

Auditors in Hong Kong believe that incorporating their practices is the best way of protecting their interests.

Incorporating Audit Firms in Hong Kong: Issues and Problems

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Introduction

Auditors, like other professionals such as doctors and lawyers, are not allowed to operate in corporate form in Hong Kong. Nowadays, Section 140(2)(c) of the Company Ordinance provides that a person can be appointed as auditor only if qualified under the Professional Accountants Ordinance (Cap 50) and not a body corporate. Moreover, the Professional Accountants Ordinance (No. 14) 1085 provided for audit firms to operate as a partnership or sole proprietorship. That is incorporating audit practices is not allowed in Hong Kong.

However, the Hong Kong Society of Accountants (HKSA) proposes to request incorporation of audit firms in Hong Kong. The reasons for such action will be discussed in this article. With this same issue being discussed in other countries, the Hong Kong experience is of interest to a wider audience.

Background Information

The Hong Kong Society of Accountants proposes a body corporate to act as auditor. It is one of six points which the Society suggested to achieve a fair measure of protection for both the public and the profession.

The HKSA claims that the accounting profession throughout the world is facing a crisis brought about by a rapidly expanding exposure to liability claims and, more immediately, the associated explosion in the cost of obtaining professional indemnity insurance (PII) against those claims. Most people believed that such increase in litigation against auditors in recent years resulted from the existence of the audit expectation gap, i.e. a difference between the public expectation of the auditor's role and the auditor's perception of that role.

In January 1986, the HKSA convened an *ad-hoc* Committee on Limitation of Professional Liability involving seven other local professional bodies. The Committee developed a joint submission, which was made to the authorities in May 1986.

The HKSA recognizes that auditors face the following problems:

- (1) Liability claims rise in tort.
- (2) Expectation gap between profession and the clients.
- (3) Role of external auditors.
- (4) Scale of increase in problems.
- (5) Cost of professional indemnity insurance increase.
- (6) Relationship between auditors and directors.
- (7) Government's non-interventionist policies bring undisputed economic rewards, definite additional dangers and certain penalties.
- (8) Auditors operate with a lower level of the support than that provided by regulatory institutions which exist in the other major financial centres.
- (9) The personal resources of a practising accountant are exposed throughout professional life and even after retirement because of the long tail of liability claims.

The HKSA also claims that allowing the incorporation of audit practices in Hong Kong is one of the possible means of projecting the profession. The Society believes that, if auditors are afforded adequate protection, they will be able to serve the public interest better.

HKSA's Proposal

The following is the working progress of HKSA:

1988. Dialogue with Government on the question of limitation of professional liability. The working group

studying the issue has made progress in its work during the year.

1989. Made a submission to the Attorney-General on the limitation of auditors' professional liability and gathered further information about the developments in this connection in a number of jurisdictions. Awaiting Government's response.

1990. Wrote to the Financial Secretary and drew his attention to an amendment to the UK Companies Act 1989, which permits auditors to incorporate their practices with limited liability, and proposed similar provision for Hong Kong. However, Government expressed itself unsympathetic towards the professions' problem.

1991. Formulating plans for a professional indemnity insurance scheme. Working Group studying a scheme to present to Government detailed proposals supporting its call for allowing auditors to incorporate their practices balances with the safeguard to the public of professional indemnity insurance.

Suggested Incorporation Criteria

Only HKSA members would be allowed to become shareholders and directors of audit corporations, subject to the Council's approval. Consideration would not be given at this stage to the admission of non-members as shareholders and directors. The same rules governing the eligibility of members for admission as partners to a partnership would apply in the case of acquiring shares in, and appointment as directors of, a corporation. A CPA corporation would have to register with the HKSA in the same way as a CPA firm. In this way, the HKSA would retain its full jurisdiction over the shareholders and directors of an auditor corporation as well as the corporation itself.

Areas Which Commonly Give Rise to Claims Against Accountants

Audit

Today auditors face a major exposure for claims in audit work. This is the single most problematic area which gives rise to litigation. Claims may arise, for example, as a result of audits for companies which subsequently fail, and the appointed liquidator or responsibility of receiver is then critically to analyse the audited financial reports and statements of the failed company. The auditor may be sued for redress, if he or she has been negligent in carrying out the audit.

Auditors encounter another area in which claims may often arise against them, and this is their failure to detect fraud or misappropriation of funds by employees. Although it is extremely difficult for auditors to pick up

crimes of this nature, they are nevertheless vulnerable, particularly if the fraud had been undetected over more than a single audit period.

Moreover, accountants from time to time will prepare reports and make valuations concerning a company which may be the target for a takeover or is up for sale and this can give rise to a claim, if the new owner finds that the profit expectations do not live up to the projections of accountants.

