Setting and Reinforcing Tone at the Top to Achieve Quality Audits

1.　　Introduction

What is tone at the top

1.1.　　Tone at the top refers to the ethical and quality-focused culture and behaviour set and reinforced by an audit firm's leadership – including its Chairperson, Managing Partners, and Engagement Partners. It permeates throughout the whole organisation and is practiced uniformly by all its staff. Tone at the top is fundamental to promoting high-quality audits.

1.2.　　The importance of tone at the top is elaborated in both the international and local context. The International Auditing and Assurance Standards Board (**IAASB**) specifies that the audit firm's leadership has a crucial role in promoting a culture guided by professionalism through appropriate tone at the top. Further, the firm's leadership must emphasise audit quality and protecting the public interest, and consistently communicate expectations to reinforce ethical behaviours.[1]

1.3.　　The Hong Kong Standard on Quality Management 1 (**HKSQM 1**) is equally clear: the audit firm's leadership is responsible and accountable for quality, and they should demonstrate a commitment to quality through their actions and behaviours. HKSQM 1 also requires firms to establish a quality-oriented culture through communication, training and professional development, performance evaluation, and accountability measures.[2]

Deficiencies identified in the AFRC's inspection findings

1.4.　　Despite repeated emphasis, the AFRC has observed that Hong Kong audit firms[3] have not consistently and effectively demonstrated tone at the top. Referring to the AFRC's 2022 Annual Inspection Report, common causes of deficiencies in audit quality identified include: (i) insufficient reviews by engagement partners; (ii) a lack of professional scepticism; and (iii)

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[1] IAASB (2014) A Framework for Audit Quality Key Elements that Create an Environment for Audit Quality
[2] Hong Kong Institute of Certified Public Accountants (**HKICPA**) (2023) Hong Kong Standard on Quality Management 1 Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements
[3] The term "audit firms" in this article is used in the general sense and refers to both CPA firms and corporate practices registered with the AFRC.

insufficient training and guidance on accounting knowledge and audit skills. These common causes indicate that Hong Kong audit firms should take immediate action to establish and reinforce tone at the top to mitigate audit quality deficiencies. Notably, the report also highlights that the leadership's increased emphasis on audit quality has contributed to improved audit quality. This finding further justifies the need for immediate action.

1.5.   As such, the AFRC strongly emphasises the importance of an audit firm's leadership in setting and reinforcing a tone at the top that fosters a culture of ethical behaviour, integrity, and a commitment to audit quality. Moreover, to fulfil the regulatory responsibility of protecting the public interest, the AFRC will not only hold each firm's Quality Control System Responsible Persons, but also their Chairperson and Managing Partners, accountable for setting and effectively communicating tone at the top.

1.6.   The article is organised as follows: Section 2 sets the context for tone at the top by describing the control environment within audit firms. Section 3 describes the ways tone at the top impacts ethical and quality-enhancing behaviours within audit firms. Section 4 outlines the strategies for implementing and reinforcing tone at the top. Section 5 describes the relationships among audit firms, audit committees, and companies' management in the financial reporting and audit process. Suggested actions for audit firms, audit committees, and companies' management to set and reinforce tone at the top are also provided.

