Auditing and Regulatory Environment

Chapter 1 Introduction

This research study investigates the audit risk control and risk mitigation measures that Hong Kong listed companies' auditors apply in response to the more stringent regulatory environment in Hong Kong and find ways to improve it. According to Hong Kong Standard on Auditing (HKSA) 200, the objective of auditing is to obtain sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, according to the first annual inspection report of Hong Kong Financial Reporting Council (HKFRC), the audit quality of listed companies' auditors is "*<u>significantly below</u> the high standard required of audits of listed entities (Emphasis added).*" Therefore, it is crucial to make significant improvements to their audit quality.

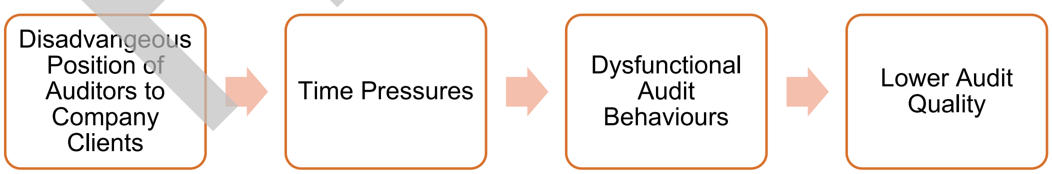
1.1. Background and Rationale

In Hong Kong, listed companies' auditors face a more stringent regulatory regime from the fully empowered HKFRC. Before that, Hong Kong had a relatively lax regulatory environment for listed companies' auditors. Previously, HKFRC only had the investigation power on audit irregularities of listed companies' auditors. The power of conducting a regular inspection on the working papers and sanctioning the listed companies' auditors was the Hong Kong Institute of Certified Public Accountants (HKICPA) power. HKICPA is a statutory organization in which all members are from the accounting profession and, in substance, a self-regulatory organization for the accounting profession. However, since Hong Kong is an International Financial Centre, such a level of regulations was deemed insufficient by the Hong Kong government.

Therefore, from October 1 2019, HKFRC formally took over the inspection and sanction power of the HKICPA on listed companies' auditors (HKFRC, 2020b). HKFRC also

As mentioned, the sources of time pressures are insufficient audit fees and tight deadlines. The disadvangeous position of auditors can explain the cause for such to company clients. As explained by DeAngelo (1981a), DeAngelo (1981b) and from my experience, company clients pay accounting firms to have their financial statements audited. However, to the company client itself, auditing and assurance services do not produce any economic value added to company clients. It is just a statutory requirement to certify their financial statements to be true and fair to the third parties. Apart from helping the company clients fulfil the statutory requirements and providing evidence for obtaining credit, clients have no direct economic benefits (DeAngelo, 1981a). Therefore, company clients are more interested in reducing the auditing fee than seeking the best service by paying a premium price. Therefore, to obtain businesses, accounting firms are inherently receiving fewer audit fees than the work they need to do (DeAngelo, 1981a, DeAngelo, 1981b). The accounting firm then needs to squeeze time to finish the audit work for more businesses. Company clients may even impose a tight deadline for their works. Auditors may even need to "please" their company clients at a legally acceptable level to retain clients (DeAngelo, 1981b). Such time pressures then lead to DAB (Donnelly et al., 2003). Therefore, the cause and effect relationship can be summarised in Figure 1. From my view, such auditor-client relationship is inherent in the audit industry and cannot be changed.

Figure 1 The Cause-and-Effect Relationship to Lower Audit Quality



Source: Author's Interpretation

Therefore, there must be appropriate audit risk control and audit risk mitigation measures to support better audit quality and reduce audit risk. Such measures may include

Chapter 2 Literature Review

This chapter is divided into four sections. The first section discusses the audit regulatory reform in Hong Kong. The next section then discusses the requirements of the International Standards on Auditing (ISA). Third, the five matters of auditing as discussed by Knechel et al. (2013): incentive matter, uncertainty matter, uniqueness matter, process matter, and professional judgement matter are then illustrated. They could influence audit quality. It then explains that the incentive matter and uncertainty matter are inherent in audit engagements. Only the uniqueness matter, process matter, and professional judgement matter can be changed and improved. The last part of this chapter is then about how these three matters can be addressed to improve audit quality. More importantly, it sets the good measures for good risk control and risk mitigation measures for the latter discussion in Chapter 4---Results and Discussion.

