

THE REGULATION OF EXTERNAL AUDIT IN THE UK
AND US AND A PROPOSAL FOR A NEW AUDIT MODEL

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28 November 2016

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Abstract

This thesis is the study of the role and regulation of the external audit in the UK and US. It argues that the current audit model is fundamentally flawed, which has a negative impact on the quality of financial audits. This research contributes to the debate on external auditing by suggesting a free-standing legal re-conceptualization of the audit model, which aims to improve the quality of audits and reduce opportunity for accounting fraud. The research findings are drawn from qualitative analysis of legal and financial accounting sources.

The thesis consists of three main themes. Firstly, it provides a comprehensive analysis of the regulatory framework for auditing by looking at why, how and by whom audit is regulated. Secondly, it analyses numerous flaws inherent in the current audit model. The focus throughout the thesis is on problems relating to auditors' independence, deficiencies in the spheres of legal, professional and social accountability of auditors, and excessive concentration of the audit market. Thirdly, following the analysis of various theoretical and international audit arrangements, the thesis suggests a new audit model. A key function in this model would be played by an external, public body - the Public Auditing Board, which would be in charge of appointment and remuneration of auditors carrying out audits in the public interest. It is submitted that moving audits to the public sector is desirable in order to introduce genuinely autonomous auditors, to provide better quality of audits and to restore public confidence in capital markets.

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Abbreviations

ABI: Association of British Insurers

AICPA: American Institute of Certified Public Accountants

AIU: Audit Inspection Unit

APB: Auditing Practices Board

ASB: Auditing Standards Board

BCBS: Basel Committee on Banking Supervision

BCCI: Bank of Credit and Commerce International

CPA: Certified Public Accountant

CSC: Codes and Standards Committee

DAS: District Audit Service

Deloitte: Deloitte Touche Tohmatsu

DTI: Department of Trade and Industry

ETIF: Emerging Issues Task Force

EC: European Commission

EU: European Union

EY: Ernst & Young

FASB: Financial Accounting Standards Board

FCA: Financial Conduct Authority

FRC: Financial Reporting Council

FRRP: Financial Reporting Review Panel

FSA: Financial Services Authority

FSI: Financial Statements Insurance

FSMA: Financial Services and Markets Act

FTC: Federal Trade Commission

FTSE: Financial Times Stock Exchange

GAAP: Generally Accepted Accounting Principles

GAAS: Generally Accepted Auditing Standards

GAO: Government Accountability Office

GPPC: Global Public Policy Committee

GPPS: Global Public Policy Symposia

GSC: Global Steering Committee

IAASB: International Auditing and Assurance Standards Board

IASB: International Accounting Standards Board
ICAEW: Institute of Chartered Accountants of England and Wales
IFAC: International Federation of Accountants
IFAD: International Forum on Accountancy Development
IFRS: International Financial Reporting Standards
IOSCO: International Organization of Securities Commissions
ISA: International Standards on Auditing
JDS: Joint Disciplinary Scheme
KPMG: Klynveld Peat Marwick Goerdeler
LCAB: Listed Companies Audit Board
LLA: Liability Limitation Agreement
LLP: Limited Liability Partnership
LSE: London Stock Exchange
LTIS: Long Term Incentive Scheme
MAS: Management Advisory Services
NAS: Non-audit services
PAB: Public Auditing Board
PCAOB: Public Company Accounting Oversight Board
POB: Professional Oversight Board
PRA: Prudential Regulation Authority
PSLRA: Private Securities Litigation Reform Act
PwC: PricewaterhouseCoopers International
SEC: Securities and Exchange Commission
SOX: Sarbanes-Oxley Act
SPE: Special Purpose Entities
SRO: Self-Regulatory Organizations

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EUROPEAN UNION

1. Seventh Council Directive of June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts OJ No L 193/1. (Directive 83/349/EEC).
2. Eighth Council Directive of April 1984 based on the Article 54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents OJ No L 126/10. (Directive 84/253/EEC).
3. Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on Statutory Audits and Annual Consolidated Accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87 (Statutory Audit Directive).
4. Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.
5. Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audit of annual accounts and consolidated accounts.
6. European Commission, Recommendation of 5th of June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms OJ L162/39 (2008).
7. Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

UNITED KINGDOM

1. Supply of Goods and Services Act 1982.
2. Financial Services and Markets Act (FSMA) 2000.

3. Companies Act 2006.
4. The Financial Services Act 2012.
5. The Reporting on Payment Practices and Performance Regulations 2017 No. 395.

UNITED STATES

1. Restatement (Third) of Agency.
2. Sarbanes-Oxley Act of 2002, PL 107-204, 116 Stat 745.
3. Securities Act of 1933.
4. Securities Exchange Act of 1934.
5. United States Code (U.S.C.) Title 11, (Bankruptcy).

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Candler v Crane, Christmas & Co.[1952] 2 K.B. 164.

Caparo Industries v Dickman and others [1990] 1 All ER 568, AC 605.

Equitable Life Assurance Society v Ernst & Young [2003] EWCA Civ 1114.

Fomento (Sterling Area) Ltd v Seldson Fountain Pen Co [1958] 1 W.L.R. 45 (HL).

Hedley Byrne & Co v Heller & Partners [1963] 2 All ER 575.

Lloyd Cheyham & Co Ltd v Littlejohn & Co [1987] B.C.L.C. 303.

Re Kingston Cotton Mill, [1896] 2 Ch. 279.

Re London and General Bank (No.2) [1895] 2 Ch. 673.

Sasea Finance Ltd v KPMG (No.2) [2000] 1 B.C.L.C 236.

UNITED STATES

AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009).

Bily v Arthur Andersen & Co., 11 Cal Rptr.2d 51(1991).
Central Bank of Denver v First Interstate Bank of Denver, 511 US 164 (1994).
Credit Alliance v Arthur Andersen, 483 N.E.2d 100 N.Y(1985).
First Florida Bank v Max Mitchel & Co, 558 So.2d 9,15(1990).
Kirschner v KPMG LP, 938 N.E.2d 941, 951 (N.Y.2010).
Landell v Lybrand, 107 A. 783 (Pa. 1919).
Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found v PricewaterhouseCoopers, LLP (AHERF), 989 A.2d 313, 332 (Pa. 2010).
Rosenblum, Inc. v Adler, 93 N.J. 324, 461 A.2d 138 (1983).
Ultramares Corp. v Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931).
United States v Arthur Young & Co., 465 U.S. 805 (1984).

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STRUCTURE OF THESIS

The aim of this thesis is to examine the functioning and regulation of the external audit function. This study contributes to the debate on audit regulation in two ways. Firstly, it provides a critique of the current regulatory framework of auditing. By arguing that despite the fact that audit plays a crucial role in maintaining confidence in capital markets, contemporary auditing practices remain fundamentally flawed. Secondly, it suggests an alternative model, that assumes greater state regulation of the audit process, which has to be imposed, in order to protect the stakeholders and the wider community. The aim of this thesis is to provide a portable set of arguments, which are intended to be generic, although illustrated by examples from the UK and US.¹

An account of the existing literature on the structural and regulatory changes that occurred within the accounting profession in the second half of the 20th century is provided in chapter one. There, it is explained how the increasing provision of consulting services transformed the accounting profession into one of business-focused consultants, and negatively impacted on their perceived independence. The chapter also provides an outline of the regulatory concessions, such as the introduction of the Limited Liability Partnership form, or proportionate liability, which the profession managed to secure through its extensive lobbying. This diminished the deterrent function of litigation and regulation and decreased the profession's accountability. The chapter then focuses on

¹ This thesis does not deal with substantive accounting. It has to be acknowledged, however, that the origins of certain problems inherent in the current audit model can actually be found in accounting treatments, e.g. special purpose entities (SPE) can be abused to achieve more desirable financial and capital ratios or to manage capital requirements.

discuss the excesses of the 1980s and the large corporate collapses, such as Enron, which have generally undermined confidence in the world's capital markets and have raised questions about the efficiency of the current audit model and the future of the auditing profession. Also, the recent global financial crisis of 2008 has drawn attention to the limitations of the auditing process, the need to reform some aspects of practice and regulation, and the relative silence of the profession at such a fundamentally important time.² Chapter one also provides a historical background to the numerous mergers between the big accounting firms which ultimately led to the excessive concentration of the audit market for listed companies.

Despite the fact that the audit process is well established in a developed society, the circumstances of its creation and the conditions necessary for its existence and continuing development are little understood.³ These questions have hardly attracted the attention of academics and hence there has been little interest in the development of audit theory. The notable exceptions are the studies of Limpberg, Mautz and Sharaf and Flint, which are discussed in chapter two. Limpberg's theory is based on the assumption that audit practices need to be adjusted to the evolving needs of society.⁴ He emphasises the importance of auditors' independence and notices that independence cannot be maintained if auditors must rely on their clients for appointment and remuneration. Mautz and Sharaf, are primarily concerned with the audit of business corporations, and not with the concept of audit in a wider sense. They base their theory on scientific logic, assuming that audit is a rational process of evaluation of evidence. Flint, similarly to Limpberg,

² Christopher Humphrey, Anne Loft, and Margaret Woods, 'The Global Audit Profession and the International Financial Architecture: Understanding Regulatory Relationships at a Time of Financial Crisis' (2009) 34(6-7) *Accounting, Organisations and Society* 810, p. 810; Prem Sikka, 'Financial Crisis and the Silence of the Auditors' (2009) 34(6-7) *Accounting, Organizations and Society* 868, p. 868.

³ David Flint, *Philosophy and Principles of Auditing: An Introduction* (MacMillan Education, London 1988), p. xii.

⁴ Theodore Limpberg, *The Social Responsibility of the Auditor* (Limpberg Instituut, The Netherlands 1985).

builds his theory around the social responsibility of auditors, which should change according to the society's needs. Both Flint's and Limpborg's theories provide a theoretical underpinning for the proposed model, which aims to restore genuinely independent auditors, and which suggests that audit plays an important social function and should be performed for the benefit of numerous stakeholders. Finally, chapter two discusses the agency theory, developed by economists, which provides one of the explanations for the origins and functions of external audit.

Chapter three provides an analysis of the regulatory framework for auditing. It contributes to the discussion on financial reporting by considering why, how and by whom audit is regulated. Firstly, the chapter examines various general theories of regulation and applies them to the auditing context. It argues that none of the theories of regulation fully explain the existing regulation of audit, as most of the regulatory changes are reactive and usually take place in the aftermath of major accounting scandals. Secondly, it addresses how audit is regulated by examining the discourse on rules versus principles-based regulation within the auditing sphere. Thirdly, it examines a variety of players involved in the regulation of audit. These include: private and public regulators at national and international level, as well as big audit firms. The aim of this chapter is to provide a comprehensive analysis of the current regulatory framework for auditing, which forms a basis for the following chapters to go on to criticise the current auditing model, and to propose a new one.

One of the main arguments in this thesis is that the current audit model is fundamentally flawed. It is therefore necessary to pinpoint the flaws inherent in the audit arrangements. To that end, chapter four focuses on three areas which are the subjects of an extensive critique in auditing literature: independence, accountability of auditors, and concentration of the audit market, which are all initially introduced in chapter one. Regarding

independence, the main flaw of the model is caused by the fact that auditors have a conflict of interest at the heart of their business in that they are appointed and paid by the companies they are supposed to assess objectively. As service providers, they rely on repeat business from their customers and it is likely that they will consider the prospects of being retained for next year's audit even as they perform this year's. This creates an incentive for auditors to acquiesce to management demands.⁵ This cannot be remedied without delegating the appointment function to an external body, which is proposed in chapter six. Furthermore, auditors are allowed to provide certain consulting services, which can in turn damage their perceived independence. This thesis argues that the only solution to this problem is the introduction of a statutory ban on the provision of these services concurrently with audits.

Furthermore, the current audit architecture is characterised by legal, professional and social accountability deficits. Issues of accountability deficits have been considered before in the context of public or governmental institutions, but few researchers have focused on accountability deficits in the private sector audit model. This thesis therefore provides insights into questions that have not previously been given significant attention in auditing literature. Over the years auditors managed to shield themselves from the effects of litigation by lobbying for a decrease in their exposure to tortious claims by non-clients, for the introduction of the proportionate liability and limited liability agreements, as well as limited liability partnerships. At the same time, professional discipline, with its lenient sanctions, does not provide a sufficient deterrent against auditors' acquiescing to managers' demands. Theoretically, the audit should fulfil a public interest role by

⁵ The term 'management' is not used in a strictly legal sense, but more in a way that would be familiar to an economist. It denotes senior management rather than the board of directors.

ensuring integrity and public confidence in the market and protecting the investing public from corporate fraud. In practice, however, auditors owe their duties only to the companies they audit. They do not have to have regard other stakeholders, whose pension savings are located in public companies. This makes the number of audit addressees very limited. Moreover, for decades the auditing profession has been refusing to accept a duty to detect fraud, claiming that its sole responsibility is to provide an opinion as to whether financial statements represent a true and fair view of the financial state of their clients. This is in stark contrast with what society expects auditors to do. The public want auditors to focus on detecting irregularities. The main finding here is that, despite numerous regulatory changes, auditors in the current audit arrangement remain undeterred and largely unaccountable. According to Sikka,

Poor audits are a systemic problem. Auditing firms are the private police force of capitalism, but are not subjected to pressures and incentives normally associated with the private sector. The market for external audit is created by the state and guaranteed to accountants belonging to a select few trade associations. In the absence of effective accountability and liability, this rarely encourages reflection on poor practices.⁶

Chapter four also finds that the audit market is highly concentrated and that there are significant barriers to entry for small and mid-size audit firms. This significantly limits the listed companies' choice of auditors and can have an even more severe impact if one of the Big Four firms withdraws from the market. It postulates that the state should play a bigger role in encouraging competition in the audit market.

⁶ Prem Sikka, 'Big Auditors Must Be Made Accountable to the Public' The Conversation 17 April 2014, available at <http://theconversation.com/big-auditors-must-be-made-accountable-to-the-public-25766> accessed 30 August 2014.

Chapter five provides a review of various theoretical and international audit models. It also considers whether some of the elements of these models could be transplanted in order to improve the financial audit architecture in the UK and US. Drawing on the elements of these models, chapter six proposes an alternative audit arrangement, which provides potential solutions to the aforementioned problems.

The alternative model proposes delegating audits of the listed companies to a designated state regulator. The proposed model suggests creating an external, public body – the Public Auditing Board – which would be in charge of the appointment and remuneration of auditors. Such a model would eliminate the ‘mother of all conflicts’ problem stemming from the fact that auditors are paid by the very companies they are supposed to audit.⁷ Furthermore, auditors would no longer be able to provide their clients with consulting services, due to the suggested statutory ban on their provision. This would alleviate the conflict of interest problem and increase their perceived independence.

The suggested model also emphasises the need for auditors to become more accountable. It is an important issue for the public as well as investors as ‘in a capitalist economy, the process of wealth creation and political stability depends heavily upon confidence in processes of accountability, of which an external audit of financial statements is considered to be an important part’.⁸ Auditors are the recipients of the legal concessions such as limited exposure to tortious claims by non-clients, proportionate liability or LLP structure. They protect auditors from excessive litigation. The thesis argues that these concessions should only stay in place if the quality of audits increases. To that end, the

⁷ Richard Kaplan, 'The Mother of All Conflicts: Auditors and Their Clients' (2003-2004) 29(2) *The Journal of Corporation Law* 363, p. 363.

⁸ Prem Sikka, Anthony Puxty, Hugh Willmott, Christine Cooper, 'The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence' (1998) 9(3) *Critical Perspectives on Accounting* 299, pp. 299-300.

suggested model offers a reorganisation of the audit architecture, with the Public Auditing Board at the centre, which would enable the auditors to be truly independent, and focus on the delivery of high quality audits. The thesis also argues that auditors should be more accountable to the public, since they perform an important role of protecting public interest. Accurate financial reporting is essential for stable capital markets and for investors to make informed decisions. Currently, the majority of society invests savings in the capital markets, either through pension funds or directly. It is essential then that auditors take into account the interests of all stakeholders, whilst performing their duty in the public interest. The model also suggests extending audit reports, so that they include a detailed risk analysis. This is particularly important in the context of banks and their portfolios of volatile, complex financial instruments. Furthermore, the thesis argues that delegating audits to a designated state regulator would also increase the supply of audit services, reduce the size of big audit firms and enable mid-tier firms to compete and bring an end to the ‘too big too close’ regulatory inertia.⁹

It is concluded that contemporary auditing practices are fundamentally flawed and if the accounting profession continues with business as usual, another major audit disaster is almost certainly inevitable. As Bromwich has written:

The auditing profession may face some very severe challenges. The continued success of the profession depends in part on its response to these challenges. Research has a role in clarifying the nature of these challenges and in exploring the possible responses. To do this successfully, the research has to explore fundamental questions about why and where the auditor’s authority and power in society reside and how this location changes over time.¹⁰

⁹ Sikka (n 6).

