

## FINANCIAL SCANDALS AND THE QUALITY OF INDEPENDENT AUDIT SERVICE IN VIETNAM

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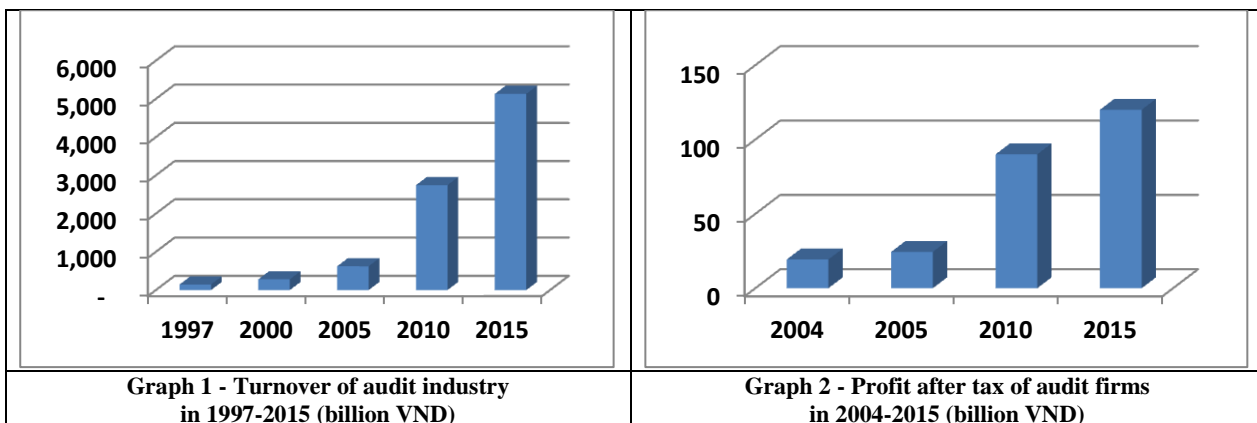
### ABSTRACT

Vietnamese independent auditing industry has made significant contribution to enhancing the transparency of corporate financial reporting, however the service quality of Vietnamese audit firms hasn't satisfied the increasing requirements of the users of audited financial statements. Recent financial scandals on the Vietnamese stock market have seriously impacted investor benefits, and especially undermined the trust for the reliability of the audited financial statements. Based on the results of in-depth expert interview, three factors considered to have the most significant impact on the quality of independent audit service in Vietnam are experience of auditors, audit methodology and audit client collaboration. In addition, many other factors including work pressure, auditors' qualifications, audit fee, State regulations and standards, audit firm reputation, and audit firm size also significantly influence the quality of audit service in Vietnam.

Key words: financial scandals, independent audit, factors affecting audit quality, expert interview.

### INTRODUCTION

Over the past 25 years, auditing industry in Vietnam has been developing rapidly especially since the Law on Independent Audit was issued and effective from Jan 1<sup>st</sup> 2012. By 2016, there have been 140 audit firms nationwide, of which 23 member firms of international auditing networks with over 3,800 certified public accountants who have Certified Public Accountants (CPA) certificate awarded by the Ministry of Finance of Vietnam and more than 1,600 auditors with international qualifications (VACPA's statistics). As shown in *Graph 1*, the overall turnover of auditing industry in 2015 reached 5,130 billion VND compared to 2014's turnover of 144 billion VND. Similarly, the performance of audit firms has been improved over the last 25 years, for example, total profit after tax of audit firms in 2015 was 742 billion VND, 38 times higher than 2004's profit after tax as illustrated in *Graph 2*.



(Source: VACPA's reports)

### FINANCIAL SCANDALS AND THE SERVICE QUALITY OF AUDIT FIRMS IN VIETNAM

Despite the rapid growth of the auditing industry in Vietnam, the size of audit market is still limited compared to its potential and high socio-economic growth. There is big gap between audit quality of big audit firms and the one of small firms which only have five auditors as required by current regulations. During the last 25 years, the growth of number of auditors hasn't caught up with the one of number of audit firms resulted in the lack of auditors. In addition, due to working under time pressure with low audit fee, auditors have not strictly followed Vietnamese standards on auditing and omitted necessary audit procedures. As a result, the audit quality has been declined, consequently more and more misstatements in the audited financial statements have been detected and legally handled as shown in *Table 1*.

