

Safeguarding Auditor Independence: Concerns Surrounding Procurement and Purchases from Audit Clients

1. Introduction

Importance of auditor independence

- 1.1. Auditor independence forms the cornerstone of ensuring that auditors can perform their duties objectively, and with integrity. Empirical research shows a positive relationship between an auditor's independence and the quality of its audit.^{1,2,3} Any breaches to independence requirements can undermine an auditor's professionalism and threaten audit quality.
- 1.2. Given the critical importance of high-quality audits for users of financial statements to make more informed capital market decisions, maintaining auditor independence should be a top priority. There are established standards and frameworks in place to govern auditor independence and uphold its importance.

Independence concerns surrounding procurement and purchases from audit clients

- 1.3. Although auditor independence is crucial, breaches of independence by audit firms persist. Instances of these breaches have been identified through regulatory inspections and investigations both locally and internationally.^{4,5}
- 1.4. Among various independence matters, we will focus specifically on procurement and purchases from audit clients in this article, as they could

¹ Aliu, M. M. / Okpanachi, J. et. al. (2018) [Auditor's independence and audit quality: an empirical study](#)

² Suseno, N. S. (2013) [An empirical analysis of auditor independence and audit fees on audit quality](#)

³ Sarwoko, I., Agoes, S. (2014) [An Empirical Analysis of Auditor's Industry Specialization, Auditor's Independence and Audit Procedures on Audit Quality: Evidence from Indonesia](#)

⁴ AFRC (2024) [2023 Annual Inspection Report](#)

⁵ IFIAR (2024) [Survey of Inspection Findings 2023](#)

be easily overlooked in the consideration of independence, given their common perception as low-risk business transactions. While these transactions may seem innocuous, they can, in fact, pose significant threats to auditor independence if not properly managed.

Purpose of the article

- 1.5. Given the importance of auditor independence, audit committees need to take this into account when recommending the appointment of auditor who could perform audit objectively, and with integrity. Self-assessments and declarations from audit firms regarding their independence are therefore crucial for audit committees to fulfil these duties effectively. This highlights the critical need for audit firms to establish effective mechanisms to identify and mitigate risks to their independence, and for audit committees to scrutinise the assessment to make informed decisions on auditors' abilities to exercise professional skepticism and conduct high-quality audits.
- 1.6. Ensuring independence goes beyond mere procedures and compliance, and it requires commitments from both audit firms and audit committees. By heeding the AFRC's advice and proactively mitigating independence threats, audit firms and audit committees can better fulfil their vital roles as trusted, objective, and impartial gatekeepers, safeguarding the interests of investors, creditors, and the public at large.

2. Code of Ethics and standards requirements concerning procurement and purchases from audit clients

- 2.1. The Code of Ethics for Professional Accountants (**Code of Ethics**) and Hong Kong Standard on Quality Management 1 (**HKSQM**) establish the framework for auditor independence. They require professional accountants to be independent when performing audit, review and other assurance engagements.
- 2.2. Code of Ethics states that independence is linked to the principles of objectivity and integrity. It comprises:

- a) **Independence of mind** - this refers to the state of mind that allows an individual to express a conclusion without being unduly influenced, thereby enabling the individual to act with integrity, objectivity and professional skepticism; and
 - b) **Independence in appearance** - this refers to the avoidance of significant facts and circumstances that could likely lead to the conclusion of a lack of independence by an informed third party.
- 2.3. Provided that the purchase of goods and services from audit clients occur in the normal course of business and is conducted at arm's length, the transaction does not usually create a threat to the auditor's independence. However, depending on the nature and magnitude of these transactions, self-interest threats to independence may arise. If an audit firm or its personnel receives preferential treatment, rights or privileges – such as better pricing, improved product availability or enhanced accessibility when making purchases - it may create self-interest threats, both in mind and in appearance.
- 2.4. HKSQM requires audit firms to establish quality objectives to address their responsibilities in accordance with relevant ethical requirements, including those related to independence. Audit firms must assess the quality risks, and design and implement a robust and consistent approach to deal with independence requirement. This includes developing relevant policies and procedures, and ensuring their independence is maintained and monitored periodically to allow timely actions to be taken to address threats arising from procurement and purchases, especially from audit clients.
- 2.5. While the standards set the overarching framework, the AFRC aims to offer practical and specific advice to help audit firms and audit committees effectively identify and mitigate independence threats, with details set out below.