¹⁰ Michael Bromwich and Anthony Hopwood, *Introduction, Auditing Research: Issues and Opportunities*. Pitman Books in Association with Deloitte (Haskins & Sells, Chartered Accountants, London 1982), p. 21.

The thesis argues that a shift towards a state-backed audit model that provides better quality of audit, eliminates self-serving bias and addresses the public interest is essential to restore confidence in capital markets and the accounting profession.

METHODOLOGY

The aim of this section is to provide the reader with an understanding of how this research was done. The thesis adopts a mix of methods such as doctrinal, problem, policy and law reform based research.¹¹ The main focus of chapter one is to provide a literature review, whilst chapter two reviews a theoretical framework for auditing. The research presented there is based primarily on the analysis of financial reporting and legal secondary sources.

A doctrinal method is adopted in chapters three and four in order to establish what the law is in the area of external auditing in the UK and US. Chapter three looks at why, how and who regulates audit. This is done through the analysis of not only legal, but also political science and economics literature. This thesis therefore adopts an interdisciplinary approach to legal analysis. A particular emphasis is placed on the institutional framework and policies of the enforcement agencies such as the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC) and the Financial Reporting Council (FRC) responsible for the effective functioning of audit function. A consideration of problems currently affecting the audit model is discussed in chapter four. To that end, the thesis collects and analyses numerous primary sources relating to the independence and accountability of auditors. This involves, among others, comparative and historical perspectives on case law related to auditors' liability in the UK and US, the analysis of the provisions of the Sarbanes-

¹¹ Ian Dobison and Francis Johns, 'Qualitative Legal Research' in Mike McConville and Wing Hong Chui (eds) *Research Methods for Law* (Edinburgh University Press 2007), p.19.

Oxley Act 2002 and the FRC's Ethical Standards regarding auditors' independence. Based on the findings in these chapters, the thesis argues that the current audit model needs a regulatory overhaul.

The analysis of the flaws of the existing audit model also leads to a discussion on various theoretical and international audit models in chapter five. The purpose of this chapter is to review these models and consider their suitability to improve the regulation of external audit in the UK and US. This is done mainly through analysis of the secondary sources available in English language.

Drawing on the evidence presented in the thesis, chapter six proposes a free-standing legal reconceptualisation of the external audit function in the Anglo-American system. The Audit Commission, as one of the examples of the macro models of audit regulation, is used as a theoretical basis of the new model, which suggests moving audits to the public sector. The new model is centred on a public agency – the Public Auditing Board - in charge of appointment and remuneration of auditors. Chapter six adopts Limperg and Flint's theories, discussed in chapter two, as a theoretical grounding that offers solutions to the problems inherent in the current external audit function. The proposed model implies policy changes, which aim to introduce truly independent auditors, protect the interests of investing public, and restore confidence in capital markets.

CHAPTER 1. INTRODUCTION.

This chapter introduces the three problematic areas inherent in the current audit model, which are the focus of this thesis. These areas are auditors' independence, lack of accountability and excessive concentration of the audit market. They will be analysed in greater detail throughout the thesis. These problems have been subject to intellectual inquiry and public debate for decades without resolution, which suggests that the audit model is conceptually flawed. The aim of this thesis is to show that only substantial reform of the auditors' business model, which this thesis outlines in chapter six, will eliminate the problems inherent in the present auditing arrangement, improve the quality of audit and end the cycle of disappointment with auditors' work.

This chapter does not attempt to present a complete genealogy of the issues identified, but instead focuses on the second half of the twentieth century leading up to the arrival at the present position. It is structured as follows; a brief analysis of the origins of audit; the issues of auditors' remuneration including cultural change that occurred within the accounting profession leading to the rise of consulting services; discussion of legal concessions that the accounting profession extensively lobbied for, which in turn contributed to the decrease in the deterrent function of regulation and litigation; and finally, an analysis of the rise of short-termism providing two examples of the link between short-termism and accounting failure, namely the Enron debacle and the financial crisis of 2008. The chapter then discusses mergers between the biggest audit firms and their influence on the concentration of the audit market. The final section concludes by stating that audit has been built and developed on faulty foundations and misaligned incentives, which make it difficult for the accountants to provide good quality

audits. This lays the foundation for the rest of the thesis, which further criticizes the current auditing arrangement and suggests an alternative audit model.

1.1. THE ORIGINS OF AUDIT

Although there is no legal definition of the external financial audit, systematic attempts have been made to describe its meaning and function.¹² In 1969 the US Auditing Concepts Committee¹³ described audit as:

A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.¹⁴

More broadly an audit is concerned with evaluation of the data contained in the financial statements to determine if the data are presented in accordance with the applicable financial reporting framework and whether they properly reflect the events that have occurred during the period in question. The audited financial statements are then provided to third-party users with a vested interest in an audited company. Power, for example, describes audit as an

independent examination of, and expression of opinion on, the financial statements of an enterprise. Here are the most general conceptual ingredients of an audit practice: *independence* from the matter being audited; technical work in the form of *evidence* gathering and the examination of documentation; the expression of a

¹² Flint, for example, focuses on the conditions required for an effective audit. Firstly, there must a relation of accountability between an agent and a principal. Secondly, the principals must be distant from the actions of the agents, above note 3.

¹³ The Auditing Concepts Committee was established by the Executive Committee of the American Accounting Association in 1969 in order to enhance research and recognition to the field of auditing; in Joseph A. Silvos, 'Committee on Basic Auditing Concepts, 1969-71' (1972) 47(4) *The Accounting Review* 14, p. 17.

¹⁴ Silvos (n 13) p.18.

view based on this evidence; a clearly defined *object* of the audit process, in this case the financial statements.¹⁵

Additionally, Power emphasises the need for auditors to be independent from the companies they audit. The independence of the audit provider from a reporting company is important, as it adds credibility to the reported information by enhancing the intended users' degree of confidence in the accuracy of the financial statements. Indeed, some writers suggest that independence is the most important indication of the quality of an audit.¹⁶ The issue of auditors' independence is further discussed in chapter four.

The audit process itself consists of many stages. First of all, the auditor acquires an understanding of the audited company and its activities through assessment of the accounting system and internal control mechanism.¹⁷ With this in view, the auditor develops an audit strategy and an audit plan that will produce evidence helpful in forming an opinion on financial statements. A significant part of this stage is fieldwork, which concentrates on transaction testing and communication with the client. It is during this phase that an auditor determines whether the controls identified during the preliminary review are operating properly and in the manner described by the auditee. This stage concludes with a preparation of the draft audit report. In the final stage, the auditor issues a final report providing information to shareholders and other third parties. The auditor's opinion on the financial statements is meant to provide a reasonable assurance on whether financial statements are free from material misstatements caused by fraud or error, and whether they were prepared in accordance with the appropriate accounting standards and

¹⁵ Michael Power, *The Audit Society: Rituals of Verification* (Clarendon Press, Oxford 1997), pp. 4-5.

¹⁶ Amanda Ball, David L. Owen, and Rob Gray, 'External Transparency or Internal Capture? The Role of Third-Party Statements in Adding Value to Corporate Environmental Reports' (2000) 9(1) *Business Strategy and the Environment* 1, p. 7.

¹⁷ Brenda Porter, Jon Simon, and David Hatherly, *Principles of External Auditing* (2nd edn, John Wiley & Sons 2003), p. 149.

laws.¹⁸ If the auditor is satisfied with the evidence and considers that the financial statements provide a true and fair view of the company, he issues an unqualified audit report.¹⁹ The auditor may also decide to issue a qualified audit report as a result of misstatements, or due to lack of sufficient evidence about the accuracy of the financial statements.²⁰

There are several hypotheses explaining the origins of audit. First of all, it has been argued that the appearance of independent audit is a product of government regulation.²¹ For example in the UK the requirement of a compulsory audit was introduced by the 1900 Companies Act.²² In the US, the 1933 Securities Act required corporations, subject to the Act, to have audits conducted by independent or certified public accountants.²³ An alternative hypothesis suggests that the development of audit was driven by market forces. Audits conducted by an external and independent party were useful in reducing the incentive problems that arose when the manager did not supply all the capital.²⁴ Accordingly, audits were found in the earliest firms where the manager did not own all the residual claims on the firm. The latter hypothesis seems much more plausible, as there is some evidence pointing to the early existence of audit.²⁵

¹⁸ Joshua Ronen, 'Corporate Audits and How to Fix Them' (2010) 24(2) *Journal of Economic Perspectives* 189, p. 191.

¹⁹ ISA 700, para 10.

²⁰ Before issuing a qualified audit report, an auditor needs to modify the opinion in the report. There are three types of modified opinions: a qualified opinion, an adverse opinion, and a disclaimer of opinion. If there are material misstatements, but there is nothing pervasive to the financial statements, the auditor issues a 'qualified opinion'. This is still a clean opinion. If the misstatements are material and pervasive to the financial statements, the auditor expresses an 'adverse opinion'. This is an unclean audit opinion. Lastly, an auditor may issue a disclaimer of opinion when he is unable to obtain sufficient audit evidence regarding the accuracy of financial statements. The auditor disclaims the audit opinion because of the risk that undetected misstatements could have a material and pervasive effect on the financial statements; in ISA (UK and Ireland) 705, para 7, 8, 9 and US AU-C-00705.

²¹ Howard F. Stettler, *Auditing Principles* (4th edn, Prentice - Hall 1977), pp. 20-21.

²² Porter (n 17), p.22.

²³ Ross L. Watts and Jerold L. Zimmerman, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' (1983) 26(3) *Journal of Law and Economics* 613, p. 614.

²⁴ Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305, pp. 338-339.

²⁵ Lawrence Robert Dicksee, *Auditing: A Practical Manual for Auditors* (Gee & Co, London 1892).

Watts argues that audits existed early in the development of business corporations (C1200AD) and initially were conducted by directors or shareholders forming the committees of auditors.²⁶ The use of external professional auditors became the usual practice in the latter half of the nineteenth century in the UK, and the early part of the twentieth century in the US. However, despite the fact that the use of professional auditors became common at that stage, corporate audits were not typically required by law either in the UK or the US. This suggests that the use of professional auditors occurred due to the changes in the market for auditing rather than government fiat.²⁷ There are some market developments which help explain the rise of the professional audit firm. To begin with, the demand for audits in the UK in the 1860s and 1870s increased because of the complexity of the accounts and the enormous expansion in the size and number of corporations. The increased complexity in turn encouraged specialisation in accounting and the growth of professional firms.²⁸ The reasons for the development of professional audit firms in the US are consistent with this approach, albeit that the change there occurred later than in the UK.²⁹

It has been argued that audit developed as a response to the principal-agent conflict³⁰, which lies at the centre of the agency cost theory.³¹ The agency conflict stems from an information asymmetry and the fear that agents might have different motives and interests

²⁶ Watts (n 23), p. 616.

²⁷ Watts (n 23), p. 614.

²⁸ Watts (n 23), p. 630.

²⁹ Watts (n 23), p. 629.

³⁰ Watts (n 23), p. 614; Rick Antle, 'The Auditor as an Economic Agent' (1982) 20(2) *Journal of Accounting Research* 503, pp. 503-506, D. J. Hardman, 'Towards a Conceptual Framework for Government Auditing' (1991) 31(1) *Accounting & Finance* 22, pp. 22 - 25, Mohinder Parkash and Carol F. Venable, 'Auditee Incentives for Auditor Independence: The Case of Nonaudit Services' (1993) 68(1) *Accounting Review* 113, p. 115, Chee W. Chow, 'The Demand for External Auditing: Size, Debt and Ownership Influences' (1982) 57(2) *The Accounting Review* 272, p. 272, Ross L. Watts, 'Corporate Financial Statements, a Product of the Market and Political Processes' (1977) 2(1) *Australian Journal of Management* 53, p. 56.

³¹ Agency cost theory is also known as a contracting cost theory, which derives from the financial economics literature and belongs to the positivist group of economic theories, in Michael B. Adams, 'Agency Theory and the Internal Audit' (1994) 9(8) *Managerial Auditing Journal* 8, p. 8.

than the principals.³² Information asymmetry occurs when management (agents) have a competitive advantage of information about the company over that of the owners (principals).³³ This can potentially result in the agents maximising their own interests at the expense of the principals³⁴ and problems such as ‘adverse selection’ (e.g. when sellers have information that buyers do not) and ‘moral hazard’ (when one person takes more risks, because someone else bears the cost of those risks), which are further discussed in chapter two.³⁵ Audit is considered to be a partial solution to this, as it provides a mechanism which aligns the interests of the agents and principals and reinforces trust between them.³⁶ Auditors, as an independent and external party, are hired by the companies in order to produce stewardship³⁷ information on the financial status of the companies.³⁸ They provide an independent check on the work and information provided by the agents, diminishing the negative influence of the agency problem.

So far this section has provided a definition and explanation of the origins of audit. In essence, the auditors’ role has not changed significantly over time. The current regulatory audit model can be characterized by the same basic issues that existed at the birth of the modern audit in the nineteenth century.³⁹ This means that there may be a deep, historical flaw in the functioning of audit. Many of the problems, such as lack of independence and

³² Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26(2) *The Journal of Law and Economics* 301, pp. 303-304, Eugene F. Fama, 'Agency Problems and the Theory of the Firm' (1980) 28(2) *Journal of Political Economy* 288, pp. 288-295.

³³ Jensen and Meckling (n 24) pp. 310 - 15, Fama (n 32) p. 290.

³⁴ Beth Arnold and Paul de Lange, 'Enron: An Examination of Agency Problems' (2004) 15(6/7) *Critical Perspectives on Accounting* 751, p. 753.

³⁵ Jensen and Meckling (n 2433) pp. 355-60.

³⁶ The Institute Of Chartered Accountants in England and Wales. *The Audit and Assurance Faculty. 'Agency Theory and the Role of Audit'* (2005), p. 6.

³⁷ Stewardship embodies responsible planning and management of resources. In the auditing context, stewardship refers to the auditor’s function of verifying whether information contained in the financial statements represents a true and fair view of the company’s financial health.

³⁸ Antle (n 28) p. 504.

³⁹ Richard P. Brief, 'The Accountant's Responsibility in Historical Perspective' (1975) *April Accounting Review* 285, p. 285; Roy Chandler and John Richard Edwards, 'Recurring Issues in Auditing: Back to the Future' (1996) 9(2) *Accounting, Auditing and Accountability Journal* 4, p. 4.

accountability, which are discussed in chapter four, are not capable of permanent solution without the fundamental rethinking of the audit model, which is offered in chapter six. The objective of the remainder of this chapter is to set the context for the rest of the thesis by examining crucial changes that occurred in the last several decades which affected the regulation of audit and the accounting profession. The following section will examine one of the most contentious issues of the present audit architecture - the conflicts of interests inherent in the professions' organisational structure and their impact on auditors' independence.

1.2. CONFLICT OF INTERESTS AND REMUNERATION

This section starts off with a discussion on the conflict of interests embedded in the current audit arrangement, which is derived from the fact that auditors are hired and paid by the very companies they are supposed to provide with an independent audit opinion. The thesis then moves on to discuss the issue of auditors' compensation and the phenomenon of low-balling. To follow, the use of consulting services is discussed, which combined with changes in the earnings pressures on the auditors' corporate clients, caused the value shift inside the big audit firms.⁴⁰ This, in turn, contributed to the fact that auditors became more susceptible to accommodating questionable accounting practices, which put a strain on auditors' independence.