2.   Setting the scene

### Control environment within audit firms
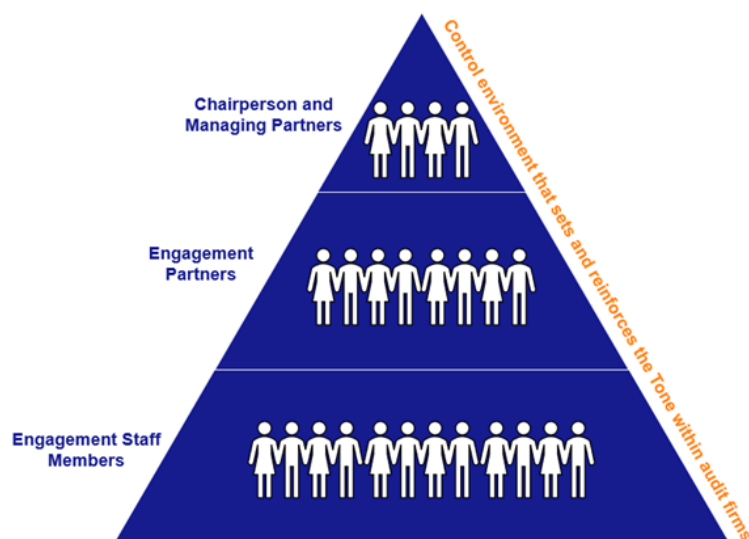
2.1.   The COSO's *Internal Control – Integrated Framework* defines internal control as a "process, carried out by the board of directors, the administration and other personnel of an entity, designed to provide reasonable assurance with respect to the achievement of objectives relating to operations, reporting, and compliance." [4] The control environment, being the foundation of other components of internal control, establishes the tone of an organisation and influences the control mindset of its members. The control environment encompasses integrity and ethics, management philosophy, competence, and oversight and accountability.

2.2.   In the audit firm context, effective controls are contingent upon the unwavering integrity and ethical values exhibited by its leadership, including its Chairperson, Managing Partners, and Engagement Partners, who are responsible for administering and overseeing these controls. When a strong foundation exists, tone at the top with effective internal controls can prevent unethical conduct and ensure that the audit firm is compliant with laws and regulations.

2.3.   As such, tone at the top and the control environment encompass factors such as prioritising audit quality over commercial considerations, setting and reinforcing actions and behaviours that enhance audit quality, and establishing positive behaviours, such as encouraging speaking up, within subordinate-supervisor relationships.

2.4.   Lastly, tone at the top establishes internal controls comprising policies and communications designed to ensure all members comprehend the firm's objectives, how their actions contribute to them, and the methods for holding them accountable.

2.5.   The next sections expand on these aspects.

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[4] COSO (2013) Internal Control – Integrated Framework

3.   Why is tone at the top important
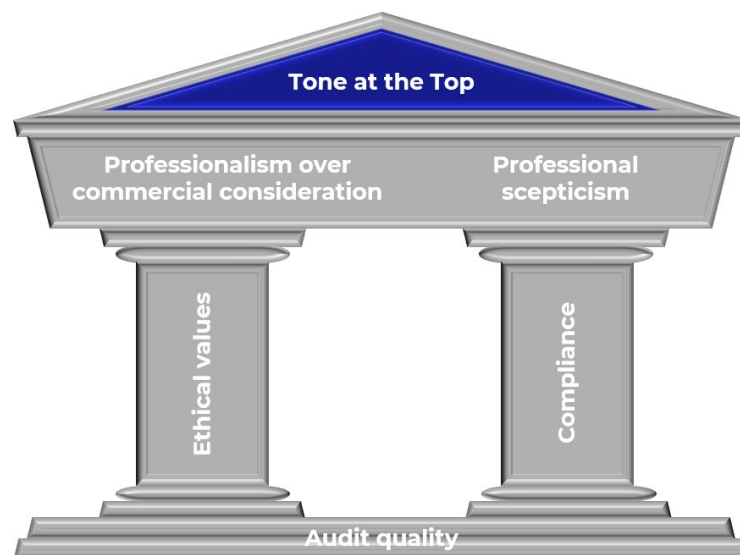
It sets an ethical and compliance culture

3.1.   Given the public interest nature of audits, the audit firm's leadership must promote an ethical and compliance culture that emphasises audit quality and avoids situations that might compromise the firm's objectivity or independence.

3.2.   There has been an abundance of empirical research on how tone at the top is critical to establishing and sustaining an ethical culture and minimising illegal or unethical activity.[5] Consistency is critical, as research found that junior audit staff will disregard a company's ethical standards unless they observe a strong ethical tone from both their partner and their supervisor. Audit staff will also be more influenced by their direct supervisor's tone than their partner's, if they conflict.[6]

3.3.   Further, the AFRC considers compliance a commitment that must be ingrained in the firm's culture and embraced by all individuals of an audit firm. Establishing such a culture is not just a legal obligation but a fundamental pillar of responsible and sustainable practice.[7]

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[5] Schwartz M. (2013) Developing and sustaining an ethical corporate culture: The core elements, Business Horizons, Vol. 56 Issue 1.