Taxation

Accountants also have an exposure to claims as a result of errors and omissions in the preparation of taxation returns or incorrect advice. Taxation is becoming increasingly complex, and clients are relying more heavily on their accountants to assist them in minimizing their tax liability.

Receiverships and Liquidations

The duties of an accountant appointed as a liquidator or receiver to a failed company can be extremely onerous. They often have to carry out their duties in very difficult circumstances and, if they are negligent in doing so, creditors in particular will generally seek the redress to which they are entitled.

General

The following are other common areas which have been known to give rise to claims:

- Inaccurate investment advice.
- Activities related to share registry.
- Erroneous calculation of the value of shares.
- Failure by an accountant to arrange insurances for the clients when requested to do so.
- Loss of documents or financial data belonging to clients.

Foreign Experience

Numerous countries in the world have already allowed the formation of audit corporations, such as Australia, Austria, Denmark, Finland, France, Germany, Iceland, Israel, Japan, Luxemburg, Norway, Portugal, Sweden, Switzerland and the UK. We would like to learn the experience of some influential countries, so as to equip ourselves with a better understanding of the legislation. Moreover, HKSA always follows the practices in the UK so that it is especially worthwhile for us to know the UK situation.

United Kingdom

Audit firms in the UK have traditionally been restricted to the form of partnership with unlimited personal

liability. One major reason for allowing incorporation is to comply with the EC Eighth Directive, which came into force in 1990. The directive allows up to 49 per cent of shares to be held by non-CPA shareholders. Big Eight firms did not favour this move and questioned whether the independence of audit firms will be guaranteed.

In 1988, the accountancy profession bodies proposed the allowance of incorporation of audit firms. The outsiders should be allowed to hold up to 25 per cent of an accounting firm, but not to vote or influence the appointment of directors. The employees in incorporated audit firms were to be allowed to hold up to 50 per cent of the voting shares. Up to 50 per cent of the directors of audit firms may be employees or independent outsiders. Moreover, any individual holding of more than 5 per cent would be under the supervision of a special monitoring body appointed by the profession. However, audit firms would still not be allowed to be listed on the International Stock Exchange, nor would financial institutions such as banks hold the whole 25 per cent of the audit firm.

In addition the audit firms are prohibited from auditing one of their own shareholders. This move was welcomed by the larger multi-disciplinary firms, which will be able to offer partnerships to non-CPA employees and seek external capital. However, the small firms and sole practitioners feared that the auditors' independence would be threatened. The medium-sized firms argued that the limit of 25 per cent is too small to attract sufficient funds to be able to compete with large firms.

In 1989, the Company Act was amended so as to allow incorporating audit practices in the UK and came into force in 1990.

According to the Eighth European Community Company Law Directive, the member states have the option of allowing auditing firms to be incorporated or unincorporated. The purpose of the Directive is to harmonize the qualifications of auditors in the Community.

Consultation procedures were undertaken by the Government and rules were designed to ensure the continued independence of the audit firm from its initial and eventual shareholders. However, the statutory rules do not put a precise figure on the percentage holding of outsiders which is deemed to impair independence. The Department of Trade and Industry undertook a second consultative exercise, following the receipt of a survey carried out in the UK by the three Institutes of Chartered Accountants.

Different professional bodies have set different rules to ensure the control of auditing companies by registered auditors. ACCA rules permit an auditing company to be 49 per cent owned by non-registered auditors, whereas

the Institute of Chartered Accountants in England and Wales (ICAEW) restrict the proportion of shares permitted to be owned by non-auditors to 25 per cent.

The Department of Trade and Industry accepted both sets of regulations, and granted the ACCA and all the other Chartered Institutes permission to become Recognized Supervisory bodies under the 1989 Act in November 1989.

The ACCA and the ICAEW have issued regulations supportive of the CA 1989 restrictions on outside ownership. Few auditing firms are reported to have incorporated. None of the top 20 have considered incorporation.

The regulations are not designed to protect CPAs from personal or collective liability; rather they are designed to ensure the continuing independence and integrity of the accounting profession. Incorporation will not preclude lawsuits being launched against auditing companies, although the personal assets of partners may now have some increased degree of protection.

It is hard to see how the regulations protect the clients, since few audit firms have been incorporated yet. The regulations do not protect the corporate client directly, although the guarantee of independence may indirectly benefit the shareholders in terms of the continued credibility of the independent audit function.

A particular problem is raised in allowing outsiders to own audit firms. If the bankers can be shareholders of CPA firms, the benefit to the clients of the bank will be affected.

Australia

From 1991, the Australian Society of CPAs accepts the application of incorporation of its members.

One of the main reasons for allowing incorporation is for the purpose of income-splitting with spouses and to afford members limited liability applicable under the Corporations Law.