By its very nature, corporate management has strong incentives to manipulate the accounts. Managers want to show their positive input to the corporation's operations. They also have a personal financial stake to do so as well. Various compensation formulae tied to corporate financial performance measures and coupled with generous grants of

⁴⁰ Timothy J. Fogarty and Saad A. Al-Kazemi, 'Leadership in Accounting: The New Face of an Old Profession' (2011) 11(1) *Accounting & the Public Interest* 16, p. 16; Arthur R. Wyatt, 'Accounting Professionalism-They Just Don't Get It!' (2004) 18(1) *Accounting Horizons* 45, p. 45.

options on the corporation's stock, make managers keenly interested in their corporation's financial statements. The discussion in latter sections of this chapter shows that it is a frequent occurrence that management is actively involved in determining what goes into a corporation's financial reports. The role of the public accounting firms is to provide independent and objective scrutiny on attempts to manipulate a company's accounts against these natural tendencies of management. Under the current system, however, auditors are hired, paid and fired by the companies they audit, and it is widely known that client companies fire auditing firms that deliver adverse audits.⁴¹ Despite the fact that an auditing firm is large enough to absorb the loss of a single client, individual auditors' jobs and careers may be contingent on success with specific clients. That is why auditors have strong business reasons to stay in clients' good graces and remain highly motivated to approve the client companies' financial statements. This negatively affects auditors' independence.⁴²

Auditors' independence is the most important feature of the external audit function. It is, in fact, the sole reason for its existence. The mere suggestion that auditors might be conflicted while exercising their judgement can damage shareholders' and public confidence in the market and devalue the service they provide. The need for auditors to be independent of their client's management was emphasized very early in the development of the audit function - 'the necessity of [the auditor's] utter independence of any influences which may colour his conclusions must be insisted upon.'⁴³ Even an early edition of *The Accountant* in 1883 identified this conflict of interest as a critical problem:

⁴¹ Kaplan (n 7) p. 367.

⁴² This problem, frequently described in the accounting literature as the 'mother of all conflicts', is difficult to solve without severing the direct relationships of auditors with the management; in Kaplan (n 7) p. 367. This thesis suggests in chapter six creating an external body in charge of appointing and remunerating the auditors, which would solve this conflict of interest at the heart of auditors' business.

⁴³ Chandler (n 35) p.4.

The audit of Public Companies' accounts was designed to control and check the actions of directors in their administration of the affairs of Public Companies: and yet, as a rule, the auditors who are chosen for this purpose owe their employment to the very directors whom they are presumed so to control and check in the interests of the shareholders. This is one of the evils arising out of the proxy system, which I trust we may some day see abolished, as being utterly pernicious and vicious in root and branch. It should be laid down as an invariable rule that directors, trustees, or other persons in fiduciary positions should never be allowed the direct or indirect use of proxies in voting, or in fact to vote personally, on any subject affecting the performance of the duties imposed upon them by the trusts under which they act, or on the passing of the accounts as presented by them to their proprietary or cestui que trust.⁴⁴

The pressure to retain as many clients as possible is high. In doing so auditors often agree to provide audits for artificially reduced fees, a phenomenon which is often called low-balling. Kaplan explains it in the following way: as audit of a new client normally requires additional work of a one-time nature, the auditing firm will almost certainly lose money on this particular audit engagement in the first year, and perhaps in later years as well. Accordingly, the accounting firm is confronted with huge economic pressure to retain the client. Consequently, once the firm has "invested" or lost significant resources in the new client relationship in the form of unbilled hours, it must do everything to keep this client to make the investment pay off.⁴⁵

According to the Cohen report 'accepting an audit engagement with the expectation of offsetting early losses or lower revenues with fees to be charged in future audits creates the same threat to independence (as an unpaid audit fee)'.⁴⁶ Though the literature on the

⁴⁴ Brief (n 35) p. 291.

⁴⁵ Kaplan (n 7) p. 368.

⁴⁶ Commission on Auditors' Responsibilities (Cohen Commission), *Report, Conclusions, and Recommendations* (New York 1978).

effects of low-balling on auditors' independence, is far from clear-cut⁴⁷, what has been relatively uncontroversial, is the negative impact that low-balling has on the quality of audits. According to the SEC, for example, low-balling leads to the overproduction of dishonest information.⁴⁸ Shohet claims that one of the dangers 'is the decline in quality clients receive from low-ballers as they take on more customers in order to compensate for the low price they charge'.⁴⁹

Accounting firms practice low-balling not only to retain their clients for several years. In the past decades, they have increasingly used low-cost audits to build relationships that allow them to sell their lucrative consulting services. The following section examines the provision of consulting services by the accounting firms and their impact on the profession's independence.

1.3. CONSULTING SERVICES

This section looks at the provision of consulting services and their impact on auditors' independence. Consulting is considered to pose a significant threat to the long-term audit quality and to perceptions of the audit firms' commitment to protecting public interest. It is also considered to be one of the main reasons why auditors' independence is compromised. Conflicted auditors have incentives to avoid providing negative audit opinions to the managers who hired them and paid their auditing and consulting fees. The last two decades of the 20th century have witnessed the transformation of professional auditors into business oriented consultants.⁵⁰

⁴⁷ See for example Linda Elisabeth DeAngelo, 'Auditor Independence, 'Low Balling', and Disclosure Regulation' (1981) 3 Journal of Accounting and Economics 113, p. 113.

⁴⁸ Securities Act Release No. 33-5869.

⁴⁹ Accountancy Age, Low-balling a Continuing Threat to Firms, Claim Analysts, 17 April 2015, available at <http://www.accountancyage.com/aa/news/2404522/-lowballing-a-continuing-threat-to-firms-claim-analysts> accessed 26 June 2016.

⁵⁰ Dana R. Hermanson, 'How Consulting Services Could Kill Private-Sector Auditing' (2009) 79(1) CPA Journal 6, p. 6.

The accounting profession had begun diversification into consulting services in the second half of the twentieth century.⁵¹ They began developing new information-based services, gradually expanding beyond their traditional accounting, auditing and taxation base.⁵² This new line of services became known as ‘management services’ or ‘management advisory services’ (MAS). By 1969 they constituted one quarter of accounting firms’ revenue and continued to expand.⁵³ In the UK, this rapid expansion and bullish approach to providing consulting services attracted the attention of the UK’s Auditing Practices Board (APB), which commented:

The effects of opening the profession to marketing in the mid-1980s have been aggressive competition, the building of other services onto the recurring client base and the development of new products by the profession and its firms to meet the developing needs of industry and commerce. Whilst the market clearly demands such services, it can be argued that such an expansion has led on occasion to forgetfulness that the audit service is different in that the auditor’s opinion is for the benefit of the users of financial information and confidence in the capital markets as well as for the benefit of the company itself.⁵⁴

In the 1970s and 1980s the drive to increase the scope and scale of profitable consulting services transformed the Big Eight accounting firms into businesses promoting growth, profitability and worldwide reach, which are typically business aims, not necessarily in line with the professional values of independence, objectivity, quality of service and public interest focus.⁵⁵ The mergers between the firms in the late 1980s and 1990s created

⁵¹ John C. Coffee, *Gatekeepers : The Professions and Corporate Governance* (Oxford University Press, New York 2006), p. 146.

⁵² Stephen A. Zeff, 'How the U.S. Accounting Profession Got Where It Is Today: Part 1' (2003) 17(3) *Accounting Horizons* 189, p. 194.

⁵³ Zeff (n 52) p. 194.

⁵⁴ Auditing Practices Board, *The Audit Agenda* (Auditing Practices Board, London 1994), p. 3.

⁵⁵ The accounting professions both in the UK and US claim to adhere to these values, available via <http://www.aicpa.org/ABOUT/MISSIONANDHISTORY/Pages/MissionHistory.aspx> accessed 25 January 2015, <http://www.icaew.com/en/about-icaew/who-we-are/our-business-values-and-standards-of->

the 'Big Five' worldwide oligopoly. At the same time the dialogue of the profession over the accounting standards, which was so vivid in the 1960s, had declined in the 1980s largely due to the increasing business focus of the profession.⁵⁶ All of the big accounting firms aimed at being business firms more than professional accountants. In the mid-1980s, chief executive of Deloitte, Michael Cook, defined the goal of his company 'to change Deloitte's self-image from that of a professional firm that happened to be in business... to a business that happened to market professional services'.⁵⁷

The drive towards profitability and growth put extra pressure on partners to generate more income by securing new clients. This was getting increasingly hard due to the saturation of the audit market. According to Coffee, firms began to compete with each other based on the 'low-balling' strategy, under which they were setting audit fees below cost during the initial audit engagements.⁵⁸ It operated effectively as a marketing practice, which enabled the accounting firms to access the companies in order to sell other services.⁵⁹ Moreover, major audit firms were rewarding senior personnel for completing audits in as short time as possible. Senior personnel then pressurised junior staff, who sometimes engaged in falsifying audit schedules in order to deliver audits on time.⁶⁰ Low cost audit became the audit of low quality. The profession's traditional function, auditing, became a 'loss-leader' and the pressure was shifted onto audit partners to cross-sell consulting services.⁶¹ Cross-selling became a main tactic for increased revenue and the most

[behaviour](#) accessed 25 January 2015. On accountants as part of 'the system of professions' see Andrew Delano Abbott, *The System of Professions: An Essay on the Division of Expert Labor* (University of Chicago Press, Chicago 1988), p. 26.

⁵⁶ Zeff (n 52) p. 200.

⁵⁷ Stephen A. Zeff, 'How the U.S. Accounting Profession Got Where It Is Today: Part 2' (2003) 17(4) *Accounting Horizons* 267, p. 271.

⁵⁸ Coffee (n 51) p.151.

⁵⁹ Lee Berton, 'Audit Fees Fall as CPA Firms Jockey for Bids', *Wall Street Journal*, 28 January 1985, p. 33.

⁶⁰ C. Willet and M. Page, 'A Survey of Time Budget Pressure and Irregular Auditing Practices Amongst Newly Qualified UK Chartered Accountants' (1996) 28(2) *British Accounting Review* 101, p. 105.

⁶¹ Berton (n 59) p. 33.

significant criteria in evaluation of the audit partners' contribution to the firm. Not meeting the 'income targets' frequently resulted in forced resignations, thereby ending the old norm of 'partnership for life'.⁶² Furthermore, some of the accounting firms compensated their audit partners with incentive fees or bonuses dependent on the amount of consulting services they cross-sold.⁶³ After the collapse of Enron in 2001, the SEC expressed its strong view that 'such incentives programs ... are inconsistent with the independence and objectivity of external auditors that is necessary for them to maintain, both in fact and appearance.'⁶⁴ As a result of that, the accounting firms' culture changed. Arthur Wyatt, once a Financial Accounting Standards Board (FASB) member and a senior partner at Arthur Andersen, noted that 'primarily commercial interests had undermined the core values of the professional firm'.⁶⁵

The drive towards profitability associated with the increasing provision of consulting services meant that client service had become more important than accounting and stewardship. Pleasing client was put higher in a value hierarchy than a public accounting firm's central responsibility to protect the public interest.⁶⁶ According to William R. Gregory, the Board Chairman of the American Institute of Certified Public Accountants (AICPA):

The effects of the phenomenal growth in the profession and competitive pressures have created in some CPAs attitudes that are intensely commercial and nearly devoid of the high-principled conduct that we have come to expect of a true professional. It is sad that we seem to have become a breed of highly skilled technicians and businessmen, but have subordinated courtesy, mutual respect, self-

⁶² Zeff (n 57) p. 271.

⁶³ Coffee (n 41) p. 151.

⁶⁴ Securities Act Release No.33-8154, 'Strengthening the Commission's Requirements Regarding Auditor Independence', 2 December 2002, pp. 95-96

⁶⁵ Wyatt (n 40) p. 50.

⁶⁶ Susan E. Squires, *Inside Arthur Andersen: Shifting Values, Unexpected Consequences* (FT Prentice Hall, Upper Saddle River, NJ 2003), p. 63.

restraint, and fairness for a quest for firm growth and a preoccupation with the bottom line.⁶⁷

As the firms were more closely involved with their clients through providing consulting services, and thought of themselves more as consultants that happened to do audits, they continued to reward sales and marketing over stewardship and professionalism.⁶⁸ Consulting revenues more than doubled from 1990 to 1999 and the accounting firms were subject to the countervailing pressures, a conflict between client sales and protecting the public.⁶⁹ This was no longer an environment where the auditors could oppose questionable accounting and disclosure treatments. Despite the major accounting scandals of 2002 and the subsequent regulatory reforms, the problem of auditors' independence remains unresolved and accounting firms continue violating the independence rules.⁷⁰

To conclude, the evidence shows that the rapid expansion of accounting firms blurred the traditional boundaries between a client relationship and a public obligation. Public accounting firms blended into consulting firms through hiring and training information specialists, cross-selling and compensation practices.⁷¹ The traditional hallmarks of the profession and the duty to protect the public had been gradually eroded and substituted by the business aims of increasing profit and worldwide reach.

⁶⁷ Zeff (n 57) p. 267.

⁶⁸ Mark Stevens, *The Big Six: The Selling out of America's Top Accounting Firms* (Simon & Schuster 1991), p. 26.

⁶⁹ John C. Coffee, 'What Caused Enron? A Capsule Social and Economic History of the 1990s' (2004) 89(2) *Cornell Law Review* 269, p. 291.

⁷⁰ On 24th January 2014 the SEC charged the public accounting firm KPMG with violating independence rules by providing prohibited non-audit services such as bookkeeping and expert services to the affiliates of companies whose books they were auditing. Also some of the KPMG staff owned stock in companies that were KPMG clients, which constituted a further violation of the independence rules, available via <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540667080> accessed 10 February 2016.

⁷¹ Wanda A. Wallace, 'The Economic Role of the Audit in Free and Regulated Markets: A Look Back and a Look Forward' (2004) 17 *Research in Accounting Regulation* 267, p. 268.

This thesis argues that the cultural change that occurred within the accounting profession and the repeated breaches of auditors' independence rules call for a fundamental reconsideration of the current audit model. Auditors should not be allowed to offer consulting services to management, as this impairs the appearance of independence and siphons their efforts away from protecting the public. This thesis suggests in chapter six a new regime under which auditors are banned from providing consulting services to their audit clients.

The issue of compromised independence and the excessive provision of the consulting services is only one of the problems in the current audit arrangement. Another issue is the decline in deterrence. In the past few decades, the legal threat facing auditors for their involvement in audit failure declined dramatically.⁷² Auditors, less deterred by the threat of private litigation, could more easily get involved in managerial attempts to inflate the results. The following section will discuss the regulatory changes that led to the decline in expected liability costs for auditors, which left the auditors undeterred and more willing to acquiesce to the managers' demands.

1.4. THE DECLINE IN DETERRENCE

This section looks at the judicial and regulatory changes in the expected liability costs that faced auditors who were considering whether or not to submit to the risky accounting practices favoured by managers. It examines judicial changes in tort rules governing third party claims, which restrict the liability of auditors for negligent misstatements. It also analyses the provisions allowing for the introduction of the proportionate liability and the limited liability partnership structure. This section argues that these considerable privileges diminished the deterrent function of regulation and litigation and left the

⁷² Coffee (n 51) p. 55.

accounting profession largely unaccountable. This in turn created an environment where auditors were more inclined to engage in risky accounting practices rather than focus on the quality of the audit.

Accountants have suffered from numerous liability crises, which at times threatened to overwhelm the entire profession. Nineteenth century accounting practitioners in Britain were faced with legal difficulties and a confidence crisis bearing remarkable similarities to the one of the 1990s. The 1890s saw the start of negligence suits against professional auditors. These included famous auditors of the time, such as F.W. Pixley in Woodhouse Rawson United or William Barclay Peat in the Millwall Dock case.⁷³ This litigation trend persisted even after the professional class of auditors had gained the monopolistic position over corporate audits. This regularly raised doubts over the value of audit, and the standards of the profession's most competent individuals who had been questioned by the courts.⁷⁴

Numerous auditing scandals of the 1960s, 1970s and the beginning of the 1980s such as the Continental Vending Machines, National Student Marketing Corporation, Equity Funding Corporation and The Four Seasons Nursing Homes increased litigation for auditors in the US. In the UK, scandals at London and County Securities Bank and Johnson Matthey Bankers called into question the auditors' responsibilities and increased their legal exposure.⁷⁵ A liability wave had its peak in the 1980s and early 1990s, and then decreased rapidly during the 1990s.⁷⁶ Most of the scandals followed a similar pattern; management in each firm used a unique set of methods of creative accounting or fraud in

⁷³ Roy Chandler, 'Judicial Views on Auditing from the Nineteenth Century' (1997) 2(1) Accounting History 61, pp. 70 - 71.