[6] Pickerd J., Summers S., Wood D. (2015) An Examination of How Entry-Level Staff Auditors Respond to Tone at the Top *vis-à-vis* Tone at the Bottom, Behavioral Research in Accounting. Vol. 27 Issue 1.

[7] AFRC (2023) AFRC expects active cooperation and full compliance by PIE auditors with the AFRC Ordinance and their self-reporting of critical incidents in a timely manner

3.4. Therefore, the audit firm's leadership should **communicate expected behaviours as an essential component of audit work**, including compliance with all legal and regulatory requirements, and adherence to ethical and independence standards. **Consistency in tone between an audit firm's leadership and its engagement team is critical** to ensuring all audit staff follow the same set of behaviours.

It prioritises professionalism over commercial considerations

3.5. Tone at the top should prioritise professionalism over commercial considerations. It should ensure that commercial considerations do not drive decisions that impair audit quality. Empirical research provides evidence that the culture of an audit firm is most oriented towards quality if leadership emphasises professionalism over commercialism.[8]

3.6. Commercial considerations can manifest in two ways:

   i. through a client focus, which includes winning and retaining clients, the ability to sell additional services, and focusing on client satisfaction;[9] or

   ii. through an efficiency focus via time budgets and billable hours. Research found that dysfunctional behaviours such as premature signoff and skipping audit procedures are more frequent with a client focus but not with an efficiency focus.[10]

3.7. Other studies found that a tone at the top that emphasises client service was associated with poorer audit quality, proxied by lower adjustments to clients' aggressive accounting [11] and willingness to resist client pressure. [12] Nonetheless, some research suggests that professional and commercial considerations can co-exist with each other without compromising audit quality.[13,14]

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[8] Alberti CT., Bedard J., Bik O., Vanstraelen A. (2020) Audit Firm Culture: Recent Developments and Trends in the Literature, European Accounting Review, Vol. 31 Issue 1.
[9] In a roundtable discussion organised by the AFRC, some participants erroneously equated the quality of service with audit quality. For more details, see the AFRC's Roundtable Discussion on Audit Quality and Climate-integrated Audits in Hong Kong.
[10] Johansen TR., Christoffersen J. (2017) Performance Evaluations in Audit Firms: Evaluation Foci and Dysfunctional Behaviour, International Journal of Auditing, Vol.21 Issue 1.
[11] Koch C., Salterio SE. (2017) The Effects of Auditor Affinity for Client and Perceived Client Pressure on Auditor Proposed Adjustments, The Accounting Review, Vol. 92 Issue 5.
[12] Ittonen K., Johnstone K., Myllymäki ER. (2015) Audit partner public-client specialisation and client abnormal Accruals, European Accounting Review, Vol. 24 Issue 3.
[13] Broberg P., Umans T., Skog P., Theodorsson E. (2018) Auditors' professional and organizational identities and commercialization in audit firms, Accounting, Auditing & Accountability Journal, Vol. 31 No. 2.
[14] Coram P., Robinson M. (2017) Professionalism and Performance Incentives in Accounting Firms, Accounting Horizons, Vol. 31 Issue 1.

3.8.   Hence, an audit firm's leadership should ensure that the tone at the top strikes an appropriate balance between the audit firm's commitment to audit quality and commercial considerations. They should clearly and consistently state that **client service should never come at the expense of audit quality**.

It fosters professional scepticism

3.9.   Professional scepticism is an essential part of an audit professional's mindset and integral to audit quality. As financial reporting evolves to respond to users' need for relevant and timely information, the extent of an auditor's assessment of management assumptions and subjectivity is increasing. This includes in areas such as fair value and expected credit loss measurements. This makes professional scepticism increasingly vital.