The Corporations Law also allow non-members to practise with members, while ensuring that members retain control of the practice, and the practice is conducted in accordance with the society's ethical controls.

The Society sets a limit on the number of incorporations per year. Currently, about 60 incorporations are allowed per year, with the requirement that the total number of incorporated practices would not exceed those which remain unincorporated. All incorporated practices and other practices are required to have a minimum level of

professional indemnity insurance for negligence arising out of the provision of public accounting services; this protects the clients. Under the by-laws, the member is made liable for the action of the non-members, so that further protection to clients can be achieved.

Members become personally liable on winding-up, if there exists a shortfall in the assets of the incorporated practice, and liquidators will make a call on shareholders.

The main features of by-laws related to incorporation are:

- (1) Not less than 75 per cent of voting shares are held by members.
- (2) Not less than 75 per cent of directors are members.
- (3) Non-member directors must have tertiary qualifications or equivalent experience and skill.
- (4) Any change in shareholders must be communicated to the society for allowance.
- (5) Maintain a policy of professional indemnity insurance against claims of civil liability. The insured sum must be greater than \$250,000. The maximum excess to be met by the members shall be no more than \$5,000.

Canada

The three accounting societies: Chartered Accountants (CA), Certified General Accountants (CGA), and Certified Management Accountants (CMA) have different regulations for their members in the five provinces in Canada.

We will take British Columbia (BC) as an example. Since 1985, the individual CA has been allowed to incorporate in BC, but accounting firms could not, until the Institute of Chartered Accountants of British Columbia passed a rule to change it at the beginning of 1990. Since then, CGA has allowed its members to form unlimited liability corporations. The attitude of the associations was that, as a profession, they are willing to take full responsibility for what they have done. Nevertheless, they would like to provide the benefit of incorporation for their members. That is why only *limited liability corporations* are allowed to be formed.

Those incorporated audit firms must engage in professional indemnity insurance. As a result, whenever lawsuits against the audit company arise, any award can be covered by the insurance. The regulation also allows non-CGA people to be shareholders; it gives great flexibility for incorporated audit firms.

However, the percentage of incorporation is found to be quite low. It is because the benefit from incorporation is diminishing. The reasons why audit firms should incorporate in BC are mainly:

- (1) Limited personal liability.
- (2) Tax benefit.
- (3) Ease of getting credit.

Owing to tax reform, the enormous benefit from tax reduction no longer exists. It turns out that audit firms are not willing to change their structure.

The societies have not planned to change the existing regulations to allow their members to form limited liability corporations. Such change would induce most of the firms to incorporate, providing enormous protection against the property of accountants. However, such reform will afford great possibilities of abuse, which will seriously damage public interest. As a profession, the societies think that it is inappropriate to do so.

View of Different Parties

In this part, we investigate the attitudes of scholars, audit firms, clients, financial statement users and the Hong Kong Government towards incorporation of audit practices in Hong Kong, because they are the parties involved in this issue. Accordingly, we would express our opinion on whether incorporation of audit firms should be allowed or not.

Scholars' View

Through a literature review, we have gathered the following pros and cons of incorporation of audit firms. Allowing the incorporating of audit practices has been discussed in many foreign countries. We find that incorporating is not only the issue of limiting the liability of auditors, it also has several effects on the profession as well as the clients and the financial institutions. However, the major concern is still the limitation of auditors' liability.

Limiting the Liabilities of Auditors

We must first study the liabilities of the auditors because of the claim that incorporating audit practices can provide shelter:

- (1) *Duties of auditors.* In Hong Kong, Companies Ordinance requires auditors of a company to report to the members on the accounts examined by them and on every balance-sheet, profit and loss account and all group accounts set before the company at a general meeting, while they hold the office of auditors.

Also Section 121 of the Companies Ordinance requires of the auditors in preparing their report that it is their duty to carry out such investigation as will enable them to form an opinion as to whether:

- Proper books of accounts have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them.
- The company's balance-sheet and profit and loss account (unless framed as a consolidated profit and loss account) are in agreement with the books of accounts and returns.
- In the case of group accounts submitted by a holding company, of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company.

The auditors have no involvement in or responsibility for the management of the company. They are not required to look for fraud or evidence of mismanagement.

At the same time, the auditors must act honestly and with reasonable care and skill. They will not be considered negligent, if they rely on information from the manager or any other responsible official of the company, unless they have reason to suspect that the information is inaccurate.

Their opinion on those documents presents a true and fair view of the company's affairs at the end of the financial year of the company's profit or loss.

- (2) *Liabilities of auditors.* If in their report the auditors knowingly or recklessly make a statement which is misleading, false or deceptive in a material particular, they are guilty of an offence and liable to a fine and imprisonment.