⁷⁴ Chandler (n 73) p. 75.

⁷⁵ In the US the litigation outbreak could partially be explained by the amendment of the Federal Rules of Civil Procedure in the late 1960s, which allowed the aggregation of small or negative value class actions.

⁷⁶ Coffee (n 51) p.153.

order to cover up poor performance, to preserve the company's stock price, and to further personal benefit. There was often an involvement of a charismatic and 'overstrong' individual who succeeded to convince the business community that everything was fine, even though it was not. On top of that, there was always a failure of either internal control system or external auditor.⁷⁷

During the four year period ending in 1984, Arthur Andersen alone paid over \$137 million in private lawsuit settlements.⁷⁸ A study conducted in 1984 estimated that 'more lawsuits had been filed against accountants in the last decade-and-a-half than in the entire history of the profession.'⁷⁹ By 1994, the accounting profession settled fifty class actions for \$482 million.⁸⁰ In the UK, there were only three outstanding claims against auditors in 1983, ten years later that number had increased to over 600.⁸¹ Many of these cases turned out to be the biggest accounting failures in the UK. These included the audits of Barlow Clowes by Spicer & Pegler, Polly Peck by Stoy Hayward, BCCI by Price Waterhouse and Ernst & Whinney, and Maxwell's Mirror Group Newspapers by Coopers & Lybrand.⁸²

Litigation expenses represented a big part of the cost of doing business and there was a significant risk of an accounting firm going bankrupt in case of an adverse judgement. That was a risk that the profession could not control. The accounting profession argued that big damages awarded against one of the larger accounting firms could actually contribute to its bankruptcy and the further concentration of the audit market. The profession used a variety of arguments to justify the need to reduce its liability exposure.

⁷⁷ Michael J. Jones, *Creative Accounting, Fraud and International Accounting Scandals* (John Wiley & Sons, Chichester 2011), p. 520.

⁷⁸ Coffee (n 51) p.153.

⁷⁹ Coffee (n 51) p.153.

⁸⁰ Coffee (n 51) p.153.

⁸¹ Chandler and Edwards (n 39) p. 6.

⁸² Chandler and Edwards (n 39) p. 6.

First, the potential difficulty in recruiting and retaining business students.⁸³ Second, new and risky businesses could struggle to obtain audit services.⁸⁴ Third, the profession could be forced to reduce the type of audit services available. Fourth, the auditor might not be able to obtain sufficient insurance.⁸⁵ The profession presented the need to reduce their liability exposure as a matter of public welfare with consequences for the capital markets and employment.⁸⁶ The increased level of litigation, however, did not act as a spur to promote better quality audits. Instead, it encouraged the accounting profession to lobby extensively for the passage of various regulatory changes, which did ease their litigation pressure.

One of the regulatory arrangements, which the auditors welcomed, was the judicial change to tort rules governing third party claims. Over many decades the courts struggled to find a balance between the two dominant views – one arguing for the narrow scope of liability based on the contractual nature of audit, and the other arguing for broader liability centred on the foreseeability of harm to third parties from a negligently performed audit.⁸⁷ In the US, public accountants may incur liability based on the federal securities laws, or on state law theories of negligence, misrepresentation and fraud.⁸⁸ Even though the configuration of these rules varies from state to state, courts have increasingly rejected expansive liability rules in favour of a more balanced approach in most of the states. This is based on the Restatement of Torts approach, according to which third parties are able to sue a negligent auditor if they belong to the group of foreseen individuals whom the

⁸³ Duncan L. Green, 'Litigation Risk for Auditors and the Risk Society' (1999) 10(3) *Critical Perspectives on Accounting* 339, p. 339.

⁸⁴ Carl Pacini, William Hillison, Ratnam Alagiah, Sally Gunz, 'Commonwealth Convergence toward a Narrower Scope of Auditor Liability to Third Parties for Negligent Misstatements' (2002) 38(3) *Abacus* 425, p. 427.

⁸⁵ Pacini (n 84) p. 427.

⁸⁶ Green (n 83) p. 340.

⁸⁷ John A. Siliciano, 'Trends in Independent Auditor Liability: The Emergence of a Sane Consensus?' (1997) 16(4) *Journal of Accounting and Public Policy* 339, p.339.

⁸⁸ Abraham J. Briloff, 'The Private Securities Litigation Reform from a Critical Accountant's Perspective' *Critical Perspectives on Accounting* (1999) 10(3) 267, p. 276.

public accountant would expect to rely on audit. In the UK, the House of Lords in the *Caparo Industries v Dickman* [1990]⁸⁹ decision also retreated from expansive liability rules and adopted an approach favourable to auditors. In accordance with this decision, auditors owe their duty of care only to their clients and as a general rule this duty will not extend to third parties relying on the audited financial statements. The issue of litigation against accountants for negligent audits is analysed in detail in chapter four.

The contraction of auditors' liability towards third parties is consistent with other arrangements the accounting profession had lobbied for. A further change that diluted the deterrent effect of auditor liability was an introduction of proportionate liability in 1995 in the US and its UK counterpart in 2008.⁹⁰ For many decades due to their joint and several liability, auditors were usually sued alongside other co-defendants irrespectively of the level of their culpability. At the time of the trial other co-defendants were most often bankrupt, so auditors were left to pay the whole amount.⁹¹ This phenomenon was often referred to as a 'deep pockets syndrome'⁹², which implied that auditors were sued, not because of their fault or negligence, but because of their wealth.⁹³ In the US, this change came with the passage of the Private Securities Litigation Reform Act (PSLRA) in 1995. The Act was designed to thwart frivolous securities class action lawsuits brought

⁸⁹ *Caparo Industries v Dickman and others* [1990] 1 All ER 568, AC 605.

⁹⁰ Jim Cousins, Austin Mitchell, and Prem Sikka, 'Auditor Liability: The Other Side of the Debate' (1999) 10(3) *Critical Perspectives on Accounting* 283, pp. 283 - 85.

⁹¹ Ronald R. King and Rachel Schwartz, *The Private Securities Litigation Reform Act of 1995: A Discussion of Three Provisions* (1997) 11(1) *Accounting Horizons* 92, p. 94.

⁹² 'Deep pockets syndrome' refers to a situation where an injured party files a suit against anyone with the greatest wealth, when there is more than one potential defendant. Accounting firms were usually sued by the shareholders who lost money when the companies went bankrupt, as they were the only ones left with capital from whom the shareholders could potentially receive the compensation. This obviously led to increased litigation against the auditors and many meritless suits. The profession lobbied for the change of the joint and several liability to the proportionate one, under which they could only be held liable for losses arising from their own negligence. This was finally granted by the Private Securities Litigation Reform Act 1995 in the US and the Companies Act 2006 in the UK in the form of Limited Liability Agreements.

⁹³ Some argue that the US plaintiff attorneys contributed significantly to the crisis by filing suits quickly after the price of securities dropped without even investigating the violation of the securities laws. The cost of going to trial was at times higher than the cost of settling. This provided the incentives to settle irrespectively of the merit of the case, in Cousins (n 90) p. 283.

under federal securities laws against companies whose stock performed below expectations.⁹⁴ It improved the accountants' situation by introducing proportionate liability, enabling the sued accountant to be liable only for a percentage of the whole amount.⁹⁵

The available data suggest that the class actions against secondary defendants such as accountants or lawyers declined in the second half of the 1990s. In 1996 the SEC conducted a study, which revealed that out of 105 securities class actions, accounting firms were named in only six cases.⁹⁶ From 1990 to 1992 the relevant numbers were 192, 172 and 144 respectively.⁹⁷ This decline was attributable not only to the PSLRA, but also to several Supreme Court decisions, most notably the *Central Bank of Denver v First Interstate Bank of Denver* [1994]⁹⁸, which eliminated 'aiding and abetting' liability for private actions under section 10(b) of the Securities and Exchange Act. Lawsuits filed under this section followed a similar pattern. At first, investors filed civil actions against the bankrupt corporations for violations of section 10 (b) of the SEA and rule 10b-5 of the SEC, claiming the companies' officers were fraudulent in preparing financial statements. Following this, investors accused accountants, brokers and attorneys - 'deep pocket' constituencies - alleging that they aided and abetted fraud against them.⁹⁹ The Central Bank decision eliminated the right of an individual to pursue a corporate

⁹⁴ Mike Brewster, *Unaccountable: How the Accounting Profession Forfeited a Public Trust* (J.Wiley, Hoboken, N.J 2003), p. 186.

⁹⁵ As the PSLRA is applicable exclusively to lawsuits brought in federal courts, many lawyers have decided to take their cases to state courts. This loophole was closed by the Securities Litigation Uniform Standards Act 1998, which forces potential plaintiffs to adhere to the spirit and letter of the PSLRA, in Green (n 83) p. 921.

⁹⁶ Coffee (n 51) p. 155.

⁹⁷ Coffee (n 51) p. 155.

⁹⁸ *Central Bank of Denver V First Interstate Bank of Denver*, 511 US 164 (1994).

⁹⁹ Timothy Metzger, 'Abandoning Accountants' Liability for Aiding and Abetting 10b-5 Securities Fraud' (1992-1993) 87(4) Northwestern University Law Review 1374, p. 1375.

gatekeeper on an aiding and abetting claim and at the same time deprived the investors of recourse at times when gatekeepers failed to deter fraud.¹⁰⁰

In the UK, proportionate liability is not explicitly envisaged in the Companies Act 2006. The Act, however, allows contractual liability limitation agreements, which purport to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust, occurring in the course of the audit of accounts, of which the auditor may be guilty in relation to the company.¹⁰¹ It seems that contractual restrictions of liability to the proportionate share of the auditor's loss are a viable form of the liability limitation agreements.¹⁰²

Another concession granted to the accounting profession, which further eroded the regulatory deterrence function, has been the introduction of the Limited Liability Partnerships (LLP), which gave accounting firm partners considerable protection from negligence lawsuits. The LLPs emerged in the US in the early 1990s. At first only two US states allowed the LLP form. By the mid-1990s LLPs were available in most states. All of the major accounting firms have adopted the LLPs structure. In the UK, the accounting profession had lobbied the national government to introduce the LLP legislation in the early 1990s, at approximately the time when Ernst & Young and Price Waterhouse worked on the law on the LLPs for Jersey in the Channel Islands.¹⁰³ Initially,

¹⁰⁰ The court did not protect the gatekeepers from all liability. Gatekeepers can still be liable if their conduct is sufficiently pro-active, so that they could be characterized as primary violators, in Ross D. Fierman, 'The Role of Auditor Culpability in Naming Auditor Defendants in United States Securities Class Actions' (1999) 10(3) *Critical Perspectives on Accounting* 315, p.321.

¹⁰¹ Companies Act 2006, Part 16, s.534

¹⁰² Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* (8 edn, Sweet & Maxwell, London 2008), p. 796.

¹⁰³ Prem Sikka, 'Globalization and Its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey' (2008) 21(3) *Accounting, Auditing and Accountability* 398, p. 414.

the Law Commission declined to pursue this issue, but since April 2001, UK accounting firms have been permitted to operate as LLPs.¹⁰⁴

The LLP gives partners an advantage of limited personal liability. In traditional partnership structures partners are jointly and severally liable for the professional negligence and malfeasance of other partners.¹⁰⁵ This induces partners to monitor each other. In limited liability partnerships members who are not actively involved in the management are shielded from liability.¹⁰⁶ This creates a situation, where partners lack the incentives to watch other partners work. If partners face the financial pressure to hold on to their clients and there is no one to supervise and monitor their work, there is a danger that audits can become less reliable.¹⁰⁷

There is little doubt that there has been a significant increase in the size and number of claims brought against audit firms over the past 40 years. The profession has argued that the regulatory changes limiting their liability were essential to prevent another Arthur Andersen-like failure. They also claimed the protection offered by the availability of insurance has significant gaps and does not outweigh the risks of one of the big companies going bust, which would cause even further concentration of the audit market.¹⁰⁸ A study conducted by Andrew Likierman on behalf of the DTI in 1989 concluded that larger accounting firms were finding it problematic to obtain the cover they needed and

¹⁰⁴ Judith Freedman, 'Limited Liability Partnerships in the United Kingdom - Do They Have a Role for Small Firms' (2001) 26(4) *Journal of Corporation Law* 897, p. 905.

¹⁰⁵ The UK legislation on LLP leaves a lot of uncertainty on the question of liability. There is for example no clear statement that the existence of the LLP was not intended to remove liability from negligent or wrongdoing partners. This matter was entirely left to the courts. The reason behind that was that the government wanted the tort law to evolve naturally in the same way for the LLPs as for the companies. For detailed analysis of the partners liability see *ibid*, pp. 910 -11.

¹⁰⁶ Jonathan Macey and Hillary Sale, 'Observations on the Role of Commodification, Independence and Governance in the Accounting Industry' (2003) 48 *Villanova Law Review* 1167, p.1170

¹⁰⁷ Mark Klock, 'Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?' (2002-2003) 28 *Journal of Corporation Law* 69, p. 102.

¹⁰⁸ Professional indemnity insurance is compulsory for licensed accountants seeking to pass certain thresholds conditions set by the regulator.

consequently were under pressure to pull back from more-risky engagements.¹⁰⁹ It became even worse with time. For example in 1993, the maximum cover available for the auditing firms was approximately \$105 million. Such limitations covers were insufficient, with the three largest claims averaging \$340 million that year. Today, claims go well beyond these sums, with a notable example of Equitable Life's £2.6 billion claim against Ernst & Young.¹¹⁰ These types of risks make the Big Four uninsurable and hence the profession's case for lobbying for regulatory concessions is not unreasonable.

It is difficult to strike the right balance between having regulation in place, which would deter auditors from acquiescing to managers' demands, and the profession, which still persists in lobbying in favour of more regulatory protection.¹¹¹ The model suggested in chapter six asserts that the ultimate focus should be on delivering audits of the highest quality. To that end, under the proposed regime, the profession should be able to benefit from the current regulatory protection, but only at the cost of substantial reorganisation. The new model suggests creating an independent agency responsible for appointment and remuneration of auditors. It also recommends imposing a ban on the simultaneous provision of audit and consulting services by the auditors. This arrangement would eliminate conflicts of interest inherent in the current audit model, restore auditors' independence and enhance the quality of audits.

The following section will analyse the move towards short-termism and the excessive focus on quarterly earnings and short-term incentive bonuses, which has had a significant

¹⁰⁹ Andrew Likierman, *Professional Indemnity: Report of the Study Teams* (HMSO: London 1989).

¹¹⁰ Lee Roach, 'Auditor Liability: The Case for Limitation: Part 1' (2010) 31(5) *Company Lawyer* 136, p. 137.

¹¹¹ When a draft regulation suggested the possibility of a ban on consulting provisions and limitation on audit relationships to five years, the accounting profession began their extensive lobbying against the proposal. It turned out to be successful, as the profession is now allowed to carry on with the consulting work and the tender period was extended to ten years, in Michael Skapinker, 'Auditors Escape Attempts to Tame Them', *The Financial Times*, 19 February 2014, available via <http://www.ft.com/cms/s/0/7c5cdab8-97d5-11e3-ab60-00144feab7de.html#axzz32BQddivF> accessed 19 February 2016.

impact on the quality of audits and the auditing industry. It will show that as management insisted on favourable accounting treatments in order to inflate earnings, the auditors found it increasingly hard to resist these pressures and remain independent. This further builds on this thesis' proposition that compromised independence of auditors remains one of the biggest flaws of the current audit model.

1.5. THE MOVE TOWARDS SHORT-TERMISM AND ITS EFFECT ON AUDIT PROFESSION

The aim of this section is to analyse the increasing trend towards short-termism, which has had significant implications for the capital markets and for the auditing industry. Short-termism is described as 'the excessive focus of ... managers, investors and analysts on short-term quarterly earnings and lack of attention to strategy, fundamentals and conventional approaches to long term value creation'.¹¹² This section focuses on the main drivers behind this trend, such as the enhanced public disclosure of the accounts and annual reports of companies and the growing use of equity compensation which induced management to focus over the day-to-day share price.¹¹³ These had a negative influence on the auditing profession, which frequently acquiesced to management pressures to allow earnings management, which led to the production of low quality audits. The links between short-termism and poor quality audits are then explored further in the subsequent sections, which go on to discuss the Enron scandal and the financial crisis.