Table 1 : Major misstatements in the audited financial statements during 2005-2010

| No. | Audited entity  | Audited fiscal year | Audit firms  |
|-----|---|---------------------|--------------|
| 1.  | Bach Tuyet Cotton Corporation (BBT)                   | 2005-2007           | A&C and AISC |
| 2.  | Quang Ninh Book and Educational Equipment JSC         | 2006-2007           | AVA and AAC  |
| 3.  | Vien Dong Pharmaceutical Joint Stock Company (DVD)    | 2007-2010           | A&C and E&Y  |
| 4.  | Hanam Import Export Mineral Joint Stock Company (MIH) | 2008-2009           | CPA Hanoi    |
| 5.  | Kim Tin Hung Yen JSC                                  | 2009                | BDO Vietnam  |
| 6.  | Nam An Securities JSC                                 | 2010                | AA           |
| 7.  | Victoria Capital Management JSC                       | 2010                | CPA Hanoi    |
| 8.  | HAPACO Securities Investment Fund Management JSC      | 2010                | AASC         |
| 9.  | SGI Capital Management JSC                            | 2010                | CPA Hanoi    |

(Source: VACPA's reports)

In Vietnam, the financial scandal of Bach Tuyet Cotton Corporation in 2008 occurred resulted from the fact that A&C Auditing & Consulting Co., Ltd. did not fully comply audit procedures, not exercise due professional care and did express misleading audit opinions, seriously impacting investor benefits. Another scandal related to Vien Dong Pharmaceutical JSC in 2011, in which EY Vietnam did not give a true and fair view of its financial position resulted in misunderstanding for investors using the financial statements, negative impact on businesses, audit firms and especially undermining the trust for the reliability of the audited financial statements. Especially the recent financial statement frauds of Truong Thanh Furniture Corporation in 2016 have signaled a deterioration in audit quality because DFK Vietnam audit firm couldn't detect serious fraud of this corporation. Physical stock take of this corporation revealed a shortage in the inventory amounted to VND 980 billion, in addition, provisions for bad debts haven't been provided with the amount of VND 193 billion (Minh Chau, 2016). As a result, Truong Thanh Furniture Corporation suffered from net loss of VND 1,073 billion. This financial scandal has raised concerns about the reliability of audited financial statements and the audit quality of audit firms in Vietnam.

Based on the Vietnam Association of Certified Public Accountants (VACPA) annual inspection reports on audit firms' performance during the period 2007 - 2013, the common mistakes of audit firms are summarized as follows:

- Regarding organizational and operational structure: some audit firms had extremely small size (below 20 employees). For example, inspection results in 2010 revealed 5 extremely small firms over 20 audit firms.
- Regarding compliance with professional ethics: Violations of registration, lack of commitment of independence with clients, provision of both accounting and audit services to the same client have been found.
- Regarding signing service agreement: No written guidelines on the process of accepting clients have been observed, some contracts were not in full compliance with legal requirements and auditing standards.
- Regarding recruitment and training process: Lack of fully effective labor contracts signed with employees, no provision for professional risk has been made. Small audit firms did not develop and implement training programs separately for each level of staff.
- Regarding the audit process: Violations of filing audit documents such as paper records haven't been printed for being filed, no general auditing file for regular audit clients, lack of review evidence of auditors and Board of Directors, lack of audit plan. In particular, the audit process still lacked important audit procedures as specified in the auditing standards, for example, no evidence to evaluate new clients or maintain existing clients; no full understanding of clients' business activities and internal control system; no degree of materiality set up, no relevant audit evidences filed to prove audit opinion, no alternative inspection procedures carried out before giving qualified opinion, no assertion of existence obtained related to fixed assets, no evidence to discuss with clients' Board of Directors; no review of effects of events occurring after the date of closing accounting books.
- Regarding quality control system: Most of small audit firms have not designed the audit quality control regulations or some have been set up but not in practice.