The auditors will be liable to their client in both contract and tort, if they act in breach of their duty of care, and they may also be liable in tort to other persons who rely on their report.

As in all cases brought in respect of negligence, the person who alleges a breach of duty of care must establish:

- The existence of a duty.
- Breach of that duty.
- That the loss arises as a result of the breach.

If the auditors are found to be in breach of the duty of care, they are liable for the loss arising. The remedy for the breach of the duty for the auditors is increasing at a rapid speed in recent years. In the Cambridge Credit case, judgment was awarded against the sued firm Fell and Starkey in the sum of A\$145 million in Australia. Some people comment that the judgment is totally out of proportion to the fees received by the firm and unreasonably attributed the whole of the blame to the auditors.

In addition in the partnership of audit practice, there are five types of accountants' liabilities. They are:

- Acts performed personally.
- Acts of partners.
- Acts of supervised employees.
- Acts of unsupervised employees.
- General business obligations.

The auditor in partnership is liable not only for his own malpractice, but also for that of his partners and his unsupervised employees.

Besides the Companies Ordinance, the auditors are also liable for the other criminal liabilities such as the Theft Ordinance, Crime Ordinance, statute liabilities such as the Misrepresentation Ordinance, and common law liabilities such as contract law, trust law, and tort law.

Proposers of the incorporation of audit practices claim that, with the increasing liability claims for malpractice of auditors, it is unfair for the auditors, who take limited rewards, to bear unlimited liabilities. They think that a fair measure of protection for both the profession and the public must be established. If auditors are afforded adequate protection, they will be able to serve the public interest better. Incorporation of audit practices can protect the liabilities of the auditors. However, the malpractice partner cannot escape liabilities of tort law under the protection of incorporation.

Proposers also claim that it is not fair to the partners in an audit firm to share the liabilities of the misconduct of partners. In the form of corporation, the auditor shareholder would be protected from liability for the general debts and obligations of the corporation and, to some extent, from liability for the negligence or deliberate misconduct of other shareholders or employees of the corporation.

Moreover, proposers suggest that the liability protection of the innocent auditors will encourage new entrants to the profession and help the profession to develop (which is also an advantage to the public). This will be a long-term advantage to the profession.

On the other hand, some people argue that limiting the liabilities of auditors appears to be based largely on self-interest. They think that the auditors are trying to escape from professional responsibilities. The auditor, being a professional, must take all responsibilities arising in his duties and work done. In the case of misconduct, the auditor must be fully liable to the loss arising and make redress to the injured client. If an auditor does not need to uphold his professional responsibilities, there is no difference between employing a qualified and an

unqualified person. Also the limitation of liabilities of auditors will damage the professional image of the auditor.

Another strong argument against incorporation is that the burden of negligence should be borne by the audit firm involved, as the risk of exposure to liability can be reduced by professional indemnity insurance. People think that professional indemnity insurance is already a good shelter for the malpractice of auditors.

It is also argued that the public interest is not protected when incorporation is allowed. The injured party may not fully recover the loss when the corporation is of auditors. The auditor may make the capital of the corporation as small as possible to minimize any loss arising in the winding-up. Professional indemnity insurance may not be able to recover all the loss which they suffered. The profession is seen as getting protection at the expense of the public interest.

Also, the redress made by auditors in Hong Kong is not high, although there are huge claims in foreign court cases. Auditors are able to recover the amount of the redress themselves, even without professional indemnity insurance.

Furthermore, if incorporation of audit practices is allowed in Hong Kong, the other professions, such as doctors and lawyers, will also make a claim for incorporation to limit their liabilities. There will be a large impact on the relationship between the profession and the public.

To conclude the issue of liability, we find that we are dealing with the conflict of interest between the profession and the public. The person who values the interest of professionals over the public will support the audit firm to incorporate, and vice versa.

Issues on the Organization Structure of CPA Firms

Nowadays, many big audit firms involve multinational operations. In addition to the basic auditing and accounting services, these firms provide a wide variety of consulting services, such as taxation advice, financial consulting and computer system consulting. Therefore the organization structure of the audit firms inevitably becomes bigger and more complicated. In this situation, the partnership structure in an audit firm exposes its deficiencies relative to the corporate structure. In theory, corporate structure can be used to manage a big organization more efficiently and in more flexible ways than the partnership structure. Also the power and responsibilities can be more clearly defined between partners. For example, in their partnership structure, all partners act on behalf of one another, whereas, in corporation each has designated areas of responsibility.

In fact, big audit firms are now running in a "pseudo-corporation" structure, with the jobs of auditors departmentalized, and specialized responsibilities and liabilities more clearly defined than in the traditional partnership structure.