3.10.   Empirical research consistently demonstrates the critical role that tone at the top plays in shaping professional scepticism. Research found that an engagement partner's tone which emphasises audit effectiveness through professional scepticism improved audit staff's professional sceptical behaviour, particularly for those with a weak sceptical attitude. [15] They also found that audit staff exhibit higher levels of professional scepticism when the engagement partner, during brainstorming sessions, pre-emptively self-criticise by reminding them that auditors' judgements are fallible. [16]

3.11.   The audit firm's leadership must establish a tone that prioritises professional scepticism. They should recognise and accept that the exercise of professional scepticism and judgment may result in cost overruns and conflicts with management. At the engagement-level, the engagement partner can influence professional scepticism not only by **modelling those behaviours themselves, but also by communicating the right messages at the start of, and during, the engagement.**

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[15] Noviyanti S., Winata L. (2015) The Role of "Tone at The Top" and Knowledge of Fraud on Auditors' Professional Skeptical Behavior, Contemporary Management Research, Vol. 11 No.1.
[16] Harding N., Trotman K. (2017) The Effect of Partner Communications of Fraud Likelihood and Skeptical Orientation on Auditors' Professional Skepticism, Auditing: A Journal of Practice & Theory, Vol. 36 Issue 2.

Key messages for audit firm's leadership to <u>establish</u> tone at the top:

Set and reinforce an ethical and compliance culture
- Communicate expected behaviours as an essential component of audit work, including compliance with all legal and regulatory requirements, and adherence to ethical and independence standards.
- Ensure the tone at the engagement level is consistent with the tone at the top.

Prioritise professionalism over commercial considerations
- Ensure tone at the top prioritises professionalism and audit quality over commercial considerations.
- State clearly and consistently that client service should never come at the expense of audit quality.

Foster professional scepticism
- Prioritise professional scepticism by setting a clear and consistent tone at the top.
- Lead by modelling professional sceptical behaviours and consistently communicating the right messages before starting, and during, an audit engagement.

4. How should tone at the top be implemented and reinforced

Foster a culture of communication and openness

4.1. Regulators and standard setters have emphasised the importance of ongoing communication around audit quality. HKSQM 1 states that "although leadership establishes the tone at the top through their actions and behaviours, clear, consistent, and frequent actions and communications at all levels within the firm collectively contribute to the firm's culture and demonstrate a commitment to quality."[17]

4.2. Ongoing communication may take a variety of forms, such as newsletters, partner updates, email alerts, or office meetings.It must be positive, constructive, refreshed frequently, and addresses integrity, objectivity, and public accountability.[18]

4.3. Besides, effective communication must be complemented by an open culture. When audit staff feel their firm's leaders encourage such a culture, they will be more inclined to speak up, seek out additional information or guidance from senior team members when facing audit issues, and positively challenge management's judgements. This, in turn, improves audit quality.

4.4. Empirical evidence suggests that an audit firm's senior team leaders can improve collaboration by fostering ongoing communication, sharing real-world experiences, and building relationships.[19] One of the key elements of openness is the willingness of leaders to discuss their own errors, which can encourage their subordinates to communicate their errors without hesitation.[20] Speaking up is also more likely when leaders are team oriented rather than solely interested in self-advancement, which can reduce subordinates' fear of speaking up.[21]

4.5. Hence, the audit firm's leadership should cultivate a tone at the top that encourages a culture of communication and openness. They should **consistently model the behaviours and actions they advocate for** and nurture audit team members to **speak up and positively challenge**

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[17] HKICPA (2023) Hong Kong Standard on Quality Management 1 Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements
[18] International Federation of Accountants (2017) Tone at the Top and Audit Quality
[19] Asare SK., Wright M. (2018) Field Evidence about Auditors' Experiences in Consulting with Forensic Specialists, Behavioral Research in Accounting, Vol. 30 Issue 1.
[20] Emby C., Zhao B., Sieweke J. (2019) Audit Senior Modeling Fallibility: The Effects of Reduced Error Strain and Enhanced Error-Related Self-Efficacy on Audit Juniors' Responses to Self-Discovered Errors, Behavioral Research in Accounting, Vol. 31 Issue 2.
[21] Nelson M., Proell C., Randel A. (2016) Team-Oriented Leadership and Auditors' Willingness to Raise Audit Issues, Vol. 91 Issue 6. A.

management assertions if necessary, without undue obedience to authority or fear of repercussions.