¹¹² Dean Krehmeyer, Matthew Orsagh, and Kurt N. Schacht, 'Breaking the Short Term Cycle' Business Roundtable Institute for Corporate Ethics, 24 July 2006, available via <http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf> p.3, accessed 19 February 2016.

¹¹³ Coffee (n 69) p. 276.

Much concern has been expressed about the short-term perspective of the capital markets, investment and corporate managers.¹¹⁴ The reason behind this is that:

obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance.¹¹⁵

CEOs have been encouraged to pursue short-term objectives instead of long-term fundamental value¹¹⁶ and short-termism has become closely associated with agency theory and achieving high stock price.¹¹⁷

There are considerable drawbacks of keeping the share price high. These include managerial efforts to manipulate the share price using strategies such as ‘earnings management’ both as an offensive and defensive strategy.¹¹⁸ These practices harm not only the reputation of, and confidence in, securities markets, but also the long term financial stability of corporations. According to Sappideen, short-termism contributes to excessive risk taking and that risk is being shifted from managers to shareholders, then to debt holders and then in turn from subordinated to senior debt holders.¹¹⁹ The financial crisis in 2008 has shown that excessive risk taking can lead to systemic failure of many

¹¹⁴ Martin Lipton was one of the first lawyers to raise concerns about the negative effects of short-termism, in Martin Lipton, 'Takeover Bids in the Target Boardroom' (1979) 35(1) *Business Lawyer* 101. More recent studies are presented by the Business Roundtable in the US in Krehmeyer (n 112) and Discussion Paper released by the Department of Business, Innovation and Skills in the UK, see Department for Business, Innovation and Skills 'Discussion Paper, Urn 10/1225. A Long Term Focus for Corporate Britain' October 2010, available via <<http://www.bis.gov.uk/assets/biscore/businesslaw/docs/l/10-1225-long-term-focus-corporate-britain>>, accessed 18 February 2016.

¹¹⁵ Krehmeyer (n 112) p. 1.

¹¹⁶ Patrick Bolton, Jose Scheinkman, and Wei Xiong, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (2006) 73(3) *Review of Economic Studies* 577, p. 577.

¹¹⁷ Razeen Sappideen, 'Focusing on Corporate Short - Termism' (2011) *Singapore Journal of Legal Studies* 412, p. 428.

¹¹⁸ High share price is used as a defensive strategy in order to prevent the corporate raiders and secure long office tenures; as an offensive strategy it is used to secure higher remuneration packages, in *ibid*.

¹¹⁹ Sappideen (n 117) p. 423.

institutions, and can also have a negative impact on corporations, markets and society in general.

As a consequence of this, the share price has become a surrogate for corporate performance and in this sense corporate governance has undergone a paradigm shift.¹²⁰ Instead of having boards at the top and managers carrying out their directives with the shareholders assessing the response of the marketplace and determining share price, it has become the share price driving the agenda of the board, managers and shareholders. Instead of the board deciding what is good for the company in the long run, based on accounting notions of earnings and provisions for the future, the focus has been shifted to share prices based on cash-flow estimates, with a permanent drive to increase them.¹²¹

One of the main drivers of short-termism has been the increasing demand on listed companies for information.¹²² More information, transparency and disclosure have been an instinctive response to a wide range of corporate governance problems.¹²³ Some commentators explain the need for increased disclosure on efficiency grounds, claiming that disclosure is helping market participants to determine stock prices that accurately reflect all available information.¹²⁴ Others base their explanation for mandatory disclosure in the agency cost theory, which will be discussed in chapter two, contending that the principal purpose of disclosure is to address agency problems that arise between managers and shareholders. Disclosure can help reduce the cost of monitoring managers'

¹²⁰ Coffee (n 69) p. 275.

¹²¹ Sappideen (n 117) p. 428.

¹²² Lynne L. Dallas, 'Short-Termism, the Financial Crisis and Corporate Governance' (2011-2012) 37(2) *Journal of Corporation Law* 265, p. 324.

¹²³ Paul G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62(3) *The University of Chicago Law Review* 1047, p. 1048.

¹²⁴ John C. Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70(4) *Virginia Law Review* 717; Frank H. Easterbrook and Daniel R. Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70(4) *Virginia Law Review* 669; Gregg A. Jarrell, 'The Economic Effects of Federal Regulation of the Market for New Security Issues' (1981) 24(3) *Journal of Law and Economics* 613.

use of corporate assets for self-interested aims.¹²⁵ The agency cost theory also proposes that information asymmetry can be overcome if markets are provided with frequent, widely available, consistent and comparable information. This view has contributed significantly to a market emphasis on quarterly disclosure.¹²⁶

According to the Kay Review, however, much of the information provided is simply ‘a noise’ and is insignificant in assessing the financial condition of the companies.¹²⁷ For companies with long-term investment plans, such as those in the oil, mining, utilities or pharmaceutical industry, profitability can only be measured over a period of many years. Construction enterprises can only be assessed over a complete economic cycle and, as the recent financial crisis revealed, the same is true of the financial sector. For these types of businesses, interim assessments are important, but they should be delivered in qualitative and subjective form. Quarterly earnings in their current shape are unreliable, as they are dominated by random fluctuations and frequently managed.¹²⁸

The fact that ‘quarterly capitalism’ leads to short-termism has been widely recognised.¹²⁹ In order to minimize the negative effects of short-termism, some US companies, such as AT&T, Coke, and MacDonalDs, have decided not to disclose their quarterly results.¹³⁰ Changes made to the EU Transparency Directive¹³¹ in November 2013 abolished the

¹²⁵ Mahoney (n 123) p. 1050.

¹²⁶ John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making: Interim Report' BIS URN 12/917 February 2012, p. 10; Mei Cheng, K.R. Subramanyam, and Yuan Zhang, 'Earnings Guidance and Managerial Myopia' (2005) available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=851545> accessed 15 September 2015.

¹²⁷ Kay (n 126) p. 73.

¹²⁸ Kay (n 126) p. 73.

¹²⁹ Will Hutton, ‘‘Quarterly Capitalism’ is Short-term, Myopic, Greedy and Dysfunctional’, *The Guardian*, 26 July 2015.

¹³⁰ Alan Dignam, 'Remuneration and Riots: Rethinking Corporate Governance Reform in the Age of Entitlement' (2013) 66 (1) *Current Legal Problems* 401, p. 422.

¹³¹ Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive

requirement for companies with shares admitted to trading on a regulated market in the EU to publish quarterly interim management statements (IMS), although issuers may continue to publish this information if they so choose. The European Commission, while amending the Transparency Directive, described the obligation to prepare IMSs as a ‘burden for many small and medium-sized issuers... without being necessary for investor protection’.¹³² This approach was welcomed by the Department for Business, Innovation and Skills, which observed that quarterly reporting requirements produce an excessive focus on short-term results. Also the Kay Review recommended the removal of quarterly reporting obligation and suggested a move towards non-financial, narrative reporting, which can ‘put the financial results in the context, highlight important factors and communicate strategy and risks to investors in an understandable, engaging and concise format’.¹³³

Short-termism has also been exacerbated by the increasing use of equity compensation. The rationale behind the use of equity incentive is to make changes to executive wealth directly dependant on the changes in stock price, hence giving executives incentives to maximize shareholder wealth. No incentives would be necessary if shareholders could constantly watch the firm’s opportunities and executives’ actions, in order to make sure that executives always serve shareholders’ interests.¹³⁴ As the shareholders cannot always see all the opportunities, they must delegate the decision-making to the executives, who should have superior knowledge regarding these decisions. In order to keep the executives motivated to act in the best interest of the shareholders, their compensation would usually be linked to the firm’s performance. This is a direct effect of the agency problem. Jensen,

2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.

¹³² Ibid. (n 131).

¹³³ Kay (n 126) p. 74.

¹³⁴ Stephen G. Ryan, 'Accounting in and for the Subprime Crisis' (2008) 83(6) *The Accounting Review* 1605, p.1628.

in his analysis of the agency theory and its corollary executive compensation, observed that what mattered was not how much executives are paid, but how they are paid.¹³⁵

The 1990s was a decade when executive compensation shifted from being primarily cash-based to being mostly stock-based.¹³⁶ At the start of the 1990s in the US, equity-based compensation for chief executives of the US public companies amounted to approximately 5 per cent of their total annual compensation; however, by 1999 this amount had risen to 60 per cent.¹³⁷ Alongside this change, management became increasingly focused on the performance of the company's stock over the short-term. The use of equity compensation was facilitated by legal changes. Before 1991, an executive of a public company exercising a stock option was required to hold an underlying security for six months in order to comply with the holding requirements stemming from Section 16(b) of the Securities Exchange Act of 1934. In 1991, the SEC revised this rule and deregulated it. As a result of this, executives could tack the holding period of the stock option to the holding period of the underlying shares. Hence, as Coffee explains:

if the stock option had already been held for six months or longer, the underlying shares could be sold immediately on exercise of the option. Because qualified stock options usually must be held several years before they become exercisable, this revision meant that most senior executives were free to sell the underlying stock on the same day they exercised the option.¹³⁸

Even though it was not the intention of this regulation, it became a regular pattern for the executives with vested options to exercise them and to sell in a single day.

¹³⁵ Kevin J. Murphy and Michael C. Jensen, 'Performance Pay and Top Management Incentives' (1990) 98(2) *Journal of Political Economy* 225, p. 225.

¹³⁶ Conyon Martin and Kevin Murphy, 'The Prince and the Pauper? CEO Pay in the United States and United Kingdom' (2000) 110 (467) *The Economic Journal* 640, p. 644.

¹³⁷ Ryan (n 134) p.1609.

¹³⁸ Coffee (n 69) p. 279.

Also in the UK, the rate of option grants grew dramatically from the mid-1980s to the early 1990s. According to Murphy, only 10 per cent of companies offered options to their senior executives in 1978. This number rose to 30 per cent by 1983 and by 1986 almost 100 per cent of companies offered options.¹³⁹ In the mid-1990s, however, this trend was reversed and the use of share options fell substantially as a result of corporate governance reforms. In 1997 only 68 per cent of companies offered options to their executives.¹⁴⁰ While CEO cash compensation was growing at the same pace in both of the countries, share options use in the UK began to decline.¹⁴¹ There are various political and economic factors that offer potential explanation for these cross-country differences.

Exercising options in the UK became controversial in the first half of the 1990s, when some executives in newly privatised utilities exercised options worth millions of pounds.¹⁴² This caused a widespread concern about remuneration accountability, not only in the privatised industries, but also in other listed companies, particularly as members of the public were encouraged to invest in these companies through taxation incentives.¹⁴³ In 1995, building on the Cadbury recommendations, the Greenbury Report was published with a remit to identify good practice in determining directors' remuneration.¹⁴⁴ Despite its failure to curb the overall increase in the executive compensation in the following years, the Greenbury Report was influential, as it encouraged companies to use Long Term Incentive Schemes (LTIS) rather than option plans.¹⁴⁵ As a response to the

¹³⁹ Martin (n 136) p. 649.

¹⁴⁰ Martin (n 136) p. 649..

¹⁴¹ It is worth noting that even though CEO remuneration levels in the UK had grown, they remained much lower than in the US. CEOs in the 500 largest UK companies in 1997 earned £330 million, including £74 million from exercising options. This amounted to approximately £660 000 per each CEO. In contrast, the top 500 US CEOs made £3.2 billion, including £2 billion from exercising options. This left an individual CEO with £6.3 million; in *ibid*, p. 640.

¹⁴² Charlotte Villiers, 'Controlling Executive Pay: Institutional Investors or Distributive Justice?' (2010) 10(2) *Journal of Corporate Law Studies* 309, pp. 316-17.

¹⁴³ Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2000-2001) 89(2) *Georgetown Law Journal* 439, pp.450-450.

¹⁴⁴ *Directors' Remuneration, Report of a Study Group chaired by Sir Richard Greenbury*, 17 July 1995.

¹⁴⁵ See (n 144).

Greenbury Report and the controversy surrounding option grants, the government reduced the amount that could be awarded to only £30, 000.¹⁴⁶ Also the non-statutory instruments, such as the codes of conduct of institutional investors and their representatives, played a role in restricting the option grants. Even though not legally binding, policy guidelines from the Association of British Insurers (ABI) and other investor groups were very influential. The ABI guidelines, for instance, effectively restricted the issuing of share options to four times cash compensation.¹⁴⁷

Murphy also tries to attribute the divergence as to the share options practices with reference to the cultural differences between the countries.¹⁴⁸ The United States, as a society, is considered to be more tolerant of income inequality than the UK, in particular if this inequality is caused by differences in talent, effort or risk taking. This phenomenon is not limited only to top executives, but extends to other professions such as lawyers, doctors, athletes, engineers etc.¹⁴⁹

Compensation is an important way of dealing with the principal-agent problem. The agency theory compensation strategy assumes that equity-based compensation discourages shirking and induces effort and risk taking, whilst fixed compensation makes managers more conservative and risk averse. Studies show that managerial willingness to take up risky projects, such as acquisitions and divestitures, increases with the levels of CEO stock option holdings and not with their stock ownership.¹⁵⁰ Equity based compensation has also been identified as a strong proxy for predicting aggressive

¹⁴⁶ Martin (n 136) p. 666.

¹⁴⁷ Martin (n 136) p. 666.

¹⁴⁸ Martin (n 136) p. 667.

¹⁴⁹ Sherwin Rosen, 'The Economics of Superstars' (1981) 71(5) *American Economic Review* 845, Robert Frank and Phillip Cook, *Winner-Take-All Society* (Free Press, New York 1995).

¹⁵⁰ W. Sanders, 'Behavioral Responses of CEOs to Stock Ownership and Stock Option Pay' (2001) 44(3) *The Academy of Management Journal* 477; W. Sanders and D. Hambrick, 'Swinging for the Fences: The Effects of CEO Stock Options on Company Risk-Taking and Performance' (2007) 50(5) *The Academy of Management Journal* 1055.

accounting behaviour and the leading factor in manipulating the accruals in order to inflate reported earnings.¹⁵¹

Managers, whose stock and stock option based remuneration has a direct bearing on their total remuneration package, play a significant role in shaping share price through target based budgeting and corporate earnings management. Under target based budgeting systems, managers are remunerated for meeting agreed-upon targets. These targets do not need to be relative to the actions of their competitors and so managers usually have incentives to set targets that can be easily satisfied.¹⁵² Earnings management is undertaken in the form of 'managing accounting earnings (i.e. accruals management through the selective interpretation of accounting regulations), as well as real earnings (i.e. management operating decisions made to achieve desired accounting numbers)'.¹⁵³ Research shows that companies are much more likely to report earnings that precisely match analysts' predictions than report earnings that undershoot or overshoot them.¹⁵⁴

According to Jensen and Murphy:

Just as managers' compensation suffers if they miss their internal targets, CEOs and CFOs know that the capital markets will punish the entire firm if they miss analysts' forecasts by so much as a penny. Generally, the only way for the managers to meet those expectations year in and year out is to cook their numbers to mask the inherent

¹⁵¹ Daniel Cohen, Aiysha Dey, and Thomas Z. Lys, 'Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods' 1 February 2005, SSRN available via <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=658782> accessed 15 September 2015.

¹⁵² Iman Anabtawi, 'Explaining Pay without Performance: The Tournament Alternative' (2005) 54(4) Emory Law Journal 1557, p.1570.; Lisa K. Meulbroek, 'Restoring the Link between the Pay and Performance: Evaluating the Costs of Relative - Performance - Based (Indexed) Options' Harvard Business School Working Paper No. 02 - 021, 2001, available via <<http://www.hbs.edu/research/facpubs/workingpapers/papers2/0102/02-021.pdf>> p. 38, accessed 15 September 2015.

¹⁵³ Sappideen (n 117) p. 417.