3. Audit firms' actions

3.1. As an overarching principle, audit firms and their personnel must remain vigilant regarding any transactions with their audit clients and the potential impact on their independence. Audit firms need to identify and mitigate independence threats from procurement and purchases from audit clients. The AFRC has outlined four other key principles, from which the specific actions that audit firms and professional accountants shall take are derived.

 <p>Maintain proper corporate governance <i>(paragraphs 3.2 – 3.10)</i></p> <p>The leadership of the audit firms should set the right tone at the top, promoting ethical values and establishing a robust corporate governance system to ensure independence.</p>	 <p>Always stay sensitive <i>(paragraphs 3.25 – 3.26)</i></p> <p>Audit firms must remain vigilant in assessing the potential impact of transactions, both individually and in aggregate, on their independence. This involve management to revisit the policy and relevant measures from time to time and update when necessary.</p> <p>When dealing with independence issues, management and individuals shall consider the context in which the issue has arisen or might arise and take a more conservative stance, going beyond minimum requirements when necessary.</p>
 <p>Establish a comprehensive policy <i>(paragraphs 3.11 – 3.13)</i></p> <p>Audit firms should establish a comprehensive policy outlining the requirements to guide the behaviour of the audit firm and its personnel regarding procurement and purchases.</p>	
 <p>Establish rigorous measures to monitor independence risks <i>(paragraphs 3.14 – 3.17)</i></p> <p>Audit firms should perform on-going monitoring procedures to identify and mitigate threats to independence in a timely manner.</p>	
 <p>Perform diligent investigations <i>(paragraphs 3.18 – 3.24)</i></p> <p>In the event that potential independence breach is identified, audit firms should perform diligent investigations and implement appropriate corrective measures to safeguard independence and audit quality.</p>	

Maintain a proper corporate governance to ensure audit firms' independence

Lead the ethical tone at the top

- 3.2. Leadership bears the crucial responsibility of setting the right “tone at the top” and fostering an ethical culture throughout the firm. They should convey the message that upholding independence is the foremost priority, taking precedence over any commercial interests or objectives. They must set the tone for a culture that does not tolerate violations of independence. These messages should be reinforced periodically and through different communication channels.
- 3.3. Staff behaviour is heavily influenced by the actions they observe from the firms' leadership. Leaders must lead by example, serving as role models to the staff and demonstrate unwavering commitment and adherence to independence requirements. If the leaders fail to demonstrate their independence, staff are unlikely to adhere to independence requirements.

Implement a robust check-and-balance mechanism

- 3.4. Audit firms should establish an appropriate mechanism that ensures accountability and mitigates risks of abuse or override within firms. However, implementing such mechanism can be challenging due to the common partnership structure of audit firms, where partners (owners) also fulfil management roles.
- 3.5. Despite this challenge, audit firms should implement necessary safeguards to mitigate these risks. These include implementing controls to review the independence of procurement and purchases from audit clients, especially those involving firm leaders, and ensuring appropriate approval and disclosure requirements are met.

Uphold fairness and transparency

- 3.6. Leadership holds the responsibility to maintain an environment of fairness and transparency throughout the firm. This begins with ensuring staff of all

positions clearly understand and faithfully adhere to the relevant independence requirements.

- 3.7. Equally important, audit firms must vigilantly guard against any restrictive or preferential dissemination of information in the procurement process that could be perceived as being unfair, lacking transparency, and creating an appearance of favouritism towards certain individuals.

Provide on-going training on independence to staff

- 3.8. The AFRC has stressed the importance of Continuing Professional Development (CPD) activities.⁶ In terms of independence, appropriate CPD training can play a crucial role in ensuring that staff members understand the importance of independence and its specific requirements.
- 3.9. Independence training should be comprehensive and informative and provided to both new and existing staff. Such training should be conducted at induction and continue throughout their employment to ensure that they have a thorough understanding of relevant independence requirements and maintain up-to-date knowledge.

Establish effective channel to report potential non-compliance

- 3.10. Audit firms should establish accessible channels to enable individuals to report actual or suspected non-compliance with independence requirements. Effective policies and procedures should also be put in place to encourage and protect whistle-blowers.