In summary, based on the inspection reports on the operations of audit firms from the viewpoint of VACPA - the management agency, a large part of independent audit firms have not fully complied with accounting regulations and Vietnamese standards on auditing. The majority of small audit firms have not built and complied with regulations on recruitment and training, audit process and quality control system.

In general, the quality of independent audit service is not easily evaluated and measured accurately due to being affected by many impacting factors. In order to protect the benefits of investors and other stakeholders, it is necessary to identify impacting factors on the quality of independent audit service so as to enhance the quality of independent audit service in Vietnam.

## LITERATURE REVIEW

In general, the service quality of audit firms can be measured by using a marketing model like SERVQUAL model. Based on survey of 500 public listed companies in Bursa Saham Malaysia in 2005, in an attempt to explore the relationship between audit

service quality, client satisfaction and loyalty to the audit firms; Ismail, Haron & Isa (2006) found the public listed companies were satisfied with the tangible dimension but dissatisfied with the other four dimensions including reliability, assurance, empathy and responsiveness. This study's approach is to define the attributes of quality services from the clients' viewpoint.

Based on the viewpoint that audit quality is related to the auditor's ability to detect material misstatements in the financial statements, there have been many studies on factors affecting the quality of independent audit service in the world.

First, from the standpoint that the audit firm size may affect the quality of independent audit service, the study of De Angelo (1981) indicated the relationship between audit quality and audit firm size, i.e., larger audit firms provide better audit service. Lennox's study (1999) also concluded that audit service of large audit firms is often better than the one of small audit firms.

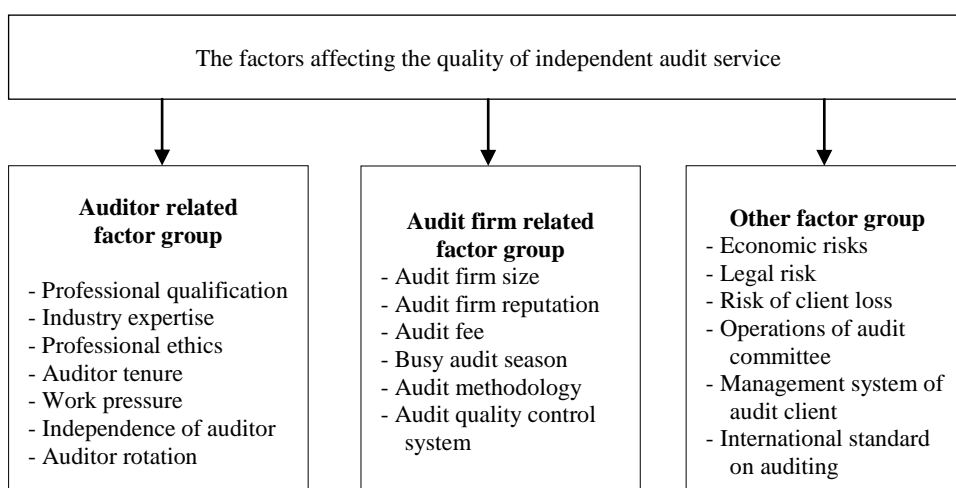
Second, audit fee is also considered one factor that can influence the audit quality. Douglas (2010) revealed that some audit firms reduced audit fee in an aim at retaining clients, maintaining revenue growth or expanding market share. This may undermine the independence of auditors and cause problems of audit quality. This research also mentioned the fact that Australian Securities and Investments Commission (ASIC) required audit firms to disclose audit fees in financial reports and ASIC would review significant fee reduction in relationship with significant change in the underlying business of a company.

Besides, other factors such as auditors tenure, management systems, scale, elements of audit clients and audit inspection can influence the audit quality (Deis & Giroux, 1992). In the same way, pressure, workload, busy audit season can reduce the quality of independent audit service (López & Peters, 2001). Economic risks, operations of audit committee, legal risk, audit firm ethics, economic independence of auditor, risk of client loss, audit firm size, international standards on auditing, audit inspection and auditor rotation may help to enhance audit quality (Beattie et al., 2010).

