

Chapter 1

Development of the Auditing Profession

Learning Objectives

Chapter 1 provides an overview of the auditing profession, including a description of its historical and recent development as well as the relevant organisations. Upon completion of the Chapter, one should be able to:

1. Offer a historical account on the development of the auditing profession;
2. Describe and account for the development of the accounting profession in Hong Kong, including the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Financial Reporting Council (FRC);
3. Define auditing and its relationship with accounting;
4. Discuss the types of auditors, the characteristics of the accountancy profession and the organisation structure of accounting practices; and
5. Outline the main sources of demand for auditors' services.

Key Ordinances / Standards Covered in the Chapter

- HKSA 200 (Clarified May 2013) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing
- Statement 1.500 (Redrafted April 2013) Continuing Professional Development
- Professional Accountant Ordinance (Chapter 50)
- Companies Ordinance (Chapter 622)
- Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32)

Over the years auditing has developed into a specialised function with complex ethical, legal, and economic implications. Present-day auditors act as independent professionals, not only issuing audit reports that lend credibility to the financial reports of organisations, but also providing assurance services for a wide variety of business activities. As a result, auditors enjoy a distinctive professional status in today's society. The role of the auditors in providing credibility is even more important in a society like Hong Kong, which relies heavily on its reputation as an international centre for finance and business. A series of corporate scandals that emerged in 2001–2002 in the United States such as Enron and WorldCom underscore the importance of high quality corporate governance in ensuring corporate transparency and honest financial reporting. In particular, high quality auditing has taken a centre stage in ensuring corporate transparency and high quality financial reporting. Subsequent developments includes the supranational Sarbanes-Oxley Act of 2002 that increases the professional and legal liabilities of accountants and auditors, the establishment of oversight bodies such as the Public Company Accounting Oversight Board (PCAOB) in the United States and the Financial Reporting Council in Hong Kong. It is witnessed in the recent years progresses over the convergence of auditing standards between Hong Kong, neighbouring areas such as the Mainland China, and other countries. ^[1]

This Chapter reviews the evolution of auditing and examines the nature and purpose of the accounting profession and the role of independent auditors.

1 Early Developments

A form of auditing existed as early as the twelfth century when the Exchequer was established in England during the reign of Henry I (1100–1135). Special audit officers were appointed to ensure that state revenue and expenditure transactions were properly accounted. It also became customary for an audit of the accounts of manors and estates to be performed. The person who made such examinations of accounts became known as the auditor. The term 'auditor' was derived from the Latin word '*audire*', meaning *to hear*, because originally the accounting parties were required to present themselves before the auditor who 'heard' their accounts.

It was not until the fourteenth and fifteenth centuries, when the Renaissance in Italy led to an expansion of trade and commerce generally, that a system of accounting was developed which was capable of accurately recording mercantile transactions. In 1494, Luca Pacioli published his treatise on arithmetic with a section on the principles of double entry. Within a few years, mercantile accounting had taken a definite shape, and it slowly spread to England and other parts of Europe. In 1581, the first association of accountants was formed in Venice. However, the practice of auditing did not become firmly established

as part of the business world until the advent of the Industrial Revolution.

The Industrial Revolution saw the emergence of large business undertakings such as railways, banks, and joint stock companies. The advantages of using the services of auditors became apparent to the investing public when a large number of corporate organisations were set up which employed enormous sums of money under the management of a few individuals (managers). Further, with growing government regulation of these business institutions, there was a need for independent auditing.

As auditing grew during the nineteenth century, the accountancy profession in England attained a position of importance. The *Companies Clauses Consolidation Act 1845* provided for the appointment of auditors for railway companies. In 1862 the *Companies Act* contained a provision for the audit of joint stock companies. The audit of the accounts of registered limited companies became compulsory with the *Companies Amendment Act 1900*. Prior to this, several organisations for professional accountants were set up in England. The earliest of these were the Society of Accountants in Edinburgh, 1854; the Institute of Accountants and Actuaries in Glasgow, 1855; and the Society of Accountants in Aberdeen, 1867. The three bodies merged to form the Institute of Chartered Accountants of Scotland in 1951. The Institute of Chartered Accountants in England and Wales was established in 1880 as a result of a merger of four accountancy bodies — Incorporated Society of Liverpool Accountants, 1870; Institute of Accountants in London, 1871; Manchester Institute of Accountants, 1871; and the Society of Accountants in England, 1872.

1.1 The Hong Kong Institute of Certified Public Accountants

The formation of professional accountancy bodies in England provided the impetus for the development of the profession in the United States, Australia, Canada, Hong Kong, Malaysia, Singapore, and other countries. In the early days of British occupation in Hong Kong, British accountants provided auditing services with their head offices in London. There was no formal professional accounting body based in Hong Kong until 1973, when the Hong Kong Society of Accountants (the Society) was incorporated under the Professional Accountants Ordinance (PAO), Chapter 50. Before the incorporation, the Authorised Auditors Board under the Government's Registrar of Companies carried out registration of accountants for public practice.

The formation of the Society was a milestone in the development of a professional accounting body in Hong Kong. In 1982, the Society established its own Accounting Standards Committee to prepare and issue accounting standards. The committee membership was drawn from members of professional accounting firms, industrial and commercial organisations and academics. In October 1977, the Society became a member of the International Federation

of Accountants (IFAC) upon its inauguration, and in April 1995, it became an associate member of the International Accounting Standards Committee (IASC). In January 1982, the Joint Examination Scheme with the Association of Chartered Certified Accountants (ACCA) commenced. A Steering Committee on Professional Accreditation was formed to consider setting the Society's own examinations and related matters in July 1994. On 8 September 2004, the Society formally renamed itself as the Hong Kong Institute of Certified Public Accountants (HKICPA).

The HKICPA today is the only statutory licensing body of accountants in Hong Kong, responsible for regulation of the accountancy profession under the PAO. It has been very active in promoting the quality and status of accountants in Hong Kong. For example, it conducted three long-range planning exercises in 1981, 1987 and 1992. The 1992 long-range plan was important in the sense that HKICPA recognised its role in the wider context of Mainland China and the return of Hong Kong to China. The committee also recognised the impact of Information Technology (IT) in the profession and the business community. The fourth long-range plan in 2000 focused on the development of the services and practices of professional accountants, the development of professional competences and attitudes, as well as the relationship between the Society and its strategic alliances and the changing external environment. In the most recent long-range plan in 2007, HKICPA emphasises the role of the accountancy profession in the Hong Kong's status as one of the world's leading financial centers, and contributes to the development and future of the global profession and that on the mainland.