Under the corporate structure, the management of the audit firm can be more flexible in allocating funds and other resources to different divisions. Expansion and retrenchment will be less complicated and costly, since the change in the partnership is easier. As a result, the audit firm can easily adjust the size of the firm to the minimum economies of scale.

Moreover, the corporate structure can also allow the ease of transfer of equity to other partners or shareholders. This is especially important in the case of resignation, dismissal or death of a partner.

Under corporation structure, auditors can more easily join or leave an audit firm and the audit firm must provide more competitive salaries and fringe benefits to retain the auditors. Therefore this healthy competition can raise the standard of living of auditors and attract more capable people to join the profession.

It has even been argued that incorporated audit firms can be more flexible, and with lower costs, with the changing of directors. However, we find no significant difference in the process of changing partners between incorporated and partnership firms. When either a partner or director is to leave the audit firm, the firm must invoke the same processes, such as notification of the changes in the public domain, and incur a similar amount of fees for legal services.

Admission of Non-CPA Shareholders

If audit firms are allowed to incorporate and accept the non-CPAs as shareholders there will now be two categories of professionals in the audit firm:

- (1) *Capital investors.* Like any other growing business, audit firms need ever-increasing amounts of capital to support daily operations, staff training, computer systems and pension obligations to retired partners as well as the opportunities for further development. The internal funds from partners may be very limited. If raising funds from debts, the audit firm will be restrained by debtors and incur the burden of repayment of debts. The competitive power of the audit firm will be affected, if it cannot raise enough funds at the right time and place to grasp profitable opportunities.

On the other hand, auditing is a stable business. The client needs the auditing service, no matter whether the business is experiencing good times

or bad. Therefore audit firms would attract a certain amount of investors requiring stable returns.

Capital investors can provide a new source of funds for the expansion of the audit firm. Moreover, according to the regulations of other foreign countries, in general the investors are not allowed to interfere with the management of the audit firm. Therefore the management of the audit firm can freely use the invested funds, and the control of the firm remains in their hands.

- (2) *Non-CPA experts.* Under partnership structure, audit firms can accept only CPAs into the firm as partners. This means that no matter how important other non-CPA experts are in the audit firm, these experts can gain the status of employee only. Under corporate structure, audit firms can give incentives to these experts through stock options, which may increase their commitment and effort.

Tax Reduction

In foreign countries, one of the major advantages, other than limited liability, of incorporation is tax reduction. In some foreign countries, although limited liability may not be allowed, tax rate of corporations is lower than that of non-incorporated firms. Thus audit firms may still consider incorporation.

However, in Hong Kong, the corporate profit tax rate is currently 17.5 per cent, which is, on the contrary, higher than the 15 per cent of the non-corporate profit tax. Moreover, under the present system, any audit firm having over 20 partners is obliged to pay at the corporate profit tax rate. On the whole, it is quite unattractive for audit firms to incorporate under the present taxation system, i.e. tax reduction may not be an important consideration of incorporation in Hong Kong.

Disclosure of Secret Information

When an audit firm is incorporated, the accounting information must be disclosed to the public or at least to the shareholders. As a result, some of the vital information related to the operations of the firm will be exposed. Other audit firms, as its competitors, will be interested to know the equity distribution of partners in the firm. In addition, major sources of income and the distribution of expenses will be valuable references for other competitive audit firms.

On the other hand, occasionally, the audit firm may be at a low profit level or incur losses. If this kind of information is released to the public, the confidence of the clients may be adversely affected. In the worst situation, the audit firm may find it difficult to attract new clients

and incur pressure from debtors. The business will further be affected.

The Client-Auditor Relationship

It is argued that, when the audit firm is incorporated, the relationship between clients and auditors will be negatively affected. Under the corporation structure, the auditors may feel that they are no longer being self-employed. Therefore they may make less effort to retain the client.

Sometimes, clients may require the auditor to perform some extra services. Under the partnership, auditors can determine by themselves whether to do it or not. However, under the corporation structure, this might be against the regulations imposed by the upper level management, and intrude on the responsibilities of other auditors. Also the impersonal nature of corporation audit firms may invite lawsuits. The clients might be more willing to sue a limited corporation for damages.

Clients' View

Survey. To collect the view of audit clients, we conducted a telephone survey on audit clients in March 1992.

Objectives. The objective of the survey was to study:

- (1) The percentage of clients who knew the proposed change in allowing incorporating audit practices in Hong Kong.
- (2) Whether the clients would object to incorporating audit practices in Hong Kong.
- (3) Whether the clients would change to another partnership or sole proprietorship auditor, if the original auditor had incorporated the practices.