By using the data of 175 auditors working in public accounting offices in Indonesia, Ningrum and Wedari (2017) found work experience, independence, objectivity and accountability had significant impact on audit quality while integrity, competency of auditors did not. In addition, Ebo (2016) tried to evaluate the impact of auditors' independence on audit quality by examining five threats described in the professional code of conduct and guide of the Institute of Chartered Accountants of Nigeria. The research found environmental factors might have negative impact on auditor's independence and lower audit quality.

Among domestic studies, Bui Thi Thuy (2014) mentioned 03 factor groups affecting audit quality, namely as external factors (including legal environment, listed companies and other factors), auditor/audit team related factors (including professional qualifications and ethics) and audit firm related factors (including audit fee, audit firm size, audit methodology, quality control system and other factors). In this study, the author has proved that professional qualification (auditor related factors), audit firm's quality control system (audit firm related factors) and listed company related factors (external factors) are the most influential factors that affect the quality of audited financial statements of listed companies in Vietnamese stock market. Besides, using the method of qualitative and quantitative research based on regression analysis, Phan Thanh Hai (2016) found the cost and staff capacity, ownership of enterprises audit, quality control work inside and outside had significant impacts on the independent audit quality in Vietnam.

Based on domestic and foreign literature review, there are three main factor groups affecting the quality of independent audit service as follows:



## RESEARCH METHODOLOGY

Previous studies tried to determine internal and external factors that may influence the quality of independent audit in Vietnam by using both qualitative and quantitative methods. Several studies attempted to measure the degree of influence of each factor by using regression model based on survey results. However, few studies on audit quality and its impacting factors using in-

depth interview method can be found. Therefore, factors affecting the independent audit service quality in Vietnam in this research were identified based on the results of in-depth expert interviews. The in-depth interview questionnaires were designed in conformity with Circular no. 157/2014/TT- BTC dated October 23<sup>rd</sup> 2014 on audit service quality control. Experts involved in in-depth interview are audit firms' directors, senior auditors, audit researchers and practical experts working at VACPA and the Department of Accounting Policy, Ministry of Finance of Vietnam. The numbers of in-depth interview respondents are 12 votes. The scale to measure the degree of influence of factors that affect the quality of independent audit service in Vietnam has 5 levels: (1) absolutely no effect, (2) no effect, (3) moderate effect, (4) high effect, (5) extremely strong effect. In addition, based on the legal framework on auditing in Vietnam including Standards on Auditing (VSA 200, VSA 210, VSA 220), and quality control standard (VSQC1), this research summarizes factors that affect the quality of independent audit service in Vietnam.

### THE QUALITY OF INDEPENDENT AUDIT SERVICE IN VIETNAM FROM THE VIEWPOINT OF EXPERTS

Based on the overall results of in-depth expert interview, three factors considered to have the most significant impact on the quality of independent audit service in Vietnam are experience of auditors, audit methodology and audit client collaboration. In addition, many other factors related to auditors and audit firm also significantly influence the quality of audit service (see Tables 2-3).

Table 2 - Survey results on factors affecting audit quality in Vietnam

| No. | Factors                         | Rate of selection (%) |      |      |      |      | Grade point average |
|-----|---------------------------------|-----------------------|------|------|------|------|---------------------|
|     |                                 | 1                     | 2    | 3    | 4    | 5    |                     |
| 1   | Audit fee                       | -                     | 16.7 | 8.3  | 58.3 | 16.7 | 3.75                |
| 2   | Audit firm size                 | -                     | 25   | 25   | 50   | -    | 3.25                |
| 3   | Audit firm reputation           | 8.3                   | 16.7 | 25   | 41.7 | 8.3  | 3.25                |
| 4   | Qualification of auditors       | -                     | -    | 41.7 | 41.7 | 16.6 | 3.75                |
| 5   | Experience of auditors          | -                     | -    | 16.7 | 33.3 | 50   | 4.33                |
| 6   | Audit methodology               | -                     | -    | 16.7 | 50   | 33.3 | 4.17                |
| 7   | Audit client collaboration      | -                     | -    | 25   | 50   | 25   | 4                   |
| 8   | Work pressure                   | -                     | 8.4  | 25   | 33.3 | 33.3 | 3.9                 |
| 9   | State regulations and standards | -                     | 16.7 | 16.7 | 41.6 | 25   | 3.75                |