The success and development of the HKICPA can be seen in terms of the fact that in 1989 there were 4,754 members, and by June, 2012 there were 33,901 members. No doubt HKICPA will play an even bigger and more important role in the future in both Hong Kong and the region. More consultations and working relationships with the Chinese Institute of Certified Public Accountants (CICPA) are expected to enhance the role of the HKICPA in the development of the accounting profession in China. For example, a letter of intent has been signed with the Beijing Institute of CPAs in 2011 to boost co-operation among small- and medium-sized accounting firms in the two cities, amid China's plans to develop at least 10 large firms and 200 medium-sized firms by the year of 2015. Trips and conferences are also organised to allow the exchange of expertise and the establishment of ties between the two cities. Delegations from the Chinese Institute of CPAs, the Macau Society of Registered Auditors, the Shenzhen local tax bureau, and several other accounting and government bodies from greater China are also welcomed to improve their China accounting skills to make the most of the opportunities on the mainland. 417 members from HKICPA have enrolled in the PRC CPA Uniform Examination in 2011 (according to *HKICPA Annual Report 2011*).

1.2 The Financial Reporting Council

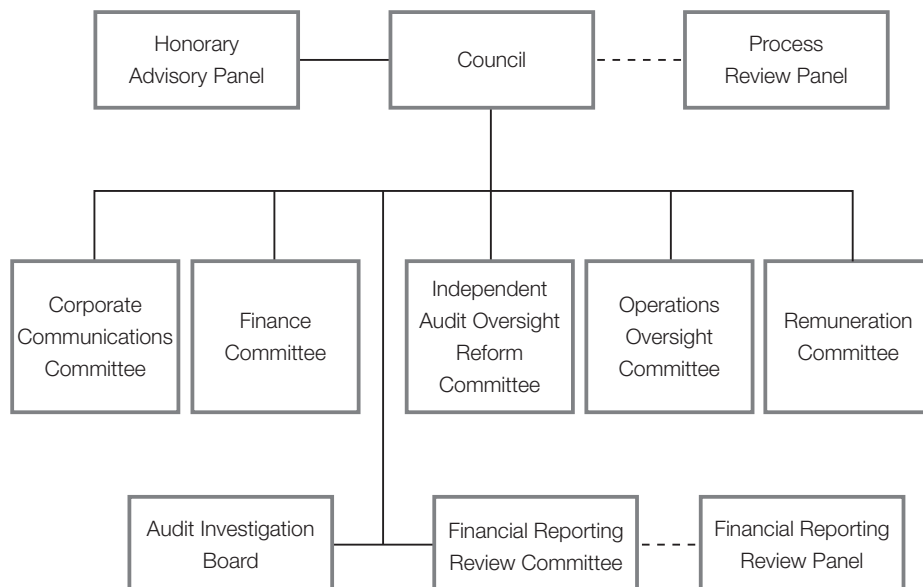
While the accounting and auditing profession in Hong Kong is largely self-regulated under the HKICPA, the public became concerned about the effectiveness of self-regulation following the high-profile corporate scandals in the United States and the suspected cases of false financial reporting by listed entities in Hong Kong. To uphold the quality of financial reporting and enhance protection for investors, the United Kingdom and Australia each established their own Financial Reporting Council (FRC), and the United States set up the Public Company Accounting Oversight Board to oversee public entity auditing and to safeguard investor interests. In Hong Kong, after the *FRC Ordinance* was enacted on 13 July 2006, the FRC, which is independent from the accounting profession, was established on 1 December 2006 and became fully operational as a statutory body on 16 July 2007. It has 11 members with a variety of professional backgrounds and the majority of whom, including the Chairman, are lay persons. The organisational chart of FRC is provided in Figure 1.1.

The FRC does not stand alone as a regulator, but work with other regulators to uphold the standard of financial reporting through (1) setting up cooperation protocols in the form of Memoranda of Understanding (MoUs) with the HKEx, the HKMA, the Insurance Authority, the SFC and the HKICPA; (2) close contact with local law enforcement agencies, such as the Hong Kong Police and the ICAC; and (3) liaising with mainland China regulators, including the CICPA, the CSRC, and the MoF.

The FRC is entrusted with the statutory responsibilities (1) to conduct independent investigations into possible auditing or reporting irregularities in relation to listed entities, and (2) to enquire into possible non-compliance with accounting requirements on the part of listed entities. The Council may initiate investigations or enquiries upon receipt of complaints or on its own initiative. However, the FRC is not empowered to discipline or prosecute. Any auditing or reporting irregularity found is referred to the HKICPA, or other professional bodies, for disciplinary action. In cases of non-compliance or fraud, a referral is made to law enforcement agencies such as HKEx, SFC or even the Hong Kong Police or the ICAC. In cases where potential non-compliance with accounting requirements, whether arising from complaints or review of financial statements, do not affect the fair presentation of the financial statements, the FRC issues letters of advice to the listed entities and/or their auditors outlining these findings and suggesting improvement measures, rather than initiates an investigation and/or an enquiry.

During 2011, seven complaints have been received, of which four related to auditing or reporting irregularities, and three involved both auditing irregularities and non-compliance with accounting requirements. This, in turn,

Figure 1.1 Organisation Chart of the Financial Reporting Council



Source: Financial Reporting Council website <http://www.frc.org.hk/en/content01_04.php>

resulted in the initiation of three investigations. In addition, in the same year the FRC screened all 131 modified auditors’ reports and made inquiries where appropriate.

2 Influences on the Development of Auditing

In this section, the general influences on the development of auditing are discussed. These influences have their roots in social, economic and technological factors. As mentioned earlier the major catalysts were the advent of the Industrial Revolution, the emergence of large industrial and commercial companies, and the separation of ownership and control associated with corporate business organisations. The separation of ownership and control had major implications for auditing. Outside shareholders were concerned that their funds may not be used in ways to maximise the value of the company by appointed managers. The audited financial statements were expected to provide some credibility to the reported earnings in the financial statements prepared by management.

The State, through the Companies Acts/Companies Ordinances and related legislation, has over the years gradually increased its regulation of business

enterprise so that now, the duties, rights and responsibilities of auditors are clearly laid out in the relevant Corporations/Companies Law. The courts of law have also extensively interpreted these statutory requirements, and cases over the years have reflected the growing expectations of the public for an improvement in the quality of audits.