Establish an effective independence policy regarding procurement and purchases from audit clients

Implement a comprehensive independence policy

- 3.11. Developing an effective policy is crucial for audit firms to ensure independence threats are addressed in a fair and transparency manner. A well-defined independence policy on procurement and purchases should

⁶ AFRC (2024) [Continuing Professional Development as a Key to Improving Audit Quality in Hong Kong](#)

cover both firm-wide perspective and individual's conduct. Other than highlighting the importance of observing independence, the policy should, at a minimum, include:

- a) clear guidance that defines the scope of the independence policy, including definition of audit teams (details of which are covered in paragraph 3.12) and firms' network, and definition of audit clients and their related entities;
- b) facts and circumstances that create or may create threats to independence; and potential actions, including appropriate safeguards, to address any such threats;
- c) clear criteria, based on the nature and magnitude (details of which are covered in paragraph 3.13) of the procurement and purchase transaction, to determine which are prohibited, and which may be permissible subject to satisfactory implementation of relevant safeguards and appropriate disclosure and approval;
- d) a well-structured approval process with transparent and unbiased criteria;
- e) an effective monitoring mechanism, including periodic independence declaration, to ensure ongoing compliance with independence requirements (details of which are covered in paragraphs 3.14 and 3.15); and
- f) a robust mechanism for exception reporting of any independence breaches, along with a framework to investigate any potential breaches, assess the impact, and determine appropriate follow up actions and consequences.

Assess audit team independence threats holistically

- 3.12. Assessing independence threats should not just be at individual level, but across the entire audit team. A series of seemingly minor threats can collectively compromise the firm's actual or perceived independence. In fact, the definition of "audit team" extends beyond just the members of the audit engagement team and includes all others within the firm who can directly influence the outcome of the audit engagement, such as those responsible

for the compensation, or oversight of the engagement partner.⁷ This broader, holistic view allows audit firms to better identify any potential independence threats.

Establish proportionate independence materiality thresholds

- 3.13. The use of materiality thresholds is a common practice to assess the significance of potential independence threats and determine the permissibility of a transaction. When establishing materiality thresholds on determining whether a transaction with audit clients creates threats to independence, audit firms should use differentiated thresholds based on employee grade or seniority levels within the firm. This allows for a more nuanced and equitable assessment as a procurement transaction exceeding the materiality threshold for an entry-level audit staff may not be considered material for a senior partner with a higher net worth.

Establish rigorous measures to monitor independence risks

Maintain a complete and current independence record

- 3.14. Audit firms should maintain a centralised, complete record of audit clients and related entities, update it periodically to capture any changes over time. This enables them to more effectively identify and manage potential conflicts of interest from audit teams.
- 3.15. This is crucial as audit firms usually serve multiple clients, some with intricate group structures, where certain entities could be subject to independence requirements despite not being a direct client. Furthermore, corporate structures are subject to change over time. Maintaining an up-to-date record allows audit firms and their personnel to remain aware of the entities for which they need to observe the relevant independence requirements.

⁷ HKICPA (2024) [Code of Ethics for Professional Accountants](#), A-11: Definition of Audit team

Obtain independence declarations

- 3.16. The first line of defence rests with the audit team individuals. Audit firms should require all relevant personnel to provide timely declarations disclosing any procurement or purchases transactions that could impair independence. Audit team members should make pre-audit declarations. Firms should also require firm-level periodic independence declarations from all personnel, including leaders.
- 3.17. Firms must establish a robust process to ensure complete and timely reporting, requiring personnel to give honest and comprehensive declarations. This allows firms to proactively identify and mitigate any engagement-specific and firm-wide independence threats, and take timely actions when necessary.

Investigate potential breaches diligently

Investigation of potential breaches

- 3.18. If potential violations of the independence policy are identified, audit firms must conduct diligent investigations. Doing so will send a powerful signal throughout the firm that the leadership is taking independence seriously. This firm-wide message will reinforce the importance of full compliance with the independence policy by all personnel.
- 3.19. A diligent investigation will involve interviewing personnel, reviewing documentation, and carefully considering the circumstances, timing, and aggregated impacts in analysing the nature and extent of the potential breach.
- 3.20. If a breach is confirmed, audit firms must take appropriate actions to properly assess and address the consequences, which could include re-performing the audit work of the concerned team members. The robust investigation reflects firm leadership's commitment to independence, as discussed in paragraphs 3.2 and 3.3.

Objective investigation

- 3.21. The investigation of potential independence violations should be conducted by independent parties (for example, an individual or a team charged with risk management responsibilities with the appropriate reporting line).
- 3.22. For cases involving senior leadership, this may require special committees to ensure objectivity. Engagement partners must take the ownership of the investigation process and be notified for all identified breaches and mitigated matters. Ultimately, engagement partners must independently assess the independence threats with respect to audit clients and make proper disclosures to the audit committees and in auditor's reports.