(Grade point average =  $\sum_1^5 i * Selection\ rate$ )

Table 3 - Ranking of degree of influence by factors affecting audit quality

| No. | Factors                         | Degree of influence |
|-----|---------------------------------|---------------------|
| 1   | Experience of auditors*         | 4.33                |
| 2   | Audit methodology               | 4.17                |
| 3   | Audit client collaboration**    | 4                   |
| 4   | Work pressure                   | 3.92                |
| 5   | Qualification of auditors       | 3.75                |
| 6   | Audit fee                       | 3.75                |
| 7   | State regulations and standards | 3.75                |
| 8   | Audit firm reputation           | 3.25                |
| 9   | Audit firm size                 | 3.25                |

*Notes:* \*Experienced involving at least 3 similar audit works;

\*\* Audit clients are ready to provide all necessary information under auditor's requirements.

Firstly, two factors related to auditors (experience and qualification) have significant impact on audit quality. These factors are important requirements for any career, especially for audit profession since experience and qualification of auditors are considered the key to facilitate auditors in gathering and evaluating sufficient evidence to deal with accounting manipulations so as to give a true and fair view of financial statements. Through every audit with clients operating in various sectors, auditors can increasingly learn by experience to form professional judgment and give appropriate audit opinions.

Secondly, being ranked second after experience of auditors, the degree of influence of audit methodology of 4.17 is the most important factor in audit firm related factor group (including audit methodology, audit fee, audit firm reputation and size). Audit methodology is defined to be the method adopted in the audit process in order to achieve the purpose of the audit. A flexible and effective audit methodology is considered the premise of ensuring audit quality.

Thirdly, with the degree of influence of 3.75, audit fee is considered an important and sensitive factor affecting audit quality in Vietnam. During the period 2004 - 2013, the number of audit firms in Vietnam increased rapidly, especially the penetration of foreign audit companies resulted in audit fee competition among audit firms. Lowering audit fee to grab clients may lead to omitting some audit procedures in comparison with the standard process; or solving problems perfunctorily without due care of audit quality.

Fourthly, the degree of influence of the two factors including audit firm reputation and audit firm size is lowest ranked of 3.25, which means more emphasis is placed on the key role of human resource in conducting audits. Big audit firms with high reputation like Big4s including EY, Deloitte, KPMG and PwC often provide higher audit quality because they have highly qualified, experienced auditors with long-term operating history with effective auditing method. On the contrary, it is difficult for small and newly-established domestic audit firms to compete with large-scale audit companies with long operating history.

Fifthly, among other factors including audit client collaboration, work pressure, State regulations and standards, audit client collaboration is the most important external factor supporting auditors to perform effective and high quality audit. With 3.92 degree of influence, work pressure is ranked the fourth among the impacting factors. According to the survey, no expert denies the terrible work pressure of audit. Massive workload within limited time is a big challenge for auditors to review and detect all misstatements in the financial statements as well as to fully implement audit procedures. Consequently, auditors always have to face up with audit risks that may badly affect the audit quality.

Finally, it is impossible not to mention the role of the State through the promulgation of accounting policy and auditing standards to guide and manage the implementation and to punish misconduct so as to improve the quality of independent audit service in Vietnam.

## CONCLUSIONS

Based on the results of in-depth expert interview, three major factors including experience of auditors, audit methodology and audit client collaboration have the most significant impact on the quality of independent audit service in Vietnam. Therefore, in order to improve the audit service quality, the most important condition is that auditors need to accumulate experience and understanding of multi-industry through practical works and self-study of the clients' business industry. In addition, auditors should develop professional competence continuously by joining full training course of updating professional knowledge annually, always maintain professional ethics, and improve ability to deal with ethical conflicts. For the management agencies, VACPA should further strengthen quality control at the audit firms so as to be able to detect errors on a timely manner. On the other hand, management agencies should apply stricter regulations to punish violations and raise deterrence of wrongdoers through inspections.

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