A major influence on the development of auditing is the role of the International Federation of Accountants (IFAC) in developing and implementing international auditing standards.^[2] In line with the globalisation of business and commerce, the IFAC has recommended a Global Quality Standard. The Standard is likely to include the following:

- having audit policies and a methodology for conducting transnational audits in accordance with International Standards of Auditing;
- complying with the IFAC Code of Ethics;
- maintaining training programmes to keep partners and staff up to date on international developments in financial reporting; and
- maintaining quality control standards and conducting regular quality assurance reviews to monitor compliance with the firm's policies and methodology.

In recent decades, another major influence on the development of auditing has been the advent of computer technology. With the increasing use of computers and E-commerce by most companies, appropriate techniques of auditing have been developed to meet the changing methods of processing accounting data. No longer can the auditor rely entirely on a visible 'audit trail',^[3] since the accounting steps are not visible to the human eye. The proliferation of computerised accounting information systems has added a new and exciting dimension to auditing and has imposed a new range of auditing skills. Subsequent chapters will discuss various issues associated with the effects of electronic commerce on the audit of financial statements, including the related business risks, internal control considerations, confirmation and retentions of audit evidence, etc.

Auditing in Focus 1.1

The China Element

The accounting and auditing profession is proven to be strongly influenced by the relevant development in China. For example, in early 2011, Hong Kong-listed mainland companies have been relieved from an obligation to hire Hong Kong accounting firms to do their annual audits, if their books

are audited by a mainland firm. Hong Kong Institute of Certified Public Accountants president Philip Tsai Wing-chung expected that firms from China may still hire Hong Kong auditors at least in the short term, 'I do not think all 164 mainland firms will change to mainland auditors immediately, as some would like to take a wait-and-see approach to see how international investors respond to the new rule... but it would be inevitable that some mainland firms may choose to hire mainland auditors later on. As a result, we are going to see some loss of auditing business.

Despite the expected loss of business, Hong Kong accounting firms will also benefit from the new rule as it allows Hong Kong companies listed on the mainland to hire the services of Hong Kong accountants and auditors.'

Another example is the convergence of auditing standards. A joint declaration was signed 5 September 2011 between the China Auditing Standards Board and the Hong Kong Institute of CPAs on the ongoing convergence between the mainland and Hong Kong's auditing standards. 'The declaration is necessary given the increasing global nature of capital markets, and desire that many companies have to raise capital in multiple jurisdictions. It is important to have a set of standards that are globally compatible,' says Philip Tsai, the president of the Hong Kong Institute of CPAs.

The only difference between the Hong Kong and mainland standards is an additional standard included in the revised China Auditing Standards about communication between predecessor and successor auditors. This reflects specific requirements and circumstances in mainland and does not conflict with the clarified Hong Kong Auditing Standards (issued in June 2010).

Sources:

'New Auditing Rules to Affect Hong Kong Accounting Firms'. (2011). CFO Innovation Asia February.

'China, Hong Kong Converge Audit Standards'. (2011). CFO Innovation Asia September.

3 Auditing Defined

The HKICPA stated in its Hong Kong Standards on Auditing (HKSAs) that the objective of an audit is:

‘to enhance the degree of confidence of intended users in the financial statements’, which is ‘achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework’, and ‘whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework’ (HKSA 200, paragraph 3).

HKSA 200 builds on this in paragraph A1 :

‘The auditor’s opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor’s opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.’

HKSA 200 focuses on the level of assurance provided by an audit and it is clear that there are certain inherent features of an audit (e.g. testing and internal control features) which make it impossible for an auditor to offer a guarantee. It further indicates that the duty of an auditor extends to the collection of ‘sufficient appropriate audit evidence and that judgement will be required of an auditor to fulfil this important requirement.

A more comprehensive definition of an audit which says more about the audit process can be found in the report of the American Accounting Association Committee on Basic Auditing Concepts (1973, pp. 8):

‘Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users’.

Several terms used in this definition warrant further comment since they affect auditing practice:

Auditing is a systematic process...

The term process connotes a dynamic activity and systematic suggests a logical, structured and scientific approach to evidence-gathering and decision-making. Auditing therefore is a logical, structured, and scientific activity.

of objectively obtaining and evaluating evidence...

Gathering and evaluating evidence is the cornerstone of auditing. The gathering and evaluation of evidence should be done in a systematic manner, though the evidence itself may not always be objective.

regarding assertions about economic actions and events...

The assertions are representations about economic matters made by management in the published financial information. The assertions made by management may include matters related to the overall control structure of the entity. There is often compelling physical evidence available to the auditor to support some of the assertions of management, such as the existence of a physical asset. For other types of assertions, such as assertions about the existence of non-physical assets (e.g. accounts receivable, creditors, and goodwill) or the non-existence of liabilities, the auditor cannot obtain physically compelling evidence. To verify these assertions, audit procedures have been developed which first confirm the existence of the asset and then confirm the proper amount. The search for unrecorded liabilities is the most difficult audit task, requiring an indirect approach and close attention to all anomalies thrown up by a range of audit techniques.

to ascertain the degree of correspondence between those assertions and established criteria.

For users of financial reports to understand the communications of the auditor, there must be some common language that the parties can understand. The common language is the established criteria, which largely consist of legal regulations and Generally Accepted Accounting Principles (GAAP).

and communicating the results to interested users.

This relates to the final task of the auditor, communication, and reporting. Here the auditor uses a formally published audit opinion to attest to the degree of correspondence between the assertions of management contained in the financial statements and the economic events represented in the statements. The auditor's opinion is in this way communicated to shareholders, creditors and other interested parties, thus lending credibility to the financial reports prepared by management.

3.1 Relationship between Accounting and Auditing

Accounting is the process of identifying, recording, classifying, summarising, and communicating information about an organisation's business activities.

It is designed to provide financial information to a wide variety of users. Two types of accounting activities may be identified: financial accounting and management accounting. Financial accounting refers to accounting information developed for the use of external parties such as investors, current shareholders, creditors, taxing authorities and employees. Management accounting refers to accounting information developed for internal decision making and facilitates the achievement of organisational objectives.