¹⁵⁴ Francois Degeorge, Jayendu Patel, and Richard Zeckhauser, 'Earnings Management to Exceed Thresholds' (1999) 72(1) Journal of Business 1.

uncertainty in their businesses. And that cannot be done without sacrificing value... and once on a treadmill, there is no going back...¹⁵⁵

This pressure by investors on managers to meet targets, budgets, market position profitability, and deliver high stock price is then translated into pressure that management exerts on auditors. The US Public Oversight Board's Panel on Audit Effectiveness described the situation as follows:

The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue, or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet 'street' expectations'. Pressures are further magnified because management's compensation often is based in large part on achieving earnings or other financial goals or stock price increases. These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.¹⁵⁶

Auditors in the 1990s were put under a lot of pressure, as management insisted on favourable interpretations of accounting rules in order to inflate their earnings. In this business-dominated climate the big audit firms did not want to lose their main source of income – consulting, so they found it increasingly hard to resist these pressures. As a result of that, accounting scandals rose exponentially. It was estimated that more than half of the accounting lawsuits involved 'premature revenue recognition'.¹⁵⁷

A link between the managers' compensation and the share price created an obvious and potentially perverse incentive for the managers to engage in short-term stock price

¹⁵⁵ Murphy (n 135) pp. 235-36.

¹⁵⁶ 'The Panel on Audit Effectiveness, Report and Recommendations', 31 August 2000, available via <http://www.iasplus.com/en/binary/resource/pobaudit.pdf> accessed 13 February 2016.

¹⁵⁷ Holman Jenkins, 'Accounting for When Dreams Become Reality' in *Wall Street Journal* 13 June 2001.

maximisation through premature revenue recognition or other earnings management techniques. Given these incentives, it became usual practice for management to use lucrative consulting contracts to induce auditors to engage in conduct which assisted their short-term market manipulations.¹⁵⁸ A key advantage of this approach was that the company could suspend the flow of consulting income to an audit firm whenever auditors refused to acquiesce to dubious accounting treatments.

The empirical evidence shows that the provision of consulting services can enhance the auditor's economic bond with a client, thereby increasing the auditor's incentive to acquiesce to client pressure, including pressure to allow earnings management.¹⁵⁹ Imhoff claims that the pressure on auditors providing consulting services to appease management is high. He argues that when ambiguous accounting treatment that might be used to manage performance or mask failure is discovered, auditors seem pressured to accept it, unless it clearly violates GAAP.¹⁶⁰ Frankel finds that firms purchasing non-audit services manage earnings to a greater extent than other firms and so the stronger the economic bond between the audit-consulting firm and its client, the poorer the quality of reported earnings.¹⁶¹

On the contrary, the provision of consulting services can also increase the auditor's investment in reputational capital, which the auditor is not likely to jeopardize to satisfy

¹⁵⁸ Coffee (n 69) p. 298.

¹⁵⁹ Frankel Richard, Marilyn Johnson, and Karen Nelson, 'The Relation between Auditors' Fees for Nonaudit Services and Earnings Management' (2002) 77(4) *The Accounting Review* 71, p. 72; Dan A. Simunic, 'Auditing, Consulting, and Auditor Independence' (1984) 22(2) *Journal of Accounting Research* 679; P.J. Beck, T.J. Frecka, and I. Solomon, 'A Model for the Market for MAS and Audit Services: Knowledge Spillovers and Auditor-Auditee Bonding,' (1988) 7 *Journal of Accounting Literature* 65; J.D. Beeler and J.E. Hunton, 'Contingent Economic Rents: Precursors to Predecisional Distortion of Client Information (2001) Working Paper, University of South Carolina.

¹⁶⁰ Eugene Imhoff, 'Accounting Quality, Auditing, and Corporate Governance' (2003) 17 (Suppl) *Accounting Horizons Supplement* 117, p. 120.

¹⁶¹ Frankel (n159) p. 100.

the demands of any one client.¹⁶² The theory of reputation, however, assumes that there is a significant probability that wrongful behaviour will be discovered and that this discovery will be communicated to the market. As long as this is not the case in practice, the effectiveness of reputation as a deterrent factor will be undermined.¹⁶³ As DeAngelo points out, if the probability of being caught is zero, there are no reputation costs to compromising independence.¹⁶⁴ The issue of reputation capital is further discussed in chapter three.

According to Coffee's 'increased managerial pressure hypothesis' rapid changes in executive compensation made managers far more interested in maximising their companies' short-term share price and seducing their auditors into acquiescence in risky accounting treatments. This, coupled with the decline in regulatory and market deterrents, such as decrease in litigation or disciplinary sanctions, provided the auditors with the incentives to acquiesce in managerial efforts to inflate their corporation's reported results and compromise their independence.¹⁶⁵

Short-termism, caused by the increased disclosure requirements and the rise of equity compensation had a negative impact on the quality of audits and the auditing profession. It was argued in this section that rigid quarterly requirements promoted an excessive focus on short-term results by company management and investors. Moreover, management, whose compensation was significantly dependent on the performance of the company's stock over the short-term, put auditors under pressure to acquiesce to dubious accounting treatments aimed at keeping the share price high. As auditors did not want to lose their

¹⁶² Benito Arrunada, *The Economics of Audit Quality: Private Incentives and the Regulation of Audit and Non-Audit Services* (Kluwer Academic Publishers, Norwell, MA 1999).

¹⁶³ David Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33(3) *Journal of Law and Society* 388, p. 409.

¹⁶⁴ Linda Elisabeth DeAngelo, 'Auditor Size and Audit Quality' (1981) 3(3) *Journal of Accounting and Economics* 183, p. 191.

¹⁶⁵ Coffee (n 51) p. 55.

clients, they frequently engaged in earnings management, which decreased audit quality and led to numerous accounting scandals. Two of them, Enron and WorldCom – the two largest bankruptcies in the US history¹⁶⁶ - were complex financial frauds in which the primary goal was to maximize the company's stock price through various means, such as fabricating earnings, deferring expenses, hiding liabilities and engaging in off-balance sheet transactions.¹⁶⁷ These frauds would not have taken place if it was not for the acquiescence and assistance of the auditors.

The next section provides an examination of the Enron scandal as a case study on the link between short-termism and audit failure. The analysis of the Enron debacle is important for this thesis, as it shows the crisis of the auditing profession, particularly the erosion of auditors' independence and the profession's excessive reliance on consulting income. Lack of auditors' independence is then considered in chapter four as one of the biggest issues facing the auditing profession. The thesis also argues that the reforms introduced in the aftermath of the Enron failure did not go far enough to improve the quality of audits and convert auditors into the trusty allies against rogue management that shareholders needed.

1.6. ENRON

This section offers an analysis of the Enron scandal. Enron is a prominent example of a complex financial fraud in which the primary goal was the short-term maximisation of the company's stock price. It also illustrates an aggressive approach to accounting and an acquiescence of the auditors to the demands of management. The demise of Enron had major implications not only for its auditor, Arthur Andersen, but for the accounting

¹⁶⁶ Coffee (n 51) p.55.

¹⁶⁷ Ibid, p. 15.

profession as a whole. It revealed numerous deficiencies in the current audit model, which remain unfixed despite the regulatory changes adopted in its aftermath.

Enron collapsed after its management disclosed that the company had incurred a \$1.01 billion charge and a \$1.2 billion reduction in its shareholder equity resulting from the off-balance-sheet dealings.¹⁶⁸ At the time of its collapse in December 2001, Enron ranked as the seventh largest company in the US with 20,000 employees and \$100 billion in gross revenues.¹⁶⁹ For six consecutive years it was voted the 'Most Innovative' corporation in America on the Fortune's list of 'Most Admired' corporations and second in 'quality of management' among all the US corporations.¹⁷⁰

Enron started as a gas pipeline company and shifted its activities to energy trading, which was facilitated due to the deregulation of energy markets. As an online energy trading company, it began to offer long-term fixed price contracts for natural gas to utilities companies and other large customers. It subsequently protected itself by hedging the risk using financial derivatives, mainly swaps contracts. Additionally, in order to have a less leveraged balance sheet and the ability to borrow more money, Enron had to get rid of the high cost, low return fixed assets. These assets, such as pipelines or production facilities, however, were either overhauled or otherwise not interesting for key buyers. Enron's solution to this problem was to sell these assets to itself or, more precisely, to its controlled affiliates. This was possible due to an obscure accounting convention that allowed the transfer of these assets off the balance sheet by selling them to the 'unconsolidated affiliates', known as the Special Purpose Entities (SPE)¹⁷¹. The only

¹⁶⁸ Peter Muchlinski, 'Enron and Beyond: Multinational Corporate Groups and the Internationalization of Governance and Disclosure Regimes' (2005) 37(3) Connecticut Law Review 725, p. 726.

¹⁶⁹ Coffee (n 51) p. 18.

¹⁷⁰ Scott Sherman, 'Enron: Uncovering the Uncovered Story' (2002) March-April Columbia Journalism Review 22, p. 22.

¹⁷¹ Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (1st edn, Times Books, New York 2003), p. 310.

condition was that independent financial buyers were to hold a minimum stake of 3 per cent of the affiliate's total debt and equity. This essentially meant that Enron could hold 97 per cent of the ownership in unconsolidated affiliates.¹⁷²

By transferring a production facility or pipeline to an SPE, Enron took an expensive asset off its balance sheet, alongside the equally expensive debt that had financed its acquisition. This allowed Enron to maintain its 'investment grade' credit rating for a considerable period of time. By transferring an asset to an SPE, Enron could nominally keep a slimmed down balance sheet, which allowed it to borrow more at a potentially lower interest rate. It also had informational advantages about the trading circumstances in the relevant market that came from its de facto control of the SPE.¹⁷³ In reality, SPEs had become instruments to hide Enron's losses alongside the source of personal enrichment of Enron's senior managers.¹⁷⁴ When these dubious accounting practices were finally discovered, in October 2001, Enron was forced to disclose that it had overstated its earnings by approximately \$613 million for the period 1996 – 2000. It was also required to restate its 31st December 2000 balance sheet, increasing at the same time its liabilities by \$628 million.¹⁷⁵

Both Enron's outside auditors and its audit committee were familiar, at least broadly, with the dubious 'structured finance' transactions taking place within the company, but neither appears to have expressed any serious concerns before Enron's fall. In order to address the question as to why Arthur Andersen failed to be sufficiently sceptical and detected so

¹⁷² This obscure convention, issued by the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB), was known as opinion 90-15. It was sanctioned in 1991 by the SEC's Office of the Chief Accountant. It later came to be known as '3 per cent rule'. It did not carry the force of law, it was just a guideline, which became an unsteady foundation for trillions of dollars of structured finance, in Partnoy (n 171) p. 311.

¹⁷³ Coffee (n 51) p. 22.

¹⁷⁴ Muchlinski (n 168) p. 726.

¹⁷⁵ Coffee (n 51) p. 23.

little, it is important to notice its transformation from a professional accounting firm to a business-oriented consulting multinational.

At first, Arthur Andersen, under the leadership of its founder and then his successor Leonard Spacek, had a reputation of high integrity. Things began to change when Andersen entered the consulting realm in the mid-1950s with the computerisation of the General Electric plant payroll. By 1984 the revenue from consulting had exceeded the audit revenue. Alongside this development, audit firms, and Arthur Andersen in particular, restructured their business strategies, by making audit the portal of entry into the large clients, through which the firms could market their more lucrative consulting services. The audit partners became salesmen rather than independent auditors, incentivized through compensation schemes that paid just as much for cross-selling as for skill and knowledge at auditing. By 1994 consulting income represented two-thirds of Andersen's revenues.¹⁷⁶

In 2000 Andersen earned \$25 million in audit fees and \$27 million in consulting fees from Enron. This apparent conflict of interest made it impossible for Arthur Andersen to produce a 'truly objective analysis of Enron's accounts'.¹⁷⁷ Enron was simply too a big client for Andersen's Houston office to lose, and survive. This clearly must have contributed to the fact that Andersen condoned Enron's use of questionable accounting and disclosure treatments.

Partial blame for the collapse of Enron should also be placed on its audit committee, which essentially failed to perform its task. The charter of the Enron audit committee 'explicitly require[d] the Committee to ensure the independence of the company's

¹⁷⁶ Flynn McRoberts, 'A Final Accounting: The Fall of Andersen: Greed Tarnished Golden Reputation' *Chicago Tribune*, 1 September 2002, pp. 1, 17.

¹⁷⁷ Muchlinski (n 168) p. 726.

auditors, assess Enron's internal controls and the quality of its financial reporting, and review Enron's financial statements.¹⁷⁸ In the proceedings of the Senate Committee on Governmental Affairs it has been shown that the Enron audit committee repeatedly ignored Andersen's warnings that the accounting practices used were very innovative and that the committee frequently relied on a subjective judgement of management.¹⁷⁹ Additionally, the audit committee did not question the independence of Andersen's auditors, despite being fully aware of the amount of consulting services provided by Andersen to Enron. Furthermore, some of the members of the audit committee had low visibility conflicts of interest.¹⁸⁰ It is now clear that the audit committee failed to see the red flags and respond appropriately to the aforementioned problems.

Additionally, Andersen's monitoring failure was puzzling. Their main competence was to anticipate internal agency problems and to find a solution to minimize the consequent risks through internal monitoring systems. They not only failed to control the internal controlling mechanisms of Enron, but also their own ones. According to Gordon, Arthur Andersen

failed to realize its evolution from a partnership of accounting professionals - certified public accountants, constrained by a strong sense of professional ethics, to

¹⁷⁸ Muchlinski (n 168) p. 729.

¹⁷⁹ Permanent Subcommittee On Investigations of the United States Senate Committee On Governmental Affairs, "The Role of the Board of Directors in Enron Collapse, S.Rep, No.107 - 70' 8 July 2002, available via <<http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT80393/pdf/CPRT-107SPRT80393.pdf>> p. 15, accessed 15 September 2015.

¹⁸⁰ Wendy Gramm, the chair of the audit committee, was the wife of the senior Republican Senator Phil Gramm, who relied on Enron for campaign contributions. Also Lord Wakeham, an audit committee member, was linked to Enron via his consulting contract worth \$6 000 a month to provide advice on Enron's European business and affiliates. John H. Mendelsohn, who was also a President of the University of Texas's M.D. Andersen Cancer Research, looked to Enron as a large benefactor for medical research, in Muchlinski (n 168) p. 729.

a profit maximising business organization using high powered incentive compensation schemes.¹⁸¹

The internal monitoring systems, which were good enough for partnership structure, could no longer fulfil their function in the business organisation: pursuing consulting services and maximising partner incomes. Andersen went through a cultural change in the profession, but its internal monitoring system did not undergo a matching change.¹⁸²

The excessive focus on financial disclosure and a shift from cash based to equity based executive compensation in the 1990s led to the short-term focus on maximization of the stock price. This gave management a reason to pressure their auditors to acquiesce to risky accounting practices aimed at inflating the stock price. The 1990s were also the decade in which the major accounting firms learned how to use their auditing role to cross-sell consulting services, which had a negative impact on the perception of auditors' independence. Audit firms also knew that audit revenues would continue to be relatively flat, while consulting revenues in other fields could grow exponentially. This led to the overall change of the audit firms' business model. Audit firms' priorities shifted away from providing an objective, professional opinion on the financial statements and towards becoming business-oriented consulting multinationals with the main focus on profitability. These changes are detailed more fully in chapter three, but the relevant point here is that the evidence suggests that an excessive focus on the short-term stock price

¹⁸¹ Jeffrey N. Gordon, 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections' (2002) 69(3) *The University of Chicago Law Review* 1233, p. 1240.

¹⁸² Ken Brown and Jonathan Weil, 'How Andersen's Embrace of Consulting Altered the Culture of the Auditing Firm' *Wall Street Journal*, 12 March 2002.

contributed to a general erosion in the quality of financial reporting during the 1990s, which culminated in the Enron scandal and the subsequent demise of Arthur Andersen.¹⁸³

The collapse of Enron and Arthur Andersen prompted significant regulatory reforms, such as the introduction of the Sarbanes-Oxley Act in the US and the establishment of the Financial Services Authority (FSA), the appointment of the independent review of the role and effectiveness of non-executive directors carried out by Derek Higgs in the UK, and the issuing of the Smith Report on audit committees.¹⁸⁴ This thesis argues that these reforms proved to be ineffective in improving the quality of audits, as they failed to address the problems of perverse incentives of corporate executives focused on short-term increases in stock price, and their auditors acquiescing in risky accounting treatments. This was particularly noticeable at the time of the financial crisis in 2008. The majority of banks and corporations that collapsed during the crisis e.g. Lehman Brothers, Northern Rock, Fannie Mae, Freddie Mac etc., had been issued with the auditors' clean bills of health. Even though auditors do not guarantee the survival of a company, at a time of crisis they failed to notice any warning signs. The following section discusses the auditors' involvement in the financial crisis of 2008, which provides another example of the link between short-termism and poor quality audits.