2.1. Hong Kong Audit Regulatory Reform

The Hong Kong Audit Regulatory Reform changed the power of allocation between HKICPA and HKFRC. Many powers previous rested on HKICPA were taken over by HKFRC in the reform. Other major changes are the significant increase in maximum penalties for confirmed audit misconduct and the governance structure.

The rationale of this reform is to remove the historical problem of audit self-regulation by HKICPA. Self-regulation of the accounting profession is obviously problematic because of the conflict of interests between enforcement and the interests of the profession. Although HKICPA has been sanctioning auditors and performing inspection for years, its maximum penalty of audit misconduct is only HK$500,000 and the cancellation of practising certificate (HKICPA, 2021). Such sanctions are not enough to disincentivise auditors from engaging in audit misconduct.

More importantly, such audit regulatory regime is seriously lagging that of many countries and regions before the reform. There are two international standards for audit regulatory regime: the International Forum of Independent Audit Regulators (IFIAR) and EU Equivalent. Despite their differences in specificities, both require the establishment of an independent audit regulators in the countries or regions to hold the inspection, investigation, and disciplinary powers (Deloitte, 2016). If the HKICPA's self-regulatory regime remained, Hong Kong's audit regulatory regime would never meet the international standards. Therefore, there was a need to strengthen the audit regulatory regime, especially in an International Financial Centre like Hong Kong. The following sub-sections shows some details of the reform that has been effective since 1 October 2019.

2.1.1. Allocation of Power Between HKICPA and HKFRC

The Hong Kong Audit Regulatory Reform represents a transition of Hong Kong Auditing Industry from a self-regulatory regime to a regulatory regime with an independent audit regulator at the centre. Previously, HKICPA was responsible for the register, inspection, and discipline of the public interest entities (PIE) auditors (HKFRC, 2016). After 1 October 2019, HKICPA handed over the inspection and disciplinary power of PIE auditors to HKFRC. Alongside the investigative power of PIE auditors on audit misconduct, HKFRC now holds all three major powers in inspecting, investigating, and sanctioning the PIE auditors. Currently, HKICPA only retains the functions of registering auditors and accounting firms, the setting of accounting standards, and the training and development of accountants. HKFRC is responsible for the oversight and governance of HKICPA in performing these functions (HKFRC, 2021a). The following Figure 2 and Figure 3 summarises the power of HKICPA and HKFRC before and after the reform.

Figure 2 HKICPA and FRC's Power Before the Reform

HKICPA

Governed by Accounting Practitioners	
Inspection	Registration
-	Standard Setting
Disciplinary and Sanction	Training and Development

HKFRC

Governed by non-accounting practitioner	
-	-
Investigation	-
-	-

Source: Author’s Interpretation and HKFRC (2016)

Figure 3 HKICPA and HKFRC's Power After the Reform

HKICPA

Governed by Accounting Practitioners	
-	Registration (Oversight by HKFRC)
-	Standard Setting (Oversight by HKFRC)
-	Training and Development (Oversight by HKFRC)

HKFRC

Governed by non-accounting practitioner	
Inspection	Oversight and governance of the Registration, Standard Setting, and Training and Development Function performed by HKICPA
Investigation	
Disciplinary and Sanction	

Source: Author’s Interpretation and HKFRC (2021a)

From Figure 2 and Figure 3, the major powers of inspection and disciplinary were officially transferred from HKICPA to HKFRC. In other words, the reform removed the powers of inspection and disciplinary of PIE auditors from HKICPA, making it much less powerful organisation. Moreover, although HKICPA retains the three functions of registration, standard setting, and training and development, HKFRC oversees and governs their performance of these functions. In other words, HKFRC becomes the watchdog of HKICPA for *professional judgement* and the *uniqueness* for each audit engagement. There are needs for risk monitoring and risk mitigation measures to reduce the differences of audit quality between different engagements within the same firm. It leads to the needs for a good hiring, remuneration, and performance assessment process, training and development, multi-level of review of audit works, and engagement of internal experts in specific audit areas such as impairment assessment, valuation of intangible assets, and areas in business combination. To reduce the risk for lack of independence, there may be additional fraud detection techniques and additional independence requirements within the firm on top of the Code of Ethics of Accountants. The following sections illustrates such areas in depth.