Auditing is related to financial accounting since it is the process of lending credibility to the financial (accounting) statements prepared by management. It is worth emphasising that the onus for preparing the financial reports lies with management. This is clearly enunciated in HKSA 200, paragraph 4:

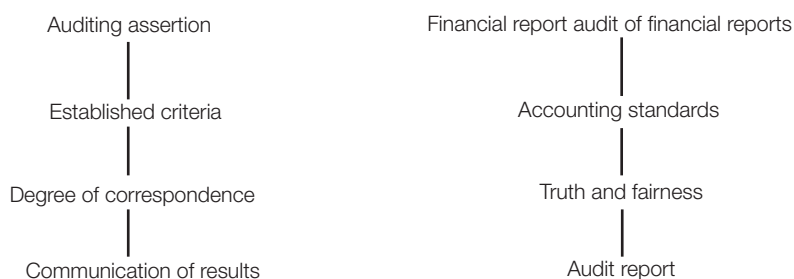
‘The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. HKSAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with HKSAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.’

As shown in Figure 1.2, the auditor’s assertion is the audit opinion regarding the financial reports. In forming an opinion, the auditor has to ascertain that the assertions made by management (published financial statements prepared by management) correspond with established criteria which are within legal regulation and GAAP. In order to do this, the auditor has to systematically and objectively collect and evaluate evidence. The evidence is expected to provide information about the degree of correspondence between the financial statements and the established criteria, and provide a basis for the audit opinion on the truth and fairness of the financial statements. The auditor has to communicate his findings in the statutory audit report. Auditing is thus a form of assurance service provided by the auditor to external parties who need to rely on these statements.

3.2 Assurance Services

In recent times, the term ‘assurance service’ is widely used to describe the various services provided by the auditor other than the financial statement audit. One common type of ‘assurance services’ is the compliance audit, which is

Figure 1.2
Auditing and the Financial Report Audit



undertaken to determine whether the client is conforming to certain procedures and regulations set by management or a regulatory authority. The established criteria in a compliance audit may include certain operating procedures of companies, or regulations for government and public enterprises. These compliance audit reports are prepared for the authority that has established the criteria.

The terms operational audit and management audit have been used interchangeably in the literature; Chapter 18 discusses this area further under the broad heading of ‘Internal and Operational Auditing’, which also includes management audit. It is, however, possible to draw a distinction between the two types of audit. Operational auditing is confined to operations in the functional areas of business and is executed for management and may be defined as a systematic independent appraisal activity within an organisation, for the review of entire departmental operations as a service to management. A management audit, on the other hand, normally deals with the management process as a whole by evaluating the various management processes and functions. The various policies and actions of management are examined, reviewed and appraised in terms of certain objective standards.

Another addition to the auditors’ portfolio of ‘assurance services’ is the ‘debt letters’, when the auditor has to issue a formal report that an organisation has complied with the restrictions of the loan agreement (e.g. to maintain working capital ratios or restrict dividend pay-outs). The ‘debt letters’ should explicitly state that the report is for the use of specific parties (e.g. parties to the debt contract). ‘Assurance services’ are rising in popularity and ‘assurance services’ provided by CPAs include assurance about:

- the reliability of E-commerce;
- the quality and reliability of medical testing care;

- the fairness of Mark Six draws; and
- the accuracy of ballot results in an election.

These services are sought by the public because of two critical skills that auditors possess: objectivity and technical knowledge.

4 Types of Auditors

Three broad categories of auditors may be identified, depending upon their different responsibilities.

4.1 *Independent Auditors*

The most visible auditors are independent auditors who render professional auditing services to clients on a fee-for-service basis. These auditors may provide any of the services identified earlier. An important aspect of this type of auditing is the ‘independence’ of the auditor. The concept of independence, taken up in Chapter 4, requires that the auditor should be without bias, and also appear to be objective so as to reassure those who are relying on the financial reports. Most independent auditors have to be registered to practise, and for registration, they have to be members of the HKICPA or another recognised accounting body.

4.2 *Internal Auditors*

The second category of auditors is internal auditors, who are employees within an entity, although outsourcing internal auditors is common practice today. In general, internal auditors assist the management of the organisation to discharge its responsibilities effectively. Their main role is to ensure that the internal controls are adequate and effective to safeguard assets; check the accuracy and reliability of financial data; promote efficiency; ensure that the financial accounting and other records and reports show the results of actual operations accurately and promptly; and ensure that each unit of the organisation follows the established policies and procedures. Internal auditors are also expected to suggest improvements and changes to increase overall efficiency. The importance of internal auditing is evidenced by the fact that there are professional bodies of internal auditors to cater for this highly specialised function. The Institute of Internal Auditors in the United States defines internal auditing as:

'...an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.'^[4]

As explained later, it can be expected that the importance and stature of the internal auditor will increase and in particular that the internal auditor's role in assisting the external independent auditor's contribution will take on more significance in the future.

4.3 Government Auditors

The third type of auditors is a government auditor employed by various government agencies, such as the Hong Kong Audit Commission. The functions of government auditors extend beyond the examination of financial reports and attesting to the fairness of the statements to matters related to compliance with laws and regulations, use of resources and overall efficiency of the government department. It is important that the auditors observe the fundamental principles of serving the public interest and maintaining the highest degree of integrity, objectivity and independence. The description provided by the United States General Accountability Office (GAO) captures the matters that government auditors are concerned with:

- financial matters and compliance — whether (1) financial operations are conducted with propriety, (2) financial reports are presented fairly, and (3) the department or unit being audited complies with applicable laws and regulations;
- economy and efficiency — whether the department or unit being audited is managing its resources in an economical and efficient manner; and
- programme results — whether (1) desired results or benefits are being achieved, (2) objectives established by the legislative or other authorising body are being met, and (3) the department or unit being audited has considered alternatives which might yield desired results at a lower cost.

5 The Accountancy Profession

As indicated earlier in this Chapter, accountants have acquired a professional status in society. This section reviews the conditions necessary for an occupational group to be considered as professionals. There are a number of characteristics that are generally considered to be necessary before a discipline can be identified as professional. The most important of these are: an underlying motive of public service; a complex body of specialised knowledge; limited admission to the right to practise; an international recognition, continuing commitment to current professional practice; the existence of a voluntary organisation, which aims to regulate and improve the discipline; and a code of ethical conduct. These characteristics are discussed below in relation to the organisation of the accountancy profession.