Promote a culture of training and learning that supports professional development and audit quality

4.6.   Tone at the top plays a key role in cultivating a learning culture.[22] Learning can happen both formally, through continuous professional development (**CPD**) activities, as well as informally, through coaching and on-the-job training. The AFRC has previously cited the positive and significant relationship between continuing professional development and audit quality and stated that "senior leaders of audit firms should view talent management, and particularly CPD, as an ethical obligation to their staff, the profession, and the public."[23]

4.7.   While CPD activities focus on the technical aspects, coaching and on-the-job training are just as important for auditors to develop their key personal characteristics, such as integrity, objectivity, and professional scepticism. Since such coaching and training would place demands on partners and other leaders' time, audit firms should create conditions that allow leaders to devote the time and attention necessary for staff development.

4.8.   Tone at the top should **emphasise the importance and effectiveness of CPD and allocate sufficient resources to support the training and development of audit partners and staff.** They should encourage staff to take greater ownership of their learning, and to consider not only what they have learnt but also how it has led to improvements in audit quality.

4.9.   Besides, tone at the top is crucial in improving partners and staff skills and taking prompt remedial actions to address deficiencies identified in the AFRC's Audit Focus 2023 Financial Year-end Audit Reminder, including IT control deficiencies and insufficient exercise of professional scepticism.

Pay for performance of high-quality audits

4.10.   Performance appraisal, rewards, and compensation systems that are targeted towards ethical and quality-enhancing behaviours can help reinforce tone at the top. Performance evaluations that emphasise audit quality have been shown to reduce dysfunctional audit behaviours. [24] Research also found an outcome bias, in that partners rewarded audit staff

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[22] Alberti, Bedard, Bik, Vanstraelen (2020) Audit Firm Culture: Recent Developments and Trends in the Literature
[23] AFRC (2024) Continuing Professional Development as a Key to Improving Audit Quality in Hong Kong
[24] Johansen, Christoffersen (2017) Performance Evaluations in Audit Firms: Evaluation Foci and Dysfunctional Behaviour

who spoke up, but particularly rewarded those who spoke up and then found a misstatement related to what they spoke up about.[25]

4.11.   Audit firms should ensure that **audit partners and staff are not penalised for exhibiting ethical, sceptical, and quality-focused behaviours,** even if this may compromise client relationships.[26] Performance evaluation and compensation systems should be **duly tied to behaviours that uphold audit quality.** It should not only be tied to behaviours associated with fostering openness, communication, coaching, and learning, but also to performance based on audit quality. **This may include linking promotion and remuneration, especially partner admission and remuneration, to the AFRC's engagement inspection ratings.**

Key messages for audit firm's leadership to reinforce tone at the top:

Communication and Openness
- Cultivate a tone at the top that encourages a culture of effective communication and complete openness, and model the advocated behaviours.
- Nurture the audit team members to speak up and positively challenge management assertions without obedience to authority or fear of repercussions.

Training and Learning
- Emphasise the importance and effectiveness of CPD and allocate sufficient resources to support the training and development of partners and staff.

Pay for Performance
- Implement performance evaluation and compensation systems that are duly tied to behaviours in upholding audit quality and performance based on it.