Target Group

Our target sample was the senior management of the medium- to small-sized companies in Hong Kong. This class of the sample was taken for the following reasons:

- (1) Auditors in Hong Kong are appointed by the shareholders in the annual general meeting of the company. It is not feasible for us to conduct a survey on the board of directors or major shareholders of any large listed enterprise. However, we believe that the managers are usually the shareholders in the medium- to small-sized companies. Even if they are not the shareholders, they will have significant influence on major policies of the companies.
- (2) The large enterprise in Hong Kong will face more constraints in choosing the audit firm because the number of audit firms which are large enough to conduct their audits are limited. The choice of switching auditors of the large enterprise will be

more difficult than the medium to small-sized companies.

Methodology

We had made 40 telephone calls, and 31 participated. The sampling was simple random sampling. We used the directory of the companies in Hong Kong and chose the sample randomly.

The survey was conducted both in English and Chinese, depending on what language the respondents used. The survey comprised the following questions:

- (1) Would you tell us how many employees there are in your company?
- (2) Would you tell us whether your company had hired an external auditor?
- (3) What is the size of the audit firm which you hired?
- (4) Recently, the Hong Kong Society of Accountants was working on a proposal to the Hong Kong Government to allow the audit firms to incorporate. Do you know about this?
- (5) Will your company object to allowing the audit firms to incorporate?
- (6) If the audit firm which you hired changes into a corporation, will you consider hiring another partnership audit firm?

Sample Description

The sample had the following characteristics:

- (1) The number of employees of the sample ranged from ten to 4,500. Fourteen of the sample employed fewer than 100 employees.
- (2) All the samples employed external auditors.

Survey Results

The summarized results were:

- (1) Fourteen per cent of the sample employed large audit firms to conduct the audit. Twelve (38 per cent) of the sample employed small audit firms to conduct the audit. However, the description of size of the firm was based on the view of the participants.
- (2) Sixteen (51 per cent) of the samples had heard the news and the rest had not.
- (3) Thirteen (41 per cent) of the samples did not comment on the issue. Seven (23 per cent) had no objection on the issue and six (19 per cent) objected. The rest refused to answer the question.
- (4) Twelve (38 per cent) replied that they would not change to another auditor. Ten per cent made no comment. Two (6 per cent) of them replied that

they would make the change. The rest refused to answer the question.

Analysis

The result showed that only half of the sample know about the issue of allowing incorporation audit practices in Hong Kong, most of them made no comment on it, and only some of them would change the auditor, if the original auditor incorporated the practice. We found that many medium- to small-sized companies were not concerned about the issue. This may be explained by the following reasons:

- (1) The issue had not been widely publicized throughout the business field in Hong Kong. Therefore it could not arouse the attention of the business people in Hong Kong to give sufficient thought to it.
- (2) The medium to small companies were not concerned about the issue. They employed an auditor possibly only for fulfilling the requirements of the Government. They may never think of suing the auditors for their malfunctions, and claiming redress from them.
- (3) Since all audit practices had been sole proprietorships or partnerships, the form of practice of the audit firm was not the criterion for selection.
- (4) There was a lack of prior experience of the impact of audit corporations on the business field. People could not make any judgement on the issue.

Conclusion

From the survey results, we could see that the issue of incorporating audit practices in Hong Kong had not been widely publicized among the business community. Therefore most of the business people did not know what would happen if CPA firms incorporated. Since no prior examples were available to the business people, they could not make any judgement on the advantages and disadvantages of incorporation to themselves. Therefore many of the sample refused to answer or said that they could not make a judgement on the issue. However, the survey showed that most of the business people lacked an intention to change their auditors, even if their original auditors incorporated the practices.

Limitation

The survey had the following limitations:

- (1) The number of the successful samples was only 31.
- (2) The results could represent the situation only as at March 1992.

- (3) Whether to change auditors or not may be different from a stated intention as in the sample.

Auditors' View

Survey

To collect the view of auditors, we conducted a mail survey on them during January and February 1992.

Objectives

The objectives of the survey were to study:

- (1) How the auditors see their legal liability.
- (2) How the auditors view the arguments on allowing incorporating audit practices, as revealed in the literature.
- (3) How the auditors see the effectiveness of different alternatives to protect their interests.
- (4) What kinds of regulation of incorporation of CPA firms should be included.
- (5) Whether they would incorporate their audit firms.
- (6) Whether the size and experience of firms would affect the results.

Target Group

Our target population is the sole proprietor and the partner of the CPA firm. This class was chosen because they were the people who could really make the decision to make a change in practices.

Methodology

We had sent a total of 100 letters to different CPA firms in Hong Kong. The information on the audit firm was obtained from the directory available in the Library of the Chinese University of Hong Kong. The target population included the Big Six and 94 audit firms, which were chosen by simple random sampling. Each letter contained only one copy of the questionnaire addressed to the sole proprietor or the partner of the firm.