5.1 Public Service

Public service is perhaps the most important feature of any profession, as it requires the professional to observe a broader public interest in performing professional services. The true professional has a contractual duty to attain the highest standards possible for the client. However, this duty must be balanced with an ethical, moral and legal duty to comply with the law, and to protect the interests of a broader group of parties who are owed a duty of care. This balancing act is among the most difficult aspects of professional life.

5.2 Specialised Body of Knowledge

An important requirement for professional recognition is the existence of a specialised body of knowledge. Individuals entering a profession should be able to demonstrate that they have acquired this knowledge. This is normally done through formal examination requirements.

5.3 Admission Requirements

Most professions have stringent requirements for admission, and the accountancy profession is no exception. The HKICPA has educational and experience requirements for admission to membership. In general, these include a recognised degree or diploma from a university; a term of relevant practical experience; and satisfactory performance in the professional study programme conducted by the accounting bodies.

The HKICPA has introduced its Qualification Programme (CPA QP) as from 1 January 1999 (with an Enhanced QP introduced in 2010). The Programme includes the requirements for student registration and membership

admission, the QP training programme, professional examinations as well as the requirements for practical experience under an authorised employer / supervisor. HKICPA members who qualified through QP will achieve the designations of CPA. The objectives of the new framework for membership requirements are designed to ensure that professional accountants will be competent and that the HKICPA can assume the full responsibility of ensuring that the standard of its professional examinations is on a par with leading professional accountancy bodies.

It is also worth noting that there are three routes for an individual to qualify as a professional accountant depending on entry qualification. These are:

- route 1 — accountancy degree holders;
- route 2 — non-accountancy degree holders; and
- route 3 — AAT graduates.

Figure 1.3 shows the routes one can take to be a qualified accountant through the CPA QP.

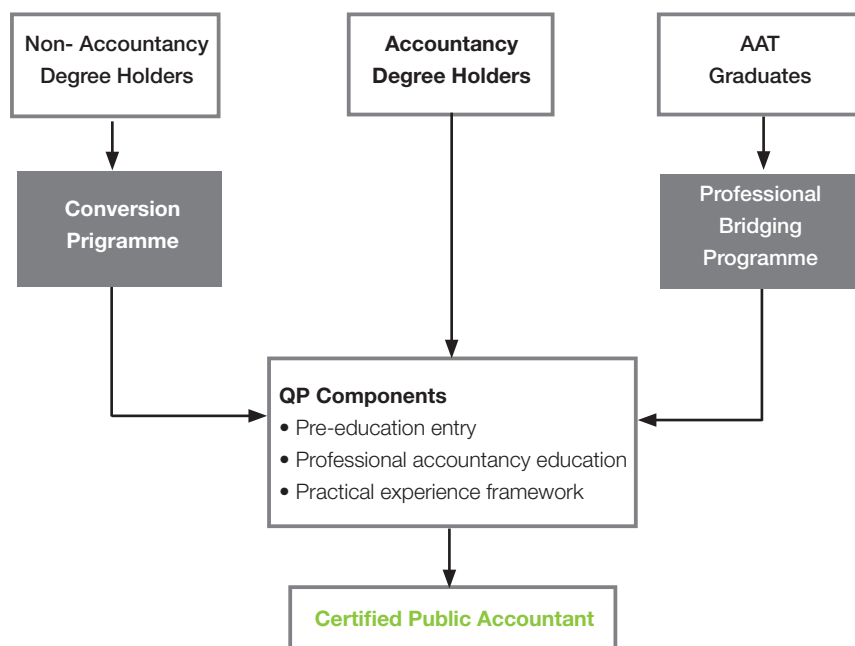
5.4 International Recognition

In 2002, the HKICPA signed milestone Reciprocal Membership Agreements (RMAs) with seven prestigious chartered accountancy bodies. They are institutes of chartered accountants in Australia, England and Wales, Ireland, New Zealand, Scotland, South Africa, and Zimbabwe. In 2005, by signing the mutual recognition agreement with the Canadian Institute of Chartered Accountants (CICA), HKICPA has been given practicing rights in North America for the first time. The Institute also signed arrangements on recognitions with ACCA in 2006 (retroactive to 1 July 2005), with the US International Qualifications Appraisal Board (representing the national Association of State Boards of Accountancy and the American Institute of Certified Public Accountants [AICPA]) in 2011, and with Chartered Institute of Management Accountants (CIMA) in 2013. These agreements mark the HKICPA as a first-tier body in the world and foster a much stronger cooperation and closer ties within the profession (see HKICPA's webpage for details).

5.5 Continuing Professional Development

In recent times, there has been emphasis on continuing professional development (CPD). This is a series of courses and a continuing commitment to current professional practice designed to ensure that accountants are kept abreast of changes in skills and knowledge that are required in a dynamic business

Figure 1.3 The Routes to Qualify as a Professional Accountant through the HKICPA Qualification Programme



Source: HKICPA. 2009. Information Paper on Enhancements to the CPA QP. April.

Notes:

1. The Conversion and Foundation Programmes offer alternative routes for non-accountancy degree holders and sub-degree holders respectively to satisfy the pre-entry educational requirement of the institute. These bridging programmes are offered by tertiary institutes and accredited by the institute.
2. HKAAT & Hong Kong Association of Accounting Technicians. It was formed in 1988 under the auspices of the HKICPA to accredit a second tier of accounting professionals.

environment. The HKICPA in its Statement 1.500 *Continuing Professional Development*, paragraph 30, for example, has stipulated that all members (except retired members) are required to:

- *complete at least 120 hours of relevant CPD activity in each rolling three-year period, of which 60 hours should be verifiable;*
- *complete at least 20 hours (of the 120 hours required in (a) above) in each year; and*
- *track and measure learning activities to meet the above requirements.*

Extreme cases of failure to comply or persistent non-compliance with the CPD requirements may be referred to the Council. Such cases may result in disciplinary action under PAO Chapter 50 s.33 (Part V: Disciplinary Proceedings). It is clear that the trend in the profession is towards more education and training to upgrade and maintain the competence and skill of accountants.

5.6 Self-regulation

Society as a whole must recognise the status of a discipline before it can be regarded as professional. This status carries with it an entitlement to certain privileged communications and rights. While society bestows this honour on the professionals, there is a concomitant responsibility to provide and maintain high standards of service to society. Accountants today enjoy this status, and to retain this recognition, they must continue to provide high quality services by exercising independence, skills, and care in their work. There must be a deliberate effort among professional accountants to avoid negligence in their work which in the long run may affect society's recognition of their status.