2.4. Good Measures for Improving Audit Quality

The good measures for improving audit quality are the solutions to all five matters of audit quality. As mentioned in Section 2.3.2, only the incentive matter, Uniqueness Matter, Process Matter, and Professional Judgement Matter can be improved through an audit quality control system. First, incentive matter is about how different financial and non-financial incentives influence the audit quality. Examples of incentives are the amount of audit fee (Houston, 1999, Gramling, 1999), perceived risk of losing an audit client (Blay, 2005, Farmer et al., 1987), performance measurement and compensation structure for audit partner (HKFRC, 2021d), client pressures on deadlines and the information given for auditing (Blay, 2005, Chang and Hwang, 2003, Trompeter, 1994, Farmer et al., 1987).

2.4.1. Good Measures to Reduce the Impact of Audit Quality from the *Incentive Issue*

To counteract the incentive issue, a firm needs to establish a firm culture that support good audit quality, design a performance appraisal system that emphasizes more audit quality (HKFRC, 2021d), and negotiate for appropriate level of audit fee for work. First, for the purpose of establishing the culture, it is important to have top management support, use of a performance evaluation system that rewards high audit quality and use training and development session to emphasise the importance of high audit quality.

Second, audit partner should try to negotiate a reasonable audit fee level. There are two phenomena at the two extremes: lowballing of audit fees and abnormally high audit fees. Lowballing of audit fees mean setting audit fees at a level lower than the audit costs during the first year of audit engagement to compete for large and prestigious clients (Cho et al., 2021, Desir et al., 2014, Kanodia and Mukherji, 1994). Abnormally high audit fees mean setting audit fees much higher than the normal practice. It may indicate financial problems within a company (Hribar et al., 2014). The phenomenon of abnormally high audit fees can be indicative of a “bribe” to audit firms to cover up the financial problems of a company (Knechel et al., 2013). Audit fees at both ends are problematic. Lowballing of audit fees squeeze the audit budget and reduces audit quality despite an inconclusive evidence (Cho et al., 2021). Abnormally high audit fees may be indicative of declining future firm performance and a higher cost of capital (Picconi and Reynolds, 2013, Hope et al., 2009, Stanley, 2011). It may also indicate lower audit quality (Asthana and Boone, 2012).

Third, appropriate compensation and time budget for audit engagement are important to increase the incentives for better audit performance. First, audit firms need to give appropriate and reasonable compensation plans for audit partners. Such compensation plans should give rewards for high audit quality instead of just about finding more audit clients (HKFRC, 2021d). Similarly, audit firms shall strive to give adequate time budget for auditors to reduce the occurrences of DAB (Houston, 1999, Gramling, 1999, Asthana and Boone, 2012).

2.4.2. Good Measures to Reduce the Impact of Audit Quality from the *Uniqueness and Professional Judgement Issues*

Several good measures have to be taken to reduce the audit issues from the uniqueness and professional judgement issues. First, audit firms need to employ experts to support the audit process such as valuation expert, information, and communication technology (ICT) experts, and internal control experts to support audit engagements (Bedard et al., 2008). Second, it needs a consultation unit which is commonly called the technical department to offer consultation and conduct additional review, research on audit issues as well as setting firm requirements for audit quality (Bedard et al., 2008, Salterio and Denham, 1997). Third, there should be regular training and development activities in accounting, auditing skills, and auditing standards (Bedard et al., 2008, Dowling and Leech, 2007). It can enhance the knowledge and competence level of lower-level auditors (Francis, 2011).

2.4.3. Good Measures to Reduce the Impact of Audit Quality from the *Process Issues*

There are several measures that can make the audit process better. First, from the initial acceptance and continuance acceptance of clients, firms can set additional firm-wide independence requirements. For example, prohibition to start audit engagements when there are overdue fees of more than 12 months from the expected date of the current audit report, contingent assurance service fees, accepting commission/fee for recommending a product or service from a third party to audit clients. Consultations before starting an audit when the agreed fee for a new audit client is significantly lower than that of audit clients of similar engagements. Other additional independence requirements are required for member firms in international network which involves operations in multiple countries.