1.7. AUDITORS' ROLE IN THE FINANCIAL CRISIS

This section examines the role that auditors played in the financial crisis of 2008. It shows that auditors' performance at the time of the crisis was below the expected level of diligence required to satisfy the public interest role that audit is meant to fulfil. It also

¹⁸³ In 2002 Arthur Andersen voluntarily surrendered its licenses to practice as CPAs in the US, after being found guilty of criminal charges relating to the handling of Enron's auditing. Although the verdict was subsequently overturned by the US Supreme Court, Andersen has not returned as a viable business.

¹⁸⁴ Paul Davis, Post-Enron Developments in the United Kingdom, available via <http://www.law.yale.edu/documents/pdf/cbl/1-2Panel_1_Davies.pdf> accessed 10 September 2015.

argues that auditors failed to provide adequate assurance about the financial statements of the key financial institutions and lacked professional scepticism during performance of the audits. This finding is crucial for this thesis, as it goes some way towards showing that the post-Enron regulatory changes in the auditing arrangements did not go far enough, and given the recurrence of audit deficiencies, the current audit model remains inadequate to serve the needs of various stakeholders relying on it.

The financial crisis has shown that business incentives have shifted to a shorter-term focus, as increasing weight has been attached to mark-to-market accounting, quarterly returns and short-term incentive bonuses. Performance metrics of CEOs remain based on share prices, which encourages a focus on short-term stock prices rather than long-term value creation. On one hand, the typical question in the aftermath of the bank failures, as to where were the auditors has been less prevalent than before.¹⁸⁵ Unlike in the Enron scandal, auditors work was not a primary cause of the crisis. Blame and criticism has been aimed at specific banking institutions, their management and business models, incentives and remuneration structures. It is clear that auditors should not be made responsible for the board's poor business decisions, such as bad lending or the board's lack of understanding of risks or flaws in the credit-rating system. On the other hand, however, auditors do have a duty to exercise care and skill and exercise professional scepticism while expressing an objective opinion on the financial health of the companies they audit. A number of commentators claim that this duty was not exercised properly in the period leading to the financial crisis and many of the financial institutions ran into serious financial difficulties soon after receiving unqualified audit reports.¹⁸⁶

¹⁸⁵ Humphrey (n 2) p. 810.

¹⁸⁶ Prem Sikka, 'Accounting for the Auditors. As Huge Corporations Tumble, What if the Auditing Firms Paid Millions to Provide Them with Clean Bills of Health?' *The Guardian*, 18 September 2008; Adam Jones, 'Auditors Criticised for Role in Financial Crisis' *Financial Times*, 30 March 2011; Prem Sikka, 'The

One of the most prominent examples of a financial institution receiving a clean bill of health a few months before its collapse was Lehman Brothers. Its auditor E&Y produced an unqualified audit report on Lehman's annual accounts on 28 January 2008 for the year to 30 November 2007, followed by clean bills of health on its subsequent quarterly accounts on 10 July 2008. By early August Lehman was experiencing severe financial problems and filed for bankruptcy on 14 September 2008.¹⁸⁷

In 2013 Ernst & Young agreed to pay \$99 million to settle class-action litigation from Lehman investors over a practice known as 'Repo 105', which allowed Lehman Brothers to make temporary sales of their securities and to use money to pay off its debts just before the submission of quarterly reports to its investors. This accounting technique, sanctioned by E&Y, allowed the bank to place \$50 billion of debts into off-balance sheet vehicles.¹⁸⁸ In April 2015 E&Y also agreed to pay a further \$10 million to settle claims from the New York attorney general's office over the same 'Repo 105' practice.¹⁸⁹ The case was also investigated in the UK, where the disciplinary body of the Financial Reporting Council had concluded that no action should be taken against E&Y or any individual in connection with the auditing of Lehman Brothers before it collapsed in 2008.¹⁹⁰ The Executive Counsel has decided that 'there is no realistic prospect that a Tribunal would make an adverse finding against E&Y in the UK or Members within that firm' and so the

Auditors Have Failed. No One Expects Auditors to Guarantee the Survival of the Company, yet They Did Not Even Notice Any of the Red Warning Flags' *The Guardian*, 7 October 2008, Phillip Inman, 'Auditors' Role in Lehman's Collapse Unites Opposition in Calls for Reform' *The Guardian*, 15 March 2010; Sikka (n 2) p.868.

¹⁸⁷ Sikka, 'Accounting for the Auditors. As Huge Corporations Tumble, What if the Auditing Firms Paid Millions to Provide Them with Clean Bills of Health?' (n 186).

¹⁸⁸ Michael Rapaport, 'Ernst & Young Reaches Settlement with New York Attorney General' *The Wall Street Journal*, 15 April 2015.

¹⁸⁹ Antoin Gara, 'Ernst & Young Settles with New York over Lehman Brothers Repo 105' *Forbes*, 15 April 2015.

¹⁹⁰ Phillip Inman, 'Regulators Demand Detailed Lehman Brothers' Papers from Ernst & Young' *The Guardian*, 15 March 2010; Financial Reporting Council, 'Outcome of Investigation: Lehman Brothers International (Europe)', 29 January 2013, available via [https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/January/Lehman-Brothers-International-\(Europe\).aspx](https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/January/Lehman-Brothers-International-(Europe).aspx) accessed 25 August 2015.

investigation was closed and no further action was taken.¹⁹¹ As the auditors complied with the existing auditing standards, there was no ground to find them negligent, which seems striking taking into account the losses incurred by the Lehman Brothers and how quickly they were placed into administration.

There are numerous other examples of the companies that collapsed shortly after receiving an unqualified audit opinion. Bear Sterns, America's fifth largest investment bank, received its clean bill of health on 28 January 2008. However, by 10 March its financial problems were made public and it was bought out by JP Morgan Chase only four days later. Carlyle Capital Corporation received an unqualified audit opinion on 27 February 2008 and was placed into liquidation two weeks later. Thornburg Mortgage, America's second largest independent mortgage provider received a clean audit on 27 February. Two weeks later the company received a letter from KPMG LLP, its independent auditor, stating that their audit report should no longer be relied on.¹⁹² Similar examples can be found in the UK, where Bradford & Bingley received a clean bill of health from auditors KPMG in 2007 and a year later became partly nationalised. The distressed HBOS was taken over by Lloyds TSB in 2009, despite an unqualified audit opinion of its accounts in 2007. The Royal Bank of Scotland was bailed out by the government after posting the biggest annual loss in UK corporate history a few months after receiving a clean bill of health from Deloitte.¹⁹³

The fact that auditors failed to spot the incoming failures of the major financial institutions brings up numerous questions as to their role and degree of involvement in the crisis. Were the auditors deceived by the managers who provided them with the edited

¹⁹¹ Financial Reporting Council (n 190).

¹⁹² Sikka (n 2) p. 870.

¹⁹³ Ian Fraser, 'Deloitte and the Demise of RBS', 18 December 2011, available via <http://www.ianfraser.org/deloitte-and-the-demise-of-rbs/> accessed 13 February 2016.

financial statements? Were they negligent while performing their duties, or were they complicit in the cover up of frauds? Apart from individual investigations into collapsed financial institutions there were only a few official inquiries that aimed clarify the role of auditors in the financial crisis. The final report of the National Commission on the Causes of the Financial and Economic Crisis in the US does not say a lot about the external auditors' role in the crisis, though a minority dissenting report criticized this omission.¹⁹⁴ In the UK, the House of Lords Economic Affairs Committee inquiry has called for a broad investigation of the limited competition in the UK audit market and posed questions about whether traditional statutory audit is capable of meeting contemporary needs.¹⁹⁵ The inquiry also focused on the effects of the adoption of the International Financial Reporting Standards (IFRS) and on how bank audits were conducted before and during the financial crisis.¹⁹⁶

The criticism of the committee was mainly aimed at PwC, Deloitte and KPMG, as EY does not audit UK banks.¹⁹⁷ Its report stated that:

...complacency of bank auditors was a significant contributory factor to the financial crisis. Either they were culpably unaware of the mounting dangers, or, if they were aware of them, they equally culpably failed to alert the supervisory authority of their concerns... We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may that the Big Four carried out their duties

¹⁹⁴ The Financial Crisis Inquiry Commission, 'Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States', 25 February 2011, available via <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/content-detail.html> accessed 13 February 2016.

¹⁹⁵ Select Committee on Economic Affairs, House of Lords, 2nd Report of Session 2010-2011, 'Auditors: Market Concentration and Their Role. Volume 1: Report' (Authority of the House of Lords, London 30 March 2011).

¹⁹⁶ Ibid.

¹⁹⁷ Jones (n 186).

properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so.¹⁹⁸

The committee also accused bank auditors of a ‘dereliction of duty’ by not sharing sufficient information with regulators informally before the crisis.¹⁹⁹ The report made some specific criticism of PwC for not being able to flag up the riskiness of the business model adopted by the Northern Rock, which subsequently had to be bailed out by the UK government.²⁰⁰ The House of Lord also criticised the use of IFRS, which tend to be more rule-based than the UK GAAP and encourage the ‘box-ticking phenomenon’ that does not necessarily reflect the true financial position of a company.²⁰¹

The auditing profession responded to the criticism by pointing out that all of the audits of companies that failed during the crisis complied with the extant auditing standards.²⁰² A spokesman for E&Y said:

Lehman’s bankruptcy was the result of a series of unprecedented adverse events in the financial markets. Our opinion indicated that Lehman’s financial statements for that year were fairly presented in accordance with generally accepted accounting principles (GAAP), and we remain of that view.²⁰³

That said, it is worth noting that the standards of financial reporting, increased volatility in accounting numbers, and the ever-increasing complexity of the financial system can contribute to the difficulties in providing good quality audits. This can further be illustrated by the debate over fair value and valuation methods. Many of the assets, such

¹⁹⁸ Select Committee on Economic Affairs (n195) p.67.

¹⁹⁹ Select Committee on Economic Affairs (n 195) p.67.

²⁰⁰ PwC was also criticised for receiving over £ 700.000 in 2006 in consulting fees from Northern Rock, pointing at the apparent conflict of interest.

²⁰¹ Alistair Osborne, ‘Were Big Four Auditors just Guilty of Failing to See Wood for Trees?’, *The Telegraph*, 31 March 2011.

²⁰² Sikka, ‘The Auditors Have Failed...’ (n 186).

²⁰³ Inman (n 190).

as mortgage-backed securities and collateralized debt obligations, held by the banks at the time of the financial crisis were highly illiquid and volatile, causing problems with their appropriate valuation.²⁰⁴ This refers in particular to ‘Level 3’ assets, where prices are marked to model and the assumptions used as inputs are unobservable and necessitate the use of internal information supplied by the preparer. This category allows ‘for situations in which there is little if any market activity for the asset or liability at the measurement date’²⁰⁵ and so the reporting entity makes its own assumptions about assumptions that market participants would use. Model-based valuations may be very prone to changes in the underlying assumptions and very subjective in nature, which makes them difficult to audit.

The use of fair value in situations where markets are volatile leads to further difficulties for auditors regarding the issuing of a going concern opinion.²⁰⁶ The going concern judgement, which is a forward looking element of the audit opinion, covers a time frame of twelve months, which in the context of volatile and illiquid markets is a long time.²⁰⁷ Regardless of the precise statutory responsibilities of auditors, this raises a question as to whether audit can be an effective early warning about the potential financial distress of a company or even its collapse, and whether a twelve month valuation period for the going concern judgement is just too long.²⁰⁸ Furthermore, there is also a related issue regarding the auditors’ ability to stand up to dominant managers who want to present the accounts of a company in unduly favourable terms. The threat of a going concern qualification is powerful enough for the managers to seek a new and more compliant auditor. It seems

²⁰⁴ Rapoport (n 188).

²⁰⁵ IFRS 13 – Fair Value Measurement, available via <http://www.iasplus.com/en/standards/ifrs/ifrs13> accessed 13 February 2016.

²⁰⁶ Humphrey (n 2) p. 819.

²⁰⁷ Humphrey (n 2) p. 819.

²⁰⁸ Sikka, 'Accounting for the Auditors' (n 186); Humphrey (n 2) p. 819.

that audit works well in good times but fails in bad times when companies are under pressure to deliver favourable results.²⁰⁹

As has been observed, even though auditors' actions were not a primary cause of the financial crisis, they failed to perform their basic watchdog function. Auditors of the collapsed or bailed-out banks were either culpably unaware of the imminent collapses of their auditees or were at fault for not sharing their concerns with their supervisors.²¹⁰ Auditors themselves claim that they carried out their duties properly and adhered to all the auditing standards. This in turn suggests that if auditors did all that was required of them and performed their duties in the strictly legal sense, there must be a problem with the system. According to Lynn Stout, 'we have to take this as a very serious red flag that there really may be something that has changed in the audit industry'.²¹¹

If audits were conducted according to these standards and auditors failed to anticipate the crisis and perform their watchdog function, then questions should be raised about the validity of the current model. First of all, managers driven by the price of shares, have incentives to submit financial statements that do not truthfully mirror the financial condition of the companies. Audit is just an opinion and it can be wrong, especially if managers stay motivated to cover up fraud. Moreover, there are some strong grounds for suggesting that auditors were not sufficiently independent while conducting their audits. There has been an inherent conflict of interest in the current model, as auditors are hired and remunerated by the very companies they are supposed to audit. Their independence was potentially further compromised by the provision of the more lucrative consulting

²⁰⁹ Humphrey (n 2) p. 819.

²¹⁰ Jones (n 186).

²¹¹ Lynn Stout in Rapoport (n 188).

services. Auditors hoping to receive more income were in danger of acquiescing with management and losing their objectivity and professional scepticism.²¹²

It seems that post Enron reforms did not go far enough to fix the fundamental problems of the audit practice and therefore basic audit model remains faulty. The disturbing silence of auditors' during the recent financial crisis is another indication of a pressing need for reform to reassert prudence and significance of the audit practice to the processes of corporate governance, which are currently in decline. This thesis argues, in chapter six, that audit of the biggest companies, and financial institutions in particular, should be conducted in the public interest by an external, public body.

The auditing profession's involvement in the financial crisis also raised questions regarding the structure of the audit market. Over the years, the accounting profession has become dangerously consolidated. This inclined the House of Lords economic affairs committee to recommend an inquiry into the dominance of the Big Four in the audit market.²¹³ The committee believed that the industry's concentration restricted choice and competition and it could have potentially become worse if one of the audit firms collapsed in a similar manner to Andersen, leaving the banking audit market with only two audit firms.²¹⁴ The House of Lords also criticized very long tenures of auditors at large companies and suggested that second-tier accounting firms such as Grant Thornton and BDO should participate in audit tenders, promoting at the same time competition and improving the quality of audit.²¹⁵ The following section provides an examination of the main mergers between the accounting firms and their impact on the availability of choice

²¹² According to Sikka, in 2007 E&Y collected fees of \$31,307,000 from Lehman Brothers, compared to \$29,451,000 in 2006, \$25,324,00 in 2005 and \$24,748,000 in 2004, in Sikka, 'Accounting for the Auditors' (n 186).

²¹³ Select Committee on Economic Affairs (n 195).

²¹⁴ Similar enquiry was conducted by the Government Accountability Office in the US in 2008.

²¹⁵ Select Committee on Economic Affairs (n 195).

and quality of audit. This issue is further discussed in chapter four, where it is argued that excessive concentration is one of the biggest problems of the current audit model.