For a profession to maintain social recognition it must be willing to regulate itself by maintaining a high level of ethical and moral conduct individually and collectively. There must also be an organisation that the public can recognise as generally controlling the activities of the profession. This organisation deals with the government and other agencies, and provides a forum for the exchange of ideas, and input for policy formulation by governments and businesses. In a general sense, this organisation provides a vehicle to maintain and develop the preconditions of a profession.

In Hong Kong, the major organisation within the accounting profession is the HKICPA. One of the objectives stated in the memorandum of the HKICPA is to support, protect and advance the character, status and interests of the accountancy profession generally and particularly of accountants as members of the HKICPA.

In recent years, in response to the increasing community concern over corporate governance, financial reporting and audit practices, as well as the public's growing expectations for the establishment of an accountable, transparent and effective oversight body that acts independently of the accounting profession, the FRC is established in 2006 (see Section 1.2). Subsequent to its establishment, the investigative powers of the HKICPA over listed company audits were passed to the FRC. Its disciplinary powers are now independent of the HKICPA with Disciplinary Committees composed of a majority of non-accountants appointed by the government. Their hearings are also open to the public. In addition, the HKICPA's governing body, the Council, composed of a certain proportion of members who are government representatives or non-accountants appointed by the government.

Auditing in Focus 1.2

PCAOB Inspections of Foreign Auditors

One of the primary duties of the Public Company Accounting Oversight Board (PCAOB), established in 2002 in the U.S., is to inspect all registered public company audit firms. SOX section 104(b) requires annual inspections for all 'large' firms that audit more than 100 issuer clients, or inspections at least once every three years for 'small' firms that audit fewer than 100 issuer clients. Inspections involve a review by members of the PCAOB inspection team of audit and review engagement work papers for sufficiency and reasonableness of conclusions.

However, the PCAOB encounters significant difficulties in the inspection of non-U.S. auditors that audit U.S. issuers due to the reluctance of many non-U.S. oversight bodies in allowing PCAOB to have access relevant information for various sovereignty and / or legal reasons. For example, only by May, 2013 PCAOB entered into a Memorandum of Understanding on enforcement cooperation with the China Securities Regulatory Commission and the Ministry of Finance of China. The deal will allow the PCAOB to get access to audit documents, including working papers from Chinese accounting firms. There are a number of detailed operational rules, including one that requires the PCAOB to describe the conduct or suspected conduct which gives rise to the request. Note, however, that this agreement only relates to sharing of documents with Chinese regulators in connection with investigations, but not on inspections. Nevertheless this would have implications on Chinese / Hong Kong auditors registered with PCAOB.

Further readings:

Nottbohm, M., D.A. Ellingson and K. Campbell. (2012). 'PCAOB Auditor Inspections and Foreign Auditors'. *The CPA Journal* 82 (11), pp. 32–35.

PCAOB website. 2013. 'PCAOB Enters into Enforcement Cooperation Agreement with Chinese Regulators'. Retrieved from http://pcaobus.org/News/Releases/Pages/05202013_ChinaMOU.aspx.

Auditing in Focus 1.3

PCAOB Censures Firm for Audit Improprieties

In 2012 it is reported that the Public Company Accounting Oversight Board in the United States penalised Brock, Schechter & Polakoff for improper work done for three companies in the mainland and Taiwan. The

regulator censured the firm for violating government rules and auditing standards, temporarily revoked its registration to audit public companies and fined it US\$20,000. James Waggoner, one of the firm's principals who was fired over the work, was banned from public accounting for three years.

Source: Hong Kong Institute of Certified Public Accountants. (2012). *A-Plus June*, p. 12.

5.7 Ethical Code

The Code of Ethics for Professional Accountants of the HKICPA provides guidelines for the ethical conduct of their members. Any breach of or failure to follow the Code may lead to disciplinary action against a member. This may include forfeiture or suspension of membership, a fine or censure. The Code is discussed in detail in Chapter 4.

6 Organisation of Accounting Practice

Accounting firms that conduct public accounting practice vary greatly in size. The smallest firm is the sole practitioner and at the other extreme, there are large international public accounting firms with hundreds of accountants as partners. The large international firms include the so called 'Big 4': Price Waterhouse Coopers; Deloitte Touche Tohmatsu; Ernst and Young and KPMG. These firms employ staff members with many different specialisations and are therefore able to offer a wide range of services including tax services, management advisory services, general accounting and corporate secretarial services. There is some concern among academics and others that public accounting firms, by providing non-audit services for the same client for whom they provide auditing, may be adversely affecting the public perception of auditor independence. This matter is taken up later in this book.

Staff positions and duties in a public accounting firm depend on the size of the firm. In small firms, an employee may perform audit functions at different levels and at other times perform the complete audit. In larger organisations, however, some general patterns in the organisational structure are discernible. At the helm of the firm are the partners, who bear the full responsibility for the practice. They concern themselves with public relations and making new client contacts. They may review the final audit reports and working papers with audit managers and determine whether each audit is in accordance with the firm's policies, and whether it meets professional standards. Before signing the

auditor's report, an expression of the truth and fairness of the financial reports, partners may also review working papers, discuss procedures and findings, and make enquiries necessary for assurance that the audit was properly and effectively conducted.

Below the partners are managers. They have less experience but may have developed a specialisation. The manager usually meets with officials of the client to plan the general nature of the audit and later discusses the final report with the officials. In addition, managers may also be given responsibility for staff training or office management. Each manager is normally assigned a number of audit seniors or supervisors.

Audit seniors normally are qualified as professional accountants through examinations and the requisite practical experience. A senior is generally placed in direct charge of sizeable audits, to which several audit assistants may be assigned. They have day-to-day contacts with the client on routine matters. The senior has sufficient experience and knowledge to coordinate all aspects of the audit and to determine whether sufficient and appropriate evidence has been gathered. On this basis the senior may prepare a draft of the audit report.

Junior employees who have not obtained their professional qualifications are generally classified as audit assistants. They follow the instructions of a superior who has the responsibility for closely reviewing their work and making constructive criticism. This aspect of the training of the assistant is critical for the development and progress of the accountant. In addition, several large firms now offer in-house training programmes for both junior and middle-level staff in their organisation. These programmes supplement the various professional development courses provided by the HKICPA.