The questionnaire was designed to facilitate statistical analysis. Part A of the questionnaire listed 17 questions about the legal liability of auditors and the arguments in the literature on allowing the incorporation of audit practices. The answers to the questions ranged from one (disagree) to six (agree). We asked the respondents to circle their choices. The results in this part would fulfil our first two objectives.

Part B listed five methods of protecting the interest of the auditors from damages arising from lawsuits related to professional liability. We asked the participants to rank the five methods from best to worst. In analysis, we gave the method which ranked as the best five points, the

second best four points and so on. This part fulfils our third objective.

We summarized the important findings on the views of auditors according to the study objectives as follows:

- (1) The participants agreed that legal liability was high and increasing. It must be limited to protect the auditors. Limiting the legal liability was not unethical and would not damage the interest of clients. Existing law provided insufficient protection to auditors.
- (2) There was also agreement that Hong Kong should follow the world trend to allow CPA firms to incorporate. The increase in capital through incorporation would be beneficial to CPA firms. Incorporation would not damage the image of the accounting profession and would not ruin auditor-client relationships. Allowing incorporation of CPA firms would be beneficial to Hong Kong and the profession. However, there were three controversial points, where opinions were divided:
 - Limiting auditors' legal liability by allowing incorporation of CPA firms can attract new entrants to the profession.
 - Public interest is more important than the auditors' interest.
 - Court judgments are fair in lawsuits against auditors' responsibility.
- (3) Among the five alternatives we stated in the questionnaire, incorporation was the first choice for most of the firms. The second choice for them was their purchase of professional indemnity insurance by auditors. The other three alternatives, such as limitation on the redress to clients by contract, a statutory capping scheme to clarify the liability of auditors in law, and limitation on the liable period of auditors, were not considered good alternatives to them. However, if we compared the results of those firms which had 20 or fewer employees, we found that most of them chose the professional indemnity insurance as a superior method to incorporation in protecting the auditors. This phenomenon could be explained by the premium of the insurance being much lower for them than for the big firms. They could more easily afford the cost than the big firms.
- (4) Most of the participants thought that regulation should include requiring CPA corporations to purchase professional indemnity insurance and setting a minimum capital level for the incorporated CPA firm. Some thought that regulation should include limiting the maximum amount of awards to the clients. About one-third of the sample thought that regulation should include allowing experts other than HKSA members to be

shareholders and forbid non-CPA shareholders to have voting rights.

- (5) Among the 31 in the sample, only one would not support his CPA firm being incorporated. The rest supported it.

The results show that most auditors in Hong Kong share the common understanding of allowing incorporating audits practices in Hong Kong. They usually support the points for the issue in the literature and disagree with the points against the issue. They believe that limiting the legal liability of auditors was beneficial to the profession, and it would not ruin the image of auditors and relationship with clients. It seemed that the auditors believed that the form of their practices was not a major factor in the relationship with their clients.

The sample preferred incorporation and professional indemnity insurance as the best methods of protecting their interests. It seemed that most of the sample did not think that the limitation on the remedy to clients, the clarification of auditor liability by law, and limitation on liable period of auditors were useful to protect them. It was consistent with the disagreement of "Existing law provides sufficient protection to auditors" which we found earlier. We could see that the samples did not show confidence in gaining protection from the law. It is possibly due to the law only reducing the chance of losing in lawsuits, but not limiting their liability if they lose the lawsuit. Therefore the sample chose a method which could limit their liability as their choice. The auditors were seeking not only a bigger shield but also a full set of armour to protect their legal liability.

Besides self-interest some auditors are also concerned about the interests of the public, as the majority of the sample thought that regulations should include requiring CPA corporations to purchase professional indemnity insurance. The insurance could give certain protection for the interests of clients.

However, it was interesting to see that the number of audit firms which had bought professional indemnity insurance was only seven out of 31. At the same time, 27 of them had recommended regulations to require the purchase of professional indemnity insurance. Auditors would view the insurance premium as the cost of incorporation. The required amount of professional indemnity insurance would become one of the major factors to influence the audit firm to incorporate or not. If the auditor believes that audit risk and liabilities would be less than the premium, he or she may not incorporate the firm to protect against the liabilities.

The survey results also showed that one-third of the sample wanted to allow the non-CPA to become the shareholders of the audit corporation. It seemed that, if there were no restrictions on this point, a number of audit

firms would admit non-CPAs as shareholders. This would create a significant impact on the profession. However, those who wanted to allow non-CPAs as shareholders also wanted to forbid the voting rights of the non-CPA shareholders. We could see that this one-third of the sample showed a desire to gain capital advantage through incorporation, but did not want their professional practices to be interfered with by the non-CPA.