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[25] Nelson M., Proell C. (2018) Is Silence Golden? Audit Team Leader Reactions to Subordinates Who Speak Up "In the Moment" and at Performance Appraisal, The Accounting Review, Vol. 93, Issue 6.
[26] IAASB (2014) A Framework for Audit Quality Key Elements that Create an Environment for Audit Quality

5. Relationships between auditors, audit committees, and management

Individual and common objectives in the context of financial reporting and audit

5.1. High-quality financial reporting and audits are in the best interests of audit committees, audit firms, and companies' management. However, they all have their own objectives and interests, which may come in the way of pursuing this common objective. The figure above shows their individual and overlapping interests.

5.2. While both management and audit firms strive for high-quality audits, relationships and client service satisfaction may threaten audit firms' objectivity and independence, and potentially compromise their professional judgment. As discussed in the AFRC's Guidelines for Effective Audit Committees – Selection, Appointment, and Reappointment of Auditors, the audit committees should obtain a description of the audit firm's policies and procedures for monitoring and complying with relevant ethical requirements to which the firm and the audit engagement are subject to, and be satisfied with the effectiveness of the policies and procedures.

5.3. Audit committees are expected to exercise oversight over the financial reporting process. They should ensure effective two-way discussion of significant financial reporting and auditing matters in a timely manner and not rely exclusively on the management. Meanwhile, companies' management is expected to welcome challenges to their financial estimates and judgements from auditors and audit committees, for the sake of promoting high-quality financial reporting. Open communication and the sharing of necessary information between management and auditors can also effectively facilitate the financial reporting and audit process, which in turn, improves audit quality.

5.4. Moreover, the AFRC conducts periodic inspections of audit firms, evaluating the quality of their audit engagements and the effectiveness of their system of quality management. The findings from each inspected engagement are shared with the audit firm. Audit committees are encouraged to request their auditors to share the AFRC's inspection results and findings, which helps them leverage our insight to strengthen their roles and responsibilities, enhance their effective oversights and, in turn, drive continual improvement of auditors.

5.5. The AFRC offers the following recommendations to audit committees to ensure tone at the top is set and reinforced in audit firms:

Key messages to audit committees:

a. **Set the tone at the top by prioritising audit quality during auditor selection and reappointment** and encouraging auditors to compete on their ability to perform high-quality audits. They should consider whether the audit firm's leadership and their communications primarily focus on audit quality and not solely on commercial considerations or client satisfaction. They should request the AFRC's inspection findings from their auditors to help oversee their audit quality.

b. **Reinforce the importance of professional scepticism with the engagement team** and support their exercise of it by forging strong relationships with auditors independent of management and modelling sceptical behaviours themselves by asking probing questions to assess audit quality.

c. **Understand the tone set by the audit firm's leadership and hold them accountable** for creating and promoting a culture that exercises compliance, integrity, and ethical behaviours and maintaining a high standard of professionalism.

d. **Scrutinise whether the engagement team has the appropriate industry expertise to perform high-quality audits**, the audit firm's commitment to training and learning, and its support for ongoing professional development of audit staff.

Key messages to companies' management:

a. **Forge a strong ethical and compliance culture** within companies by encouraging open communication, trust and transparency, and modelling ethical behaviours throughout the process of financial reporting.

b. **Set the tone at the top by prioritising financial reporting quality** and discussing with audit committees all identified, or potentially significant, issues related to financial reporting on a timely basis.

c. **Create an open and constructive relationship with auditors and welcome challenges from them** where management can improve the financial reporting quality with auditors' insights such as new reporting standards and regulatory matters.

6. Summary

6.1.   Tone at the top is the foundation of audit quality, integrity, and ethical conduct. It deserves the utmost attention and reinforcement by the leadership.

6.2.   The AFRC reiterates that it will hold an audit firm's leadership, particularly its Chairperson and Managing Partners accountable for setting and effectively communicating the right tone at the top. Going forward, as part of its inspections, the AFRC will evaluate an audit firm's tone at the top.

6.3.   Audit firm leaders, audit committees, and companies' management must collaborate to ensure that tone at the top consistently promotes the values and behaviours essential for delivering high-quality financial reporting and audits. This will help serve the public interest and strengthen Hong Kong's position as an international financial centre.