Auditing in Focus 1.4

Localisation of Audit Partners in China

In 2012, the Ministry of Finance in China required the 'Big Four' to follow a localisation rule that chief audit partners must, within three years, be locally certified Chinese citizens.

By that time, local CPAs accounted for 50% of all 'Big Four' partners, according to Ministry of Finance. But the 'Big Four' may have trouble meeting other conditions, such as ensuring that at least 60% of partners in management roles are held by local CPAs.

Affiliates of Ernst & Young, KPMG International and PwC International said they support the move.

'This is not protectionism, it's to encourage local partners to grow faster,' said James Lee, regional director for Greater China of the Institute

of Chartered Accountants in England and Wales. 'In other countries, this is normal.'

'We will respond positively to the programme by ensuring a smooth and successful transformation of the firm from the existing joint venture structure,' KPMG's Chinese affiliate said in a statement, adding it 'welcomes' the directive. Ernst & Young said the new rules are 'in line with' its strategy and PwC China said it has been 'actively localising its China practice'.

The four firms, with 25 subsidiaries in China, had US\$1.5 billion of revenue in 2010, representing 26% of the industry's total, according to Ministry of Finance.

Source:

Hong Kong Institute of Certified Public Accountants. (2012). *A-Plus June*, p. 8.

Further reading:

McMahon, D. and S. Hong. (2012). 'China Wants Local Control of Foreign Auditing Firms'. *The Wall Street Journal*, 10 May.

7 Demand for Auditors' Services

An important first step in understanding auditing is to recognise the various sources of demand for auditors' services. These sources may be conveniently classified into two main groups: regulations and external parties.

7.1 Regulations

Regulation arises as a result of the fact that companies formed under the Hong Kong Companies Ordinance, Chapter 622 (referred to as 'Ordinance' hereafter) are required to undergo an examination by external auditors. The law, rights and duties of auditors are in the main laid down in Part 9 (s.392 to s.428) of the Ordinance. In addition, when companies wish to issue new shares, a report by auditors is also required to be part of the prospectus as per the Third Schedule of the Companies (Winding Up and Miscellaneous Provisions) Ordinance [Chapter 32] and the Listing Rules of the Stock Exchange of Hong Kong. Apart from the regulations, auditing is also demanded by external users.

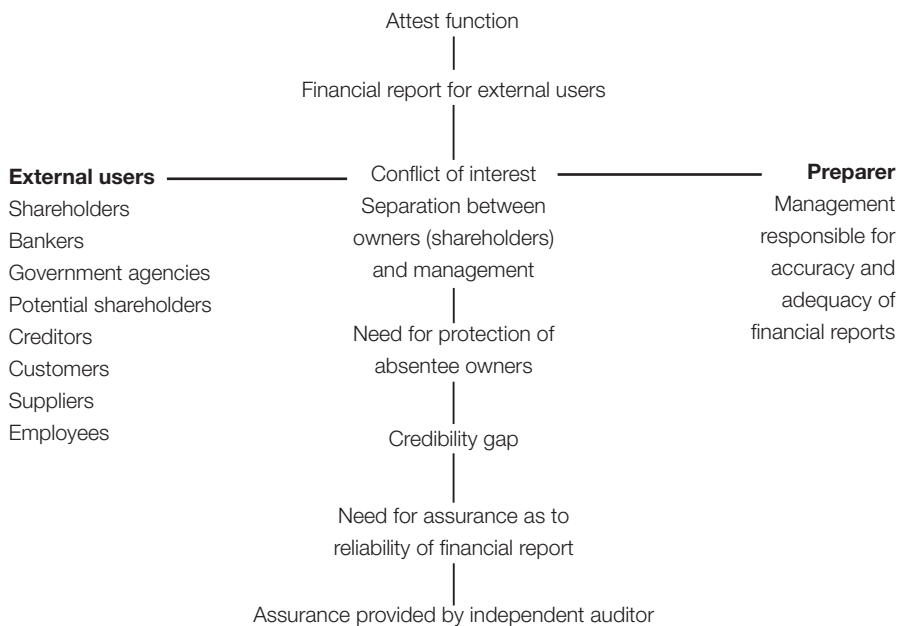
7.2 External Parties

Following agency theory discussed in the next Chapter, there is a conflict of interest between managers and the shareholders and bondholders. Managers are likely to pursue activities that are not in the best interests of the shareholders and bondholders, such as investing in non-optimal projects and providing themselves with non-pecuniary benefits. In order to reduce these potential conflicts of interests or agency costs, contracts such as accounting-based management compensation schemes and accounting-based debt covenants are written. For these contracts to be effective they must be based on reliable accounting numbers. Auditors are able to provide the assurance that these accounting numbers are reliable. Investors also demand audited financial information before they make investment decisions.

One of the most important reasons for an audit is the potential conflict of interest between those who use financial reports and those who have prepared the reports. Figure 1.4 illustrates the relationship between the preparers and the users of financial reports and the role of the auditors. As it shows, financial reports, which are prepared by management, suffer from a potential credibility

Figure 1.4

Relationship of External Users to Management and Independent Auditor Relationship



gap. In reporting on its own administration of the business, management may not be impartial and unbiased. There are also possibilities of accidental errors and deviations from accounting standards. The independent auditor (by furnishing an independent opinion on the financial reports prepared by management) provides some assurance of the reliability of the financial reports.

8 Summary

This Chapter traces the development of auditing and examines the nature and types of auditors. Auditors may be independent auditors, internal auditors, or government auditors. While the three types of auditors have the common function of providing an independent appraisal of the organisation's financial and operational status, their primary responsibilities are to different groups of people or agencies (e.g. shareholders, creditors and the Stock Exchange of Hong Kong). The characteristics of the accounting profession clearly demonstrate that it deserves to be called a profession. Some typical patterns in the organisational structure of large public accounting firms were also discussed. Finally, this Chapter concluded with a brief discussion on the demand for audit services.

Notes

1. For the recent efforts in aligning the auditing standards between Hong Kong and China, see, for example, The Joint Declaration of the China Auditing Standards Board and the Hong Kong Institute of Certified Public Accountants on the converged China Auditing Standards and Hong Kong Auditing Standards (signed 6 December 2007), and The Joint Declaration of the Chinese Institute of Certified Public Accountants and the Hong Kong Institute of Certified Public Accountants on the Ongoing Convergence of China Auditing Standards and Hong Kong Auditing Standards (signed 5 September 2011).
2. See 'The Hong Kong Accountant'. *International News*. (2001). March, p. 40.
3. The 'audit trail' has traditionally been a trail of evidence which links the individual transactions with entries in journals, postings to ledger accounts, and, at the end of the year, arrangement in preliminary financial reports.
4. 'The Institute of Internal Auditing'. *International Standards for the Professional Practice of Internal Auditing*. (2004). USA.

