fraud in the entity, knowledge of any actual, suspected or alleged fraud affecting the entity and to investigate further when inconsistencies were found;
- hold discussion among the engagement team in relation to how and where the entity's financial statements may be susceptible to material misstatements due to fraud, including how fraud might occur;
- evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risk of material misstatement due to fraud; and
- presume that there are risks of fraud in revenue recognition to evaluate the types of revenue, revenue transactions or assertions that give rise to such risks, or to document why such presumption is not applicable in the circumstances of the engagement.

5.3.3 In addition, we remind auditors of the following requirements under HKSA 240 in relation to responding to the assessed fraud risk:

- assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risk of material misstatement due to fraud for the engagement;
- evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings;
- incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures;
- conduct test of the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements;
- review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In particular, the auditors should perform a retrospective review of the management judgments and assumptions related to significant accounting estimates reflected in the prior year financial statements.
- auditors should also evaluate the business rationale (or the lack thereof) of the transactions that are outside the normal course of business or appear to be unusual, on whether they suggest that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets; and

- evaluate whether a misstatement identified is indicative of fraud, and if affirmative, evaluate the implication of the misstatement in relation to other aspects of the audit, particularly to the reliability of management representations, recognising that an instance of fraud is unlikely to be an isolated occurrence.

5.3.4 Auditors should familiarise themselves with the different types of fraud that can occur in financial reporting, including fraudulent financial reporting and misappropriation of assets. Auditors should also be aware of the common techniques used in committing fraud, such as falsifying documents, manipulating journal entries, and creating fictitious transactions. In particular, auditors should also be aware of the potential for fraud in areas such as revenue recognition, inventory, loans and guarantee contracts, and related party transactions, and should design audit procedures to address the specific fraud risks assessed for these areas.

In the paragraphs below, we share three common types of fraudulent financial reporting and misappropriation of assets that we observed in our investigations and how we expect auditors to approach them in their work.

Misappropriation of corporate funds by ways of various financing arrangements

5.3.5 We have observed various listed issuers channelling their own funds to third parties in dubious circumstances. The transactions could be in the forms of loans, advances, prepayments and similar arrangements, with some of the following shared characteristics:

- funding provided with terms that were unexplainably favourable to the counterparty, e.g. interest-free, very low-interest rate, long duration, without the backing of collateral;
- funding provided with a lack of commercial rationale, deviated from normal transaction practise and the relevant contractual terms. An example is that a listed issuer purportedly made prepayments for purchases of goods, but there was no requirement to make advance payments under the standing purchase agreements and the goods were never delivered;

- The party being funded was subsequently found to be connected to certain customers of the listed issuers, so there might be an artificial circulation of funds from and back to the company, designed to dress up the company's financial outlook;
- there were inadequate credit assessment and monitoring controls at the listed issuer level. An example is that a listed issuer prepaid a counterparty for a commodity transaction and included property as collateral in the contract, but the management of the listed issuer was not aware that the property was not held by the counterparty, so the enforceability of the listed issuer's rights on the collateral was questionable. Another example was that loans were well past their original due dates and no repayment was made, repayment periods were repeatedly extended without any legitimate commercial reason. There was neither documented justification nor proper approval for the extensions; and
- the impairment of dubious loans and advances was determined on an arbitrary basis (e.g. based on the overall probability of default and loss given default of non-investment grade bond in another country) without sufficient evidence to show how the impaired amount was objectively determined and properly approved.

5.3.6 In respect of audit procedures on loans and advances of a dubious nature recorded in a listed issuer's financial statements, we draw the attention of auditors to our expectations set out in the "*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*" which was published on 13 July 2023. In summary, we expect the auditors to be able to:

- consider the need to attribute a higher risk of material misstatement due to fraud or other irregularities;



- obtain evidence of the effectiveness of the listed issuer's internal controls over the making and monitoring of the loans and advances in question, paying particular attention to the possibility of management override;
- design and perform audit procedures responsive to the assessed risks of material misstatement due to fraud or other irregularities and management override, and to the assessed effectiveness of internal controls, including the testing of the appropriateness and proper authorisation of journal entries and other accounting adjustments;
- maintain professional skepticism and critically evaluate management's representations of different aspects of the loan and advance, e.g, its purpose, counterparty and recoverability, by corroborating them with evidence obtained from other independent sources and resolving inconsistencies between evidence obtained from different sources;
- evaluate the accounting policies adopted and the reliability of accounting estimates made by management regarding the impairment of loans and the adequacy of related disclosures in the financial statements; and
- communicate significant issues identified with the loans and advances during the audit, including deficiencies noted in relevant internal controls, to those charged with governance, including the audit committee.

5.3.7 Audit procedures which the auditor should consider to carry out in the circumstances include, but are not limited to:

- critically evaluating the commercial rationale for the loan;
- inspecting antecedent correspondence leading to the making of the loan, as well as the original contracts or agreements, to ensure the validity of the loan and that it was made in accordance with the agreed terms;

- inspecting evidence of credit assessments, due diligence procedures and proper approvals, e.g. internal or external credit reports on the counterparty and board meeting minutes;
- obtaining independent evidence of the existence and identity of the counterparty, e.g. conducting a company search, which is the basic step in the case of a corporate counterparty, and directly contacting the counterparty by phone or a site visit;
- inspecting banking and other documents relating to the transfer of funds to confirm that funds relating to the loans flowed through the company's bank accounts and to the counterparty or its authorised representatives in accordance with the agreed terms; and
- obtaining direct written confirmation of the principal, terms and outstanding balance of the loan from the counterparty.

#### Concealment of financial liabilities

5.3.8 Despite that an entity should recognise a financial liability when it becomes a party to a financing contract and therefore has a legal obligation to pay cash under HKFRS 9 *Financial Instruments (HKFRS 9)*, we found several instances of concealment of financial liabilities by listed entities in our investigations. In these cases, the then management of the Company, group companies and associates obtained financing on behalf of the respective entities, transferred the funds out of the group and concealed the resulting liabilities from financial reporting. Such concealment was often uncovered by the subsequent management team of the listed issuer because of subsequent legal actions taken by the creditors.

5.3.9 We consider that the perpetuation of the aforesaid concealment scheme was attributable to inadequate financial reporting control and review in the relevant companies and the deficiencies of audit work in relation to the completeness of financial liabilities by the relevant auditors. Therefore, we expect auditors to properly assess the risk of material misstatements and perform procedures to

obtain sufficient appropriate evidence regarding the completeness of the financial liabilities of the entity. To perform a proper assessment, auditors should also carry out procedures to obtain an understanding of the following matters:

- The reporting entity's operations and governance structure and how it was financed;
- The reporting entity's internal controls over its subsidiaries, in particular, relating to entering into contracts to obtain finance; and
- How the reporting entity's management was satisfied with the truthfulness and fairness of the financial reporting by the reporting entity's investees, including but not limited to associates and jointly-controlled entities.

#### Financial guarantee contracts

5.3.10 We have observed a significant increase in investigation cases concerning the recognition and measurement of financial guarantee contracts, which relates to their impairment assessments. Therefore, we remind both preparers of financial statements and auditors that, under HKFRS 9, an entity that issues a financial guarantee contract is required to consider its expected credit loss in the subsequent measurement of the financial guarantee. Such impairment assessment should involve identifying the financial guarantee contracts and their full terms, evaluating the change in credit risk of the counterparty since the inception of the contract, the probability for the counterparty to default and the loss given default under the structure of the financial guarantee contracts and the updated liquidity condition of the counterparty. This expected credit loss should be recognised as a provision in profit or loss of the financial statements.

- 5.3.11 We are aware that management, as the preparer of financial statements, may be biased to not recognising a financial guarantee contract to related parties, and not recognising an impairment loss on financial guarantee contracts. This is often due to a lack of understanding of the expected credit loss model or a desire to present a more favourable financial position for the reporting entity, and these could represent a significant inherent risk for the measurement of financial guarantee contracts.
- 5.3.12 In order to comply with HKSA 500 and HKSA 540, an auditor should design and perform audit procedures to obtain sufficient appropriate audit evidence regarding the existence, completeness, measurement and related disclosures of the entity's financial guarantee contracts. The auditor would need to obtain a thorough understanding of the presence, terms and conditions, and the method and assumptions adopted by management and management's expert for the measurement of the entity's financial guarantee contracts. The auditor should also plan audit procedures to identify unrecorded financial guarantee contracts and their details, particularly by paying attention to pledged assets and guarantees that are reported in external confirmation replies, conducting review of significant contracts entered by the reporting entity and conducting inquiries with management and those charged with governance.
- 5.3.13 When the auditors are presented with management's assessment of the financial guarantee contracts entered by the entity, they should perform audit procedures on the estimation approach and key parameters to evaluate whether the estimation of expected credit losses is reasonable and supportable in accordance with HKSA 500 and HKSA 540. In doing so, the auditors should maintain professional skepticism, plan appropriate audit procedures to obtain evidence from independent sources and challenge the methodologies and assumptions adopted by management if necessary.

## Section 6

# Findings and observations on financial reporting non-compliance

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## 6.1 Introduction

6.1.1 This section highlights our findings that were identified in investigation and enquiries which have been finalised or concluded, our review of financial statements under the FSRP during the year (section 6.2 below), and our observations on ongoing cases (section 6.3 below).

6.1.2 To apply principles-based financial reporting standards appropriately, preparers of financial statements and their auditors need to understand the purpose and content of the standards sufficiently for appropriate applications to their circumstances. It is therefore important that preparers have the appropriate expertise to be able to apply the applicable financial reporting standards properly, in particular for complex transactions and those that require the exercise of significant judgment and estimations.

## 6.2 Findings

### **Classification and measurement of convertible bonds issued**

6.2.1 An entity issuing a convertible bond should review the substance and terms of the contractual agreement and follow the requirements in HKAS 32 *Financial Instruments: Presentation* (**HKAS 32**) to classify the components of the convertible bond for financial reporting. Under paragraph 16(b)(ii) of HKAS 32, the issuing entity would generally need to consider whether the conversion option embedded in the convertible bond met the “fixed-for-fixed” criteria to be classified as equity, or otherwise should be classified as a derivative financial instrument liability.

- 6.2.2 If the equity conversion option has been assessed to be of a derivative financial liability classification, the issuing entity generally should finalise the financial reporting of the convertible bonds by estimating the valuations of (i) the entire convertible bonds and (ii) the conversion options and other related options such as early redemption options as at the issuance date. The difference between the two valuations would be the liability portion of the convertible bonds which should be subsequently carried at amortised cost under the effective interest method on the issuing entity's financial statements, while the equity conversion options and other embedded options would be accounted for as a single compound embedded derivative, subsequently remeasured at fair value through profit or loss.
- 6.2.3 Therefore, the entire convertible bonds should be recognised in the issuing entity's book at its fair value on the issuance date, which should be estimated on a "market participant" basis in accordance with HKFRS 13. It is common that the fair value of the convertible bonds on the issuance date differs significantly from its principal amount, which often is an agreed amount of the relevant transaction by the contracted parties. Such deviation is a result of changes in factors such as market conditions and the issuer's credit risk during the period between the contract date and the completion date, and could be particularly significant for transactions in which convertible bonds are arranged to be issued as consideration for the acquisition of assets or business, because these transactions usually take considerable amount of time to finalise.
- 6.2.4 In an investigation, we found that an entity issued convertible bonds to a vendor as consideration to acquire a coal mining right. The consideration for the acquisition was arranged to be settled by the entity's issuance of convertible bonds with a predetermined principal amount. Despite that the acquisition was negotiated in prior year, it was completed only after four years when all the required approvals and conditions were fulfilled. The entity then issued the aforesaid convertible bonds of the predetermined principal amount to the vendor. The entity estimated the fair value of the convertible bonds to be exactly the same as its principal

amount on the issuance date, and recognise a substantial fair value gain due to the decrease in fair value of the liability portion of the convertible bonds only 4 days after the convertible bonds were issued.

6.2.5 Two significant relevant non-compliance were identified for this case:

- The valuation of the fair value of the convertible bonds at its issuance date to be exactly equal to its principal amount was not reasonable and supportable; and
- The liability portion of the convertible bonds was classified as a financial liability at amortised cost measured using the effective interest method and should not be subsequently re-measured to its fair value.

### **Accounting of extinguishment of financial liability by issuing shares**

6.2.6 An entity should follow HK(IFRIC)-Int 19 to account for transaction in which the entity issued its equity instruments (such as common shares) to settle its financial liabilities.

6.2.7 If the fair value of the equity instruments issued can be reliably measured, they should be initially measured at their fair value, which again should be based on the “market participants” perspective under HKFRS 13. If the fair value of the equity instruments cannot be reliably measured, the equity instruments should be measured to reflect the fair value of the financial liability extinguished. The difference between the carrying amount of the financial liability (or part of it) extinguished and the consideration paid (fair value of the equity instruments issued) should be recognised in profit or loss.

6.2.8 In a completed investigation, we identified that a listed entity with actively-traded shares issued capitalisation shares to set off some of its financial liabilities, and in doing so the listed entity estimated that the fair value of the capitalisation shares to be

exactly the same as the carrying amount of the financial liabilities to be extinguished. The listed entity represented that it appointed a valuer who took into consideration of the terms of a lockup agreement between the listed entity and the relevant creditor regarding the capitalisation shares issued in its valuation. However, the lockup arrangement was not an instrument-specific matter which could affect the valuation from a “market participant” perspective and should be ignored in the estimation of the fair value of the capitalisation shares. In this case, the fair value of the capitalisation shares was significantly understated and consequently there was a corresponding understatement of the loss of extinguishment of financial liabilities in accordance with HK(IFRIC)-Int 19.

### **Disclosure deficiencies**

6.2.9 Disclosure notes in a complete set of financial statements provide information necessary for readers of financial statements to understand the entity’s financial performance and position, cash flow condition and any risks or uncertainties surrounding the operations of an entity, and to assist them in making informed decisions.

6.2.10 During our investigations and review of financial statements under the FSRP, we noted that there were instances of non-compliance with disclosure requirements. Non-compliance with disclosure requirements identified are summarised below. Some of these were also identified in our last Annual Investigation and Compliance Report.

#### **HKFRS 15 *Revenue from Contracts with Customers* (HKFRS 15)**

6.2.11 We identified that an entity failed to disclose the circumstances and events leading to the significant change of contract liabilities in the relevant financial statements.

#### **HKFRS 13 *Fair Value Measurement***

6.2.12 We observed that certain disclosures in relation to fair value measurements were omitted by listed entities, such as description



of the valuation techniques and the key inputs used in Level 2 fair value measurement, and key parameters used in Level 3 measurement of fair value less costs of disposal of a construction-in-progress asset.

### **HKFRS 7 *Financial Instruments: Disclosure***

6.2.13 We observed inadequate disclosures in the area of:

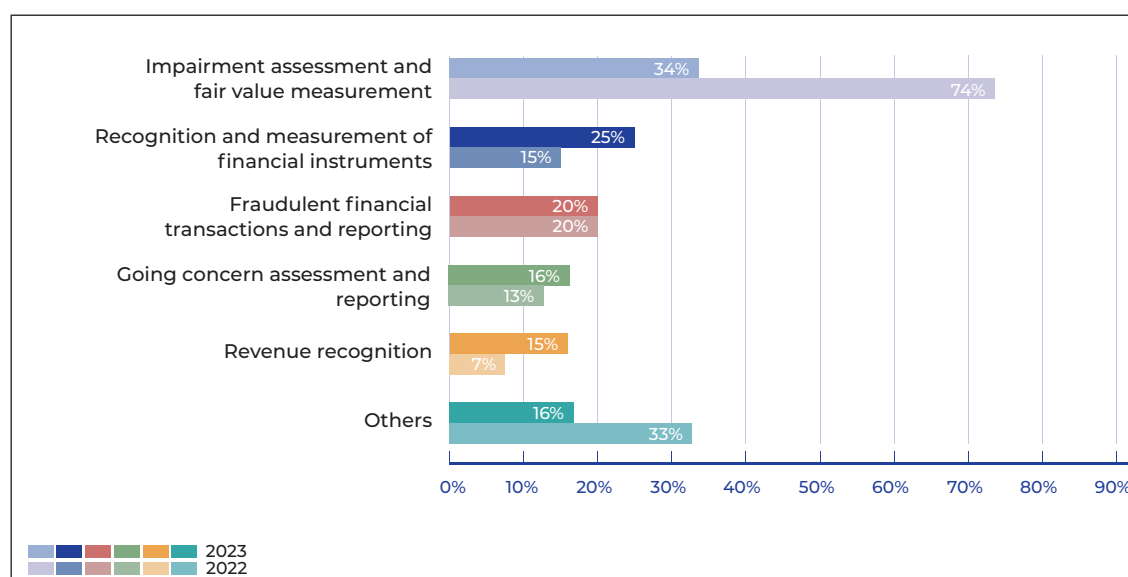
- (a) Descriptions in relation to the nature and fair value of financial guarantee received which were credit enhancements;
- (b) The gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantees contracts by credit risk rating grades, which should be made separately for financial assets:
  - with loan allowances measured at 12-month expected credit losses;
  - with loan allowances measured at lifetime expected credit losses; and
  - Purchased or originated credit impaired financial assets

### **HKAS 7 *Statement of Cash Flows***

6.2.14 While the accounting standard requires an entity to provide disclosures to enable users of the financial statements to evaluate changes in liabilities arising from financing activities, we observed a listed entity inappropriately included equity transactions in the relevant reconciliation disclosures.

## **6.3 Observations: key areas of accounting non-compliance identified from initiated investigations and enquiries**

6.3.1 The chart below shows the most common areas where financial reporting non-compliance were identified in the investigations and enquiries initiated during the year.

**Chart 6: Key areas of financial reporting non-compliance**

### Impairment assessment of non-financial assets (cash-generating unit)

6.3.2 Impairment assessment of cash-generating units remained a common focus of our investigations and enquiry cases during the year. Most of the aforesaid cash-generating units were in the business of mining, healthcare and technology. The estimations of the recoverable amounts of these cash-generating units are subject to higher measurement uncertainty, complexity and potentially higher management bias, leading to higher risk of material misstatement. We remind preparers of financial statements to:

- appropriately determine the cash-generating unit in accordance with its definition as the “smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets” under HKAS 36 *Impairment of Assets*.
- when necessary, engage management’s expert (such as valuer) that is competent, capable and objective in assisting management to perform the estimation;

- adopt reasonable and supportable key parameters in the estimation, including but not limited to projected revenues that are in line with consensus future market demand and competition expectations, and interest rates and inflation rates expected under the current market environment;
- ensure that only comparable market transactions are used in a market approach for valuation;
- ensure the findings of management's experts involved have been taken into account in the estimation;
- make financial statements disclosures which are consistent with the actual estimation.

### **Fraudulent financial transactions and reporting**

6.3.3 The deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users is considered as financial statement fraud. Such fraud can be the result of different types of fraudulent transactions or misappropriation of assets. Based on the observation in our investigations, the three common types of fraudulent financial transactions and reporting, and misappropriation of assets are: (1) misappropriation of corporate funds by ways of various financing arrangements; (2) concealment of financial liabilities; and (3) recognition and measurement of financial guarantee contracts including their impairment assessments. Details of the fraud scheme have been set out in section 5.3 above.

6.3.4 As it is the primary responsibility of those charged with governance of the company (**TCWG**) and management to prevent and detect fraud within an organisation, besides ensuring the accuracy of the company's financial statements, we remind preparers of financial statements, including management of the company, to:

- establish a proper control environment and maintain policies

and procedures for internal control to safeguard the company's assets, prevent and detect fraud and errors;

- ensure sufficient risk assessments, due diligence and documentation when entering any financing arrangements, especially granting loans or financial supports to outsider parties; and
- establish and maintain appropriate and effective internal controls for assessing and managing credit risks of the counterparties.

6.3.5 We also remind TCWG of the importance for them to oversee the company's operation of internal control and risk management system and to ensure that the company has appropriate and effective internal controls in the areas of financing arrangements.

#### **Going concern assessment and reporting**

6.3.6 HKAS 1 (Revised) *Presentation of Financial Statements* (**HKAS 1**) requires management to assess the appropriateness of the going concern basis of accounting when preparing their financial statements. An entity is required to adopt the going concern basis of accounting, except in circumstances where the management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. Management should be aware that HKAS 1 requires them to take into account all available information about the future, which is at least 12 months from the end of the reporting period.

6.3.7 The threshold for the going concern basis of accounting to be considered inappropriate is very high, as there are often realistic alternatives to liquidation or cessation of operations.

6.3.8 However, management should make proper disclosure of a material uncertainty relating to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern (**the Going Concern Material Uncertainty**).

- 6.3.9 During the year, we note that a listed entity disclosed actions or planned actions to mitigate its liquidity issues in the financial statements, but made no explicit disclosures as to whether a Going Concern Material Uncertainty exists before or after the implementation of the mitigating plans.
- 6.3.10 In addition, in an investigation case, an entity was in a significant net liability financial position and experiencing negative cash flows. Its management prepared the financial statements on a going concern basis due to their expectation that the holder of convertible bonds issued by the entity would not demand repayment by redeeming the convertible bonds on their maturity date. However, the management failed to consider this expectation as a Going Concern Material Uncertainty for the relevant financial statements and make appropriate disclosure in this respect.
- 6.3.11 It is also important for listed entities to consider not only the specific disclosure requirements relating to going concern in paragraph 25 of HKAS 1 but also the overarching disclosure requirements in paragraphs 122, 125 to 133 of HKAS 1, as described and summarised in paragraphs 4.4.7 to 4.4.9 in our *2022 Annual Report*.

### **Revenue recognition**

- 6.3.12 Revenue is an important financial statements line item and we have come across situations where an entity inappropriately recognised revenue. An example is that in an investigation, it was found that a listed entity recognised revenue from sales of goods despite the goods were still within its custody and not yet delivered to its customers.

6.3.13 We would like to remind preparers of financial statements of the importance of assessing control over the goods in revenue recognition. Under HKFRS 15, the control concept is a key criterion to determine when revenue from the sale of goods should be recognised. The standard provides a framework to evaluate the timing and amount of revenue recognition based on the transfer of control of goods or services from the seller to the customer. For sales of goods, control is typically transferred at a point in time when the customer has obtained the ability to direct the use of and obtain substantially all the remaining benefits from the asset, and the customer has accepted the asset. Factors that may indicate the transfer of control include:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.
- The customer has significant risks and rewards of ownership.
- The customer has accepted the asset.

## Section 7

# Looking ahead

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### **7.1 Introduction**

7.1.1 This section highlights key aspects of our plans to further strengthen our investigation and enquiry functions in the coming year.

### **7.2 Enhance processes and procedures**

7.2.1 The Investigation and Compliance Department continues with its initiatives to enhance processes and procedures and to prioritise the use of our resources in handling potential allegations about improper conduct and behaviour of our regulatees which would cause greater potential harm to the public interest as mentioned in the first and second Annual Investigation and Compliance Reports.

7.2.2 Amidst a substantial increase in complaints and investigations, we continued to spare no effort in tackling the ageing cases whilst forging ahead with a focus on cases with significant public interest. Our drive for improvement in timeliness and efficiency continues. During the year, we enhanced the digital channel for filing complaints and whistleblowing reports, tightened collaboration with the Inspection and Discipline Departments and established a seamless referral mechanism with them. We will continue to explore ways to optimise our processes and procedures in handling complaints, investigations, and enquiries in order to discharge our responsibilities under the AFRCO efficiently and effectively.

### **7.3 Create positive ripple impacts for the accounting profession and the public**

7.3.1 Hong Kong is now moving back to normalcy from the Covid pandemic which affected every business to a greater or lesser degree. In this economic environment, human resources shortage is not uncommon so it may be challenging for CPAs, auditors, and financial statement preparers to maintain high quality in

auditing and financial reporting. At this transformative time for the accounting profession, it is important that the AFRC remains steadfast in upholding audit quality and the quality of financial reporting.

7.3.2 We will continue to enhance stakeholders' engagement with the dissemination of investigation outcomes. Through the publication of our Annual Investigation and Compliance Report, we make transparent to all our stakeholders the common issues we are addressing and our findings of misconduct of professional persons, PIE auditors and financial reporting non-compliance by listed entities identified in our investigations and enquiries. In addition, we will continue to share our findings with regulatees and market practitioners through seminars and workshops organised by their professional bodies with a view to alerting them not to make, and urging them not to repeat the same misconduct.

7.3.3 In the past year, we successfully implemented the further reform. Now armed with the expanded regulatory powers covering all CPAs, practice units and auditors in Hong Kong, we are determined to take prioritised, proportionate, and risk-focused investigations on high-profile cases with a view to creating positive ripple impacts on the accounting profession and the public.

## **7.4 Strengthen collaboration with local and Mainland regulators**

### **Hong Kong**

7.4.1 Maintaining close collaboration with local regulators and law enforcement agencies remains our key priority. These organisations provide a steady stream of quality referrals to the AFRC which include alleged misconduct of high public interest. This signifies their trust and recognition of the AFRC's role as the independent regulator of the accounting profession, and statutory duties in combating misconduct and non-compliance in relation to financial reporting and audit quality in Hong Kong.



7.4.2 By virtue of the signed MoUs, we continue to maintain regular contacts with the local regulators and law enforcement agencies to address strategic matters and case-specific issues, such as referrals, information exchanges, joint investigations, and enforcement assistance. The cross-sector collaboration shall achieve synergies that will contribute to the betterment of the accounting profession, and the stability and effective functioning of the Hong Kong financial system.

### **Mainland China**

7.4.3 In respect of cross-border collaboration, maintaining constructive dialogues with the SEB is always high on our agenda. We have made great strides in obtaining audit working papers located in the Mainland through our MoU with SEB.

7.4.4 Given the significance of Mainland-based audit work for Hong Kong listed entities, we spared no efforts to liaise with the SEB in expediting the process of obtaining audit working papers located in the Mainland for the furtherance of our investigations.

7.4.5 At the time of going to print, we expect to receive the relevant audit working papers located in the Mainland in relation to 4 other investigations with the assistance of the SEB.

7.4.6 Following the Government's initiative in encouraging international and Mainland companies to set up and expand their business operations in Hong Kong, there will be new business opportunities for the accounting profession as companies begin to set foot in Hong Kong. Hence, we envisage a strong need for closer collaboration with the SEB in order to achieve effective cross-border enforcement outcomes.

## Contacts

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

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