1.8. MERGERS AND DECREASE IN COMPETITION

This section discusses mergers between the accounting firms and the impact of industry's consolidation on the competition in the audit market. The industry is currently dominated by four multinational accounting firms, known as the 'Big Four', i.e. PriceWaterhouseCoopers, EY, KPMG and Deloitte. All of them came into existence as a result of numerous mergers, internal growth and diversification. The aim of this section is to present a background for chapter four, where it is argued that the continuing concentration of audit firms in the market for large public companies limits these companies' choice of auditor. This in turn can strengthen an audit firm's position, potentially affecting auditors' objectivity and the quality of the audit. The proposal of reform is then suggested in chapter six.

Over the years, accounting firms have used mergers not only to grow in size, but also to specialize and diversify. Mergers have enabled firms to acquire new offices in different geographical areas and allowed them to increase the variety of services they offer. This, in turn, enabled them to become professional services providers, delivering services beyond the traditional audit and tax.

Accounting mergers are often considered to be a phenomenon of the past two decades. Most of the big accounting firms, however, came to existence as a result of hundreds of local, national and international mergers. One of the earliest international mergers took place over a hundred years ago. S.L. Price, William Holyland and Edwin Waterhouse, who established the Price Waterhouse & Co partnership in London in 1849, opened offices in New York and Chicago only twenty-five years later. In 1894, all of the Price

Waterhouse branches were combined and established as firm of Jones, Ceaser & Co. In 1899 in the US, Price Waterhouse created a firm under its own name, which became the most popular auditor among US corporations. This resulted in the dissolution of Jones, Ceaser & Co into Price Waterhouse & Co two decades later.²¹⁶

A further example of an early international merger was between Marwick, Mitchell & Co and W.B. Peat & Co. Firstly, James Marwick – a Scottish accountant - formed a partnership with a New York City accountant R. Roger Mitchell, which quickly expanded into nine branches. In 1911 Marwick agreed to merge his firm with that of another Scottish accountant William Barclay Peat, forming an American firm of Marwick, Mitchell, Peat & Co. In 1923 its name was changed to Peat, Marwick, Mitchell & Co.²¹⁷

As the clientele grew in size and became more national in scope over the first decades of the twentieth century, the accounting firms found it easier and cheaper to merge with smaller, local accounting partnerships rather than to open new branches. This allowed the accounting firms not only to gain new offices, but also to retain access to the local firm's clients, eliminating at the same time the costly soliciting process of attracting clients to new offices.²¹⁸

After World War One, accounting firms' clients in the US had begun their international expansion. According to Haskins & Sells, 'the practice of serving American clients in connection with their manufacturing and distribution centres abroad was expanded by the influx of American capital in Europe, especially in Germany.'²¹⁹ A number of accounting

²¹⁶ David Grayson Allen and Kathleen McDermott, *Accounting for Success: A History of Price Waterhouse in America 1890 - 1990* (Harvard Business School Press, Boston 1993), pp. 46 - 47.

²¹⁷ T.A. Wise, 'The Very Private World of Peat, Marwick, Mitchell', (1966) 1 *Fortune* LXXIV, p. 91.

²¹⁸ Gerard Hanlon, *The Commercialisation of Accountancy: Flexible Accumulation and the Transformation of the Service Class* (St Martin's Press, London 1994), p. 48.

²¹⁹ Haskins & Sells, *Haskins & Sells Our First Seventy Five Years* (Garland Publishing, New York 1970), p. 128.

firms responded by merging with overseas firms and establishing new branches. For instance, Haskins & Sells merged with a Shanghai accounting firm, Stevenson & Carson. In the course of the following six years, it also opened branches in Havana, Paris and Berlin. In 1924 it established a joint firm with Deloitte, Plender, Griffiths & Co, called Deloitte, Plender, Haskins & Sells, in order to handle engagements in Mexico, Cuba and Canada.²²⁰

Merger activity slowed down in the 1930s and remained at a low level for about twenty years. During World War Two, most accounting firms suffered from personnel shortages, increased demand for accounting services and greater responsibilities to their clients. They had no time or resources to focus on complicated merger procedures. Their expansion was limited to opening branches in cities, where their clients had their presence. This was the case with Arthur Anderson & Co, which by 1930 had a number of clients, such as American Telephone & Telegraph or Colgate – Palmolive, with a presence in Europe. In order to serve these clients, Arthur Andersen engaged the London firm of McAuliffe, Davis & Hope to represent its interests in Europe. Both firms began merger activities only after World War Two.²²¹

The 1950s witnessed another wave of merger activism similar to that of the 1920s. The size of accounting firms began to play an important role for a number of factors. Firstly, greater size was needed to serve an increasingly expanding clientele. Sheer growth was particularly important to Peat Marwick, which domestic and international mergers totalled fifty-three during the 1950s and mid-1960s.²²² Secondly, it was important for the

²²⁰ See (n 219) pp. 127-129.

²²¹ Charles W. Wootton, Carel M. Wolk, and Carol Normand, 'An Historical Perspective on Mergers and Acquisitions by Major US Accounting Firms' (2003) 8(1) *Accounting History* 25, p. 31.

²²² David G. Allen and Kathleen McDermott, *Accounting for Success: A History of Price Waterhouse in America 1890-1990* (Harvard Business School Press 1993), pp. 114 - 15.

accounting firms to obtain a leadership role and be considered as equal among other firms. Arthur Andersen in particular had ambitions to become the leading accounting firm of its times. Leonard Spacek – the managing partner of Arthur Andersen - was to say that ‘... if it is bigness that it takes to have any say in the accounting profession... We’ll get big... we had to do only one thing – growth, service and expansion.’²²³

The 1950s was the time, when even firms that had previously focused solely on internal growth, began recognising the value of mergers as a way to expand and diversify. For instance, before 1950 Arthur Young & Co had not participated in any merger. The completion of two mergers within that year proved to be a success both for the acquirer and the acquired.²²⁴

As the accounting firms’ clients grew in size audits became more complex and costly. Also due to the increase in the provision of consulting services, audit firms had fewer people available to conduct audits. As a result of these changes accountants faced a number of problems. First of all, there was a pressing need for more offices both nationwide and internationally. Furthermore, firms were in need of more staff. Finally, there was a need for greater volume over which to assign increased costs. Mergers were a brilliant solution to all these problems. They allowed accounting firms to acquire more offices with qualified staff who were familiar with local practices. They were also a way to gain local and international exposure.²²⁵

An additional reason for the continued use of mergers throughout the 1960s and 1970s was the attempt to achieve the economies of scale. According to Chandler, mergers

²²³ Leonard Spacek, *The Growth of Arthur Andersen & Co. 1928-1973, an Oral History* (Garland Publishing, New York 1989), pp.55 - 57.

²²⁴ Thomas G. Higgins, *Thomas G. Higgins, CPA: an Autobiography* (The Comet Press, New York 1965), p. 221.

²²⁵ Wootton (n 221) p. 36.

through the economies of scale, which are based on carefully scheduled high-volume flows, are capable of providing a more certain source of profit and market power.²²⁶ For instance, Touche, Ross, Bailey & Smart, despite its growth in the 1950s, realised that in order to keep up with competition it had to grow on a much faster rate, due to the increase in spending on research and training. In order to gain a greater base over which to allocate these costs, it merged with over fifty US firms in the period of ten years, simultaneously achieving international expansion through formal associations with firms in more than seventy five countries.²²⁷ Continuous growth through mergers became a logical choice for the accounting firms seeking to expand nationwide and internationally.

At the beginning of the 1970s, the US market was dominated by the twenty largest accounting firms, which continued merger activities ultimately creating the ‘Big Eight’ accounting partnerships.²²⁸ In the late 1980s, six of the ‘Big Eight’ participated in mergers. The KMG Main Hurdman – Peat Marwick merger in 1986 became a precursor for other mergers among the largest firms. It proved that a merger between two large international firms was possible. It enabled the firms to have access to a greater number of clients that each alone did not have. Combined firms also created economies of scale becoming serious competitors for other firms. This was important, as the accounting profession was becoming very competitive, particularly in the audit area and hence could not afford to raise audit prices. Mergers allowed for the reduction of administrative costs, enabled the firms to achieve more specialisation and spread production and financial risks over a larger volume of activity.²²⁹ Over the three years following the merger, KPMG

²²⁶ Alfred D. Chandler, *Scale and Scope. The Dynamics of Industrial Capitalism* (The Belknap Press of Harvard University Press, Cambridge, MA 1990), p. 78.

²²⁷ Theodor Swanson, *Touche Ross: A Biography* (Touche Ross & Co, New York 1972), p. 10.

²²⁸ Wootton (n 221) p. 41.

²²⁹ Frederic M. Sherer, *Industrial Market Structure and Economic Performance* (Rand McNally, Chicago 1980), p. 84.

Peat Marwick's revenues increased 44 per cent, while the overall number of offices decreased by 127 with 510 fewer partners.²³⁰

In 1989, Ernst & Whinney merged with Arthur Young to create Ernst & Young.²³¹ Soon after that Deloitte Haskins & Sells merged with Touche & Ross forming Deloitte Touche Tohmatsu. In the past, both firms had concentrated most of their marketing efforts on audit practice while consulting engagements contributed little to the firms' revenues. It was only due to the merger that Deloitte managed to significantly expand its consulting services. In 1998 Price Waterhouse merged with Coopers & Lybrand becoming the second largest firm – Pricewaterhouse Coopers. Finally, in 2002 Arthur Andersen dissolved in the wake of the Enron scandal, leaving the accounting profession dangerously consolidated with only the 'Big Four' international accounting firms.²³²

The surviving 'Big Four's' combined market share is formidable. They audit over 78 per cent of all US public companies and 99 per cent of all public company revenues.²³³ In the UK, they audit all but one of the FTSE 100 companies.²³⁴ Even though under the Companies Act, a company may only engage the auditor for one year, it has become a usual practice that companies reappoint the same auditor for a number of consecutive years.²³⁵ In 2012 the combined revenue of the four firms reached a historic record level

²³⁰ Wootton (n 221) p. 44.

²³¹ Coffee (n 51) p. 158.

²³² Coffee (n 51) p. 158.

²³³ Coffee (n 51) p. 158.

²³⁴ Adam Jones, 'Big Four's Rivals Welcome Audit Shake-Up' *Financial Times*, 22 February 2013.

²³⁵ 31 per cent of FTSE 100 companies and 20 per cent of FTSE 250 companies have had the same auditor for more than twenty years, and 67 per cent of FTSE 100 companies and 52 per cent of FTSE 250 for more than ten years, in Competition Commission, 'Statutory Audit Services Market Investigation. Summary of Provisional Findings', 22 February 2013, p. 3.

of \$110 billion, up 6% from 2011.²³⁶ The 'Big Four' have been characterised as a tightening oligopoly and 'too big to fail'.²³⁷

The consolidation of the industry has been criticised for a number of reasons. Firstly, mid-tier audit firms, other than the 'Big Four', find it very difficult to show that they have sufficient experience and reputation in order to audit large public companies. The General Accounting Office has found that significant barriers to entry exist for this reason.²³⁸ Also in the UK, the Competition Commission found that competition in the audit market is restricted by factors which prevent companies from switching auditors and by the tendency for auditors to focus on management rather than shareholders' needs.²³⁹

The most common reasons inhibiting competition are the fact that companies find it difficult to compare alternatives with their existing auditor, they prefer continuity and face significant costs in the selection and education of a new auditor. These features make companies reluctant to switch auditors and weaken their bargaining powers outside the tender process.²⁴⁰ Also misaligned incentives of the auditors may have adverse effects on competition. Auditors are more likely to satisfy management demands, rather than those of the shareholders, as boards are the key decision takers on whether to retain auditors' services. The Competition Commission also found that auditors face barriers to the provision of information that shareholders demand. This stems from the reluctance of management to allow further disclosure.²⁴¹ These factors cause negative effects on

²³⁶ Big4.com, 'The 2012 Big Four Firms Performance Analysis' January 2013, available via <http://www.big4.com/wp-content/uploads/2013/01/The-2012-Big-Four-Firms-Performance-Analysis.pdf> accessed 13 February 2016.

²³⁷ Martha Lagace, 'Are the Big Four Audit Firms Too Big to Fail?' Harvard Business School. Working Knowledge, 4 February 2013, available via <http://hbswk.hbs.edu/item/7169.html> accessed 13 February 2016.

²³⁸ Coffee (n 51) p. 159.

²³⁹ Competition Commission, 'Statutory Audit Services Market Investigation. Summary of Provisional Findings' 22 February 2013, p. 11.

²⁴⁰ Competition Commission (n 239) p. 11.

²⁴¹ Competition Commission (n 239) p. 11.

competition as auditors being insufficiently independent from management compete within the wrong parameters for statutory audit appointments and fail to respond to the demands of shareholders. As a result of this companies are offered higher prices, lower quality and less differentiation of offering than it would be the case in the market with balanced competition.²⁴²

As a response to the competition problems in the audit market, a variety of remedies is being suggested. Among the most common ones are mandatory periodic tendering, mandatory rotation of audit firms²⁴³, prohibition of 'Big Four only' clauses in loan documentation, strengthened accountability of the auditor to the audit committee or extended reporting requirements.²⁴⁴ Chapter four argues that these reforms are minimalistic and will not lead to a significant change in the audit market. Only through a radical reorganization of the industry will the structure of the audit market become less concentrated. Chapter six suggests establishing an independent public body, charged with the appointment of auditors. This would not only decrease concentration and independence problems inherent in the current model, but also increase auditors' accountability.

1.9. CONCLUSIONS

It has been well established that audit plays an important role in maintaining public confidence in the capital markets by providing an external and independent assessment of the financial health of companies. The findings of this chapter, however, suggest that the basic auditing model is flawed and that there are numerous problems inherent in the

²⁴² Competition Commission (n 239) p. 11.

²⁴³ As opposed to the rotation of the audit partners only.

²⁴⁴ Competition Commission, 'Audit Market Not Serving Shareholders' 22 February 2013, available via <<http://www.competition-commission.org.uk/media-centre/latest-news/2013/feb/audit-market-not-serving-shareholders>> accessed 13 February 2016.

current auditing arrangements which pose a significant threat to the long-term quality of audits and to perceptions of the audit firms' commitment to protecting public interest.²⁴⁵

To begin with, the analysis showed that the profession's rapid growth and diversification into consulting services transformed the auditors into business-oriented consultants. Auditors driven by the prospect of securing lucrative consulting contracts had incentives to avoid issuing qualifying audit opinions in order to keep their clients, and to increase their income. This created an environment where the auditors could not oppose aggressive accounting treatments suggested by the managers driven by the short-term share prices, leading to major accounting scandals such as Enron and WorldCom.²⁴⁶

To follow, as demonstrated above, the accounting profession had also benefited from a decreased exposure to litigation in the second half of the 20th century. This was due to the restrictive changes in the liability rules governing third party claims in negligence, introduction of the proportionate liability and the limited liability partnership business form. These changes coupled with weak disciplinary sanctions for audit firms and individual auditors lowered the cost of auditors' acquiescence to the manager's demands and left the profession undeterred, and with scarce incentives to improve the quality of audits.²⁴⁷

Moreover, the findings of this chapter suggest that the excessive focus on short-termism negatively affected the auditing profession. A close link between the managers' compensation and share price created a perverse incentive for managers to engage in short-term share price maximisation through various earnings management techniques.

²⁴⁵ Gerard Hanlon, "Casino Capitalism' and the Rise of the 'Commercialised' Service Class - an Examination of the Accountant' (1996) 7(3) *Critical Perspectives on Accounting* 339.

²⁴⁶ Coffee (n 69) p. 291.

²⁴⁷ Kershaw (n 163) p. 389.

In these circumstances, managers used lucrative consulting contracts to induce auditors to engage in conduct which assisted their share price manipulations.²⁴⁸ Unwilling to lose a significant source of income, auditors frequently engaged in earnings management, which led to a decrease in audit quality and accounting scandals. Despite the regulatory responses to these scandals, the global financial crisis of 2008 and the auditors' disturbing inaction demonstrated once more that the current auditing model remains flawed.

This chapter has also showed that the high rate of merger activities between accounting firms left the auditing market for public companies dangerously consolidated. This led to a strengthening of the already powerful 'Big Four' auditing firms and limited the choice of auditors for large companies. It also had a significant impact on small and mid-tier audit firms, which find it extremely difficult to enter the audit market for public companies.

This thesis argues that issues such as the increasing use of consulting