Exercises

Review Questions

1. What are the major influences that have affected the development of auditing, up to the present date?
2. Discuss the changes which have occurred in auditing, with respect to:
 - (a) Audit objectives, generally;
 - (b) The extent of verification; and
 - (c) The importance of internal controls.
3. Give a definition of auditing. Explain, in your own words, what is meant by the definition and outline its major points.
4. Compare and contrast the three general types of audits that can be performed.
5. List the three main types of auditors and explain their functions. How is the notion of independence different for each type of auditor?
6. What is the economic justification of the audit process? Who is responsible for preparing financial reports?
7. What is the meaning of attestation? What relevance does it have to the role of the auditor?
8. What are the conditions that must be met before accountants can call themselves professionals?
9. In most countries, only certain types of entities are required to have an audit, others may choose not to do so. Discuss the advantages of an audit.
10. What is continuing professional development? Why is it important to the auditor and the profession as a whole?
11. Briefly, explain the levels of organisation in a large public accounting firm and the functions attached to each level.
12. Why does an auditor need to remain impartial, unbiased, and independent?
13. What is the status of Hong Kong Standards on Auditing in Hong Kong in relation to International Standards on Auditing? Discuss.
14. Which of the following best describes why an independent auditor is asked to express an opinion on the presentation of financial reports?

- (a) It is difficult to prepare financial reports that fairly present a company's financial position and changes in financial position and operations without the expertise of an independent auditor.
 - (b) It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial reports.
 - (c) The opinion of an independent party is needed because a company may not be objective with respect to its own financial reports.
 - (d) It is a customary courtesy that all shareholders of a company receive an independent report on management's stewardship of the affairs of the business.
15. Independent auditing can best be described as:
- (a) a branch of accounting;
 - (b) a discipline that attests to the results of accounting and other functional operations and data;
 - (c) a professional activity that measures and communicates financial and business data; or
 - (d) a regulatory function that prevents the issuance of improper financial reports.
16. In comparison with the external auditor, an internal auditor is more likely to be concerned with
- (a) internal administrative control
 - (b) cost accounting procedure
 - (c) operational auditing
 - (d) internal accounting control
17. Which of the following best describes the operational audit?
- (a) It requires the constant review by internal auditors of administrative controls as they relate to the operations of the company.
 - (b) It concentrates on implementing financial and accounting control in a newly organised company.
 - (c) It attempts and is designed to verify the fair presentation of a company's results of operations.
 - (d) It concentrates on seeking out aspects of operations in which waste should be reduced by the introduction of controls.
18. Governmental auditing often extends beyond examinations leading to the expression of opinion on the fairness of financial presentation and includes performance audits of efficiency, economy and effectiveness. In addition, which of the following would be included?
- (a) accuracy
 - (b) evaluation

- (c) compliance
- (d) internal control

Discussion Questions

19. The following two statements are representative of attitudes and opinions sometimes encountered by auditors in their professional practice:
- (a) Today's audit consists of test checking. This is a dangerous practice because test checking depends upon the auditor's judgement, which may be defective. An audit can be relied upon only if every transaction is verified.
 - (b) An audit by an auditor is essentially negative and contributes to neither the gross national product nor the general well-being of society. The auditor does not create; he or she merely checks what someone else has done.
- Evaluate each of these statements and indicate:
- (i) areas of agreement with the statement, if any; and
 - (ii) areas of misconception, incompleteness, or fallacious reasoning included in the statement, if any.
20. In the comprehensive definition of auditing provided by the American Accounting Association (AAA), discuss the meaning of each of the following key words and phrases as they relate to the definition:
- (a) systematic process;
 - (b) objectively obtaining and evaluating evidence;
 - (c) assertions about economic actions and events;
 - (d) degree of correspondence between these assertions and established criteria; and
 - (e) communicating the results to interested users.
21. One of the directors of the Ralston Company Ltd., suggested that the company appoint as controller a CPA on the staff of the auditing firm that had made annual audits of Ralston Company for many years. The director expressed the opinion that this move would effect a considerable saving in professional fees as annual audits would no longer be needed. She proposed to give the controller, if appointed, sufficient staff to carry on such continuing investigations of accounting data as appeared necessary. Evaluate this proposal.
22. Paul Chan owns a medium-sized manufacturing firm, Chanal Co., with approximately, \$3 million in annual sales. Being the sole proprietor he acts as the manager and is actively involved in its day-to-day operations. The

company, at present has no long-term debt. Mr. Chan has no interest in expanding his company's operations in the future, because to do so would reduce the amount of time he can spend with his family.

Some of Mr. Chan's friends who operate businesses of the same size as his have annual audits performed upon their company financial reports. Should Mr. Chan have the financial reports of Chanal Co. audited by an independent auditor? If so, why? If not, why not?

23. Philip Wan, a professor of electronics at Kowloon University, recently organised a consulting firm. He was advised to consult a lawyer and an accountant, which he did.

The accountant helped Philip set up a simple accounting system, which Nora, his wife, is maintaining. Nora has called the accountant several times and always seems to get an immediate answer to her questions. The accountant has suggested that he be engaged to audit the annual financial reports.

Philip and Nora Wan have discussed the necessity of having the statements audited. They have decided it is probably a good idea to be assured that she has made no errors in maintaining the records. Also, some other professors have indicated a desire to invest in the consulting firm, and Philip says he wants the accountant to be able to certify to any new investors that the company accounting records reflect exactly what has gone on.

Nora has indicated that she will be likely to cease working sometime during the next year, and she has pointed out that it will be good to have the assurance of the accountant that whoever takes her place makes no errors or tries to steal anything.

Discuss the function of an accountant in the role of auditor in meeting the desires of the Wans.

24. (a) Describe the latest composition of the Financial Reporting Council in Hong Kong.
- (b) Describe the difference between self-regulation and government regulation of the auditing profession. Discuss the advantages and disadvantages of self-regulation.
- (c) What factors determine the proper regulatory system for the accounting and auditing profession?