Communication of independence

- 3.23. Audit firms are required to communicate with those charged with governance of the listed entities timely on their compliance with relevant ethical requirements. Other than independence breaches, audit firms should communicate any independence threats that are not at an acceptable level, and the actions taken, including any safeguard applied, to reduce the threats to an acceptable level.
- 3.24. In the event of independence breaches, audit firms are required to communicate in writing with those charged with governance on the nature of the breach, their actions taken, and their conclusions. This information allows those charged with governance to take appropriate actions within their duties to ensure the independence of their auditors.

Always stay sensitive

- 3.25. In dealing with independence matters for audit firms, individuals should have an inquiring mind, exercise professional judgement, and apply the reasonable and informed third party test as described in Code of Ethics. In circumstances where audit firms' independence policies and procedures may not directly address identified threats, they should apply professional judgement. The professional judgement exercised might need to account

for the complexity arising from the compounding effect of interconnected or interdependent facts and circumstances.

- 3.26. In such cases, audit firms may consider taking a more conservative stance, going beyond the minimum independence requirements. In extreme cases, this could involve terminating certain purchase and procurement transactions to prevent any impairment to independence, whether in fact or in appearance. This is to avoid arousing suspicion and demonstrate firms' unwavering commitment to audit quality.

4. Audit Committees' actions

Audit committees' roles and responsibility in auditor independence

- 4.1. While audit firms hold the primary responsibility in maintaining their independence, audit committees have an important obligation to review and monitor the independence and objectivity of their auditors.⁸ Instead of purely relying on audit firms' self-declaration, audit committees should take a more proactive role in their auditors' independence. Audit committees should take the following actions:

Set the right tone to guard the auditor independence

- 4.2. Audit committees should take a proactive role in setting the right tone to guard auditor independence. Regarding sales transactions, audit committees should stress and communicate to the management that the auditor, both at the firm and individual level, should not be offered any preferential treatment, rights or privileges, including pricing, product availability or accessibility.
- 4.3. If an audit committee become aware of any significant transactions between the company and its auditor, whether by nature or magnitude, the audit committee should diligently review such transactions to ensure they do not compromise its auditors' independence, before granting the approval. The

⁸ The Stock Exchange of Hong Kong Limited [Listing Rules – The audit committee's terms of reference – Relationship with the issuer's auditors](#), Section D.3.3.(b)

effectiveness of such practice could be further enhanced by establishing robust policies, procedures, and oversight mechanism.

Proactive oversight on auditors through open communication and scrutiny

- 4.4. Audit committees should maintain open and transparent communication with auditors. This dialogue is necessary for audit committees to understand any potential threats to independence and ensure auditors provide timely and transparent reporting on any independence breaches, the impact assessment, and the remedial actions taken, enabling audit committees to take appropriate actions. This transparency is therefore crucial for audit committees to discharge their obligations to oversee the independence and objectivity of auditors effectively.
- 4.5. Instead of purely relying on the auditors' assessment and accepting their declaration at face value, audit committees can take a proactive approach to raise questions to understand the auditors' processes for evaluating and maintaining their independence.
- 4.6. While the following questions are not exhaustive, they provide a starting point for audit committees to assess their auditors' independence:

Questions that audit committees should ask

1. What are the audit firm's policies and procedures to ensure audit engagement team members, including their partners, understand the relevant independence requirements that apply to them?
2. How does the audit firm fulfil its responsibilities in accordance with the relevant independence requirements?
3. How does the audit firm and engagement team identify threats to independence and evaluate the significance of the threats identified?
4. How frequently does the audit firm conduct compliance testing on its independence and what are the recent outcomes of the tests?
5. If the audit firm identified a breach of independence requirements, what action has been taken to address the consequences of the breach?

Questions that audit committees should ask

When transactions posing independence threats are identified

1. What are the business rationales for the transaction? Are these rationales in line with the company's overall strategy and objectives?
2. Are these arm's length transactions? In other words, are the terms of the transaction consistent with the market?
3. Will the transaction impact the audit firm's independence (including from the perspective of a reasonable third-party)? What are the mitigating measures in-place?

5. Conclusions

5.1. Auditors' dedication to independence can enhance the credibility of the financial reporting process. When auditors can perform their assurance role impartially without facing pressure or interference, it contributes to audit quality and reinforces trust in the capital market. This, in turn, can advance the city as a better international financial centre.