On the other hand, many auditors still objected to the admission of non-CPA shareholders, disliking the interference by the non-CPAs in their practices. The reason for these auditors to incorporate the practices seemed mainly the liability rather than the capital concern, even though they agreed that the capital increase would benefit the firm. Since the number in the sample objecting to allowing non-CPA shareholders was significantly greater than the other side, we predicted that this statement would not be easily passed by the members. Even if the final regulation included this statement, many audit corporations would remain as pure CPA owned corporations.

Survey Results

From the results, we saw that most auditors thought that they had high and increasing liability, and incorporation was a good method to protect them from the legal liability. Moreover, nearly all of them would support their firms being incorporated. Therefore we predicted that most of the auditors would try to incorporate their CPA firms, when the proposal was passed. The audit corporation would become the major form of auditor practices in Hong Kong. The number of audit corporations appearing may depend on the required amount of insurance and the views of the auditors.

Conclusion and Comments

Should We Allow Audit Firms to Be Incorporated?

Primarily, the work of the auditor is for the good of the general public, because it provides an objective evaluation on whether assertions are recorded with respect to the pre-established criteria. Therefore users of financial statements can base decisions on audited information. As a consequence, there should be no doubt that the public interest is first and foremost which is superior to the interests of auditors. However, maintaining public interest does not deny the wellbeing of the profession. Facing broadened liability and unprecedented litigation, audit practitioners are being put in a risky situation of huge damages. We believe that auditors must be able to ensure their fundamental rights before they can provide services to the general public. Auditors will not be in a good position to protect the interests of the general public, if their work is subjected to unlimited or even unreasonable awards in case of

litigation. It is unfair to the profession if they have to bear infinite responsibility while their reward is limited.

In view of this, our group believed that incorporation of audit practices should be allowed, if the practitioners considered this way to be appropriate to protect their fundamental interests.

Moreover, we absolutely believe that strict control of this regulation is necessary to prevent abuse of such an arrangement, and to ensure rights of the public (i.e. the profession is still responsible for their work done). Therefore those audit firms which apply for incorporation merely aiming to escape their responsibility are excluded from incorporation. Examples indicating such acts would include extraordinary low capital amounts.

Third-party confidence in the auditors' ability to exercise due care and skill and independence is not a trivial issue, since the whole credibility and viability of the auditing profession rest on this assumption. Therefore the following measures must be enforced to balance the interest of the profession and other parties:

- (1) Incorporated audit firms are obliged to purchase professional indemnity insurance, and meet minimal capital requirements. These measures ensure that the corporations are financially strong and able to compensate the victims for losses owing to their malpractice.
- (2) Incorporated audit firms should engage in Practice Review strictly. This measure controls the quality of audit work; it makes sure that quality does not deteriorate, even though auditors' liability is limited. Thus the public interest is safeguarded.

Of course, the auditing profession must communicate the reasons for and consequences of the above arrangements to the public, so as to maintain their public image.

All in all, after incorporating the amount of compensation out of negligence or damages claims would be limited to the professional indemnity insurance cover and the assets of the incorporated audit firms. Meanwhile, the personal assets of the partners who have not been involved in the work in question are not at risk. It is still possible for the plaintiff to sue the auditor in the practice whose conduct

is in question. As a profession, the auditors are willing to bear the professional responsibility and any justifiable awards. However, unjustifiably huge awards should not be considered their responsibility.

Implementation Problems

The following issues must be settled before incorporation of audit practices is allowed:

- (1) The premium of professional indemnity insurance is too high, but the cover has reduced. The existing professional indemnity insurance provision seems to be inadequate for insuring the public. Moreover, we do face problems in setting the amount of the insurance to be purchased. How much insurance is enough? Will the cost be eventually borne by the clients? Are the clients willing to pay the higher fee? All these questions require in-depth investigation.
- (2) We also have problems in setting the minimal capital amount; how much capital is considered to be strong enough? What should be the difference in amount of capital of the small versus large audit firm?
- (3) If the Practice Review programme is revoked by small audit firms, then how can one lower the pressure from small audit firms, so as to be able to execute this programme effectively?
- (4) Allowing incorporation of audit practices may arouse other professions to request for such an arrangement. Therefore, political parties may reject this proposal, and oppose this arrangement.

We all know that there are ways to shelter or protect one's assets. Partnerships with unlimited liabilities but inadequate capital or professional indemnity insurance cover may not mean much protection at all. Thus, allowing incorporation of audit practices in Hong Kong is a major issue to investigate. In order to maintain the status of the profession and public confidence in the profession, the HKSA and practitioners have to implement measures which could assure the public of the quality of professional work. The Government or HKSA would need a mechanism to ensure that audit practices after incorporation would still have reasonable financial strength in the form of capital and/or professional indemnity insurance to withstand the risk of litigation.

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