Second, another process criteria are a good audit processes that guide auditors to conduct audit step-by-step. They include electronic practice aids, the use of decision aids in auditing, the use of audit software that standardises the audit process, and a comprehensive

Chapter 4 Data Analysis and Discussion

This chapter discusses the data collected from the six semi-structured interviews. The researcher uses thematic analysis to analyse the data. Five themes were discovered in the process: (1) Risk mitigation measures at the initial acceptance and continuance, (2) Risk mitigation measures at the audit execution stage, (3) other measures in boosting the firm's risk mitigation, (4) the tradeoff on reputation, compliance, efficiency, and audit quality, and (5) responses to the new FRC regulatory regime. The themes and sub-themes are discussed in the following sections.

4.1. Theme 1: Initial Acceptance and Continuance's Background Search, Risk Assessment, and Meeting Independence Requirements

This theme is about the risk mitigation measures at the initial acceptance and continuance stage. As discussed in Section 2.2 of Chapter 2, the acceptance and continuance procedures are documented in ISA 210 and ISA 315. They prescribe the procedures for audit acceptance and continuance, as well as risk assessment procedures for auditing. Section 2.2 of Chapter 2 also shows factors to consider for entity and individual account balance or transactions in assessment. However, it does not provide details about the execution.

According to the partner in an international mid-tier firm interviewed, he said *that "we usually receive many requests for quotations from audit firms, we need to consider the independence of our firms and our ability to conduct the audit such as the adequacy of our firm resources, manpower, and knowledge, and most importantly, the professional risks associated"* He stated that listed company change their auditors due to many reasons such as the inability to reach an agreement on the auditor's remuneration or accounting issues exposed or regulatory issues.

4.2.1. Sub-theme 1: Planning and Resources

According to some interviewees, the planning and resources' determinations are set at the initial stage of audit planning. One senior audit manager B stated that *"we consider the operations, business model of the company, and the material items of the financial statements, the materiality, audit sampling needed, and number of locations and geographical regions of the locations in planning the audit."* Then, the audit managers assess whether there are sufficient staff resources and consider the staff level of performance and the availability of staff for the audit engagement. They typically meet with other audit managers to liaise for the suitable staff to perform the audit engagement.

As a discussion, from the representation of the interviewees, there are not many considerations for risk mitigation at that level of planning and staff resources. Typically, based on their considerations of the size and scope of businesses as well as the risk areas, they use their experience and professional judgement to determine how many staff and the grading of staff needed to perform the audit engagement. Respondent C stated that *"there are always insufficient number of staff to perform the audit engagement, especially for listed companies' engagement. Listed companies' engagements, as you know, have greater regulatory oversight and inspection which require higher level of audit works performed, for example, greater quality of audit working papers and more documentations. It then needs more manpower or more working hours to perform. Because of the insufficient manpower, staff typically needs to work overtime to complete the works."* Therefore, it is considered that there are not many specific risks mitigation measures at that level outside of the standard requirement.

4.2.2. Sub-theme 2: Availability of Technical Units and Experts for Review and Directions

members knowledge on new accounting standards and auditing standards. Besides, soft skills trainings are provided to enhance their communication and interpersonal skills in communicating with clients and team members, as well as leadership skills in leading team members in audit engagements.

Second, the external review of these international audit firms in the interviews are from the quality assurance unit of the international firm networks. Depending on different international firm networks, the quality assurance unit of the firm network regularly sends staff to the member firms to conduct quality assurance review to ensure the audit quality of member firms. As a discussion, these two measures follow the general recommendations from the literature discussed and are effective. Overall, the third theme is about the provision of accounting and auditing standard training and soft skills training to improve their conducting of audit engagement and external review from international network members' firm.

4.4. Theme 4: The Audit Firm's Tradeoff on Reputation, Compliance, Audit Efficiency, and Audit Quality

In this theme, it is discussed that the audit firms' managers and partner interviewed tend to emphasise more on reputational loss, take a flexible view on compliance, and emphasise both audit efficient and audit quality.

First, as to the tradeoff between reputational loss and the loss of clients, all respondents stated that they care more about the reputational loss than the loss of clients. One respondent, a senior manager stated that *"it is not possible for an audit client to be more than 10% of our annual revenue because of our size."* The code of ethics of accountants also required that not a single audit client can exceed 15% of an audit firm's annual revenue. Therefore, it is both not feasible and practical to consider the loss of clients over reputational loss. Besides, the only partner in the interview stated that, as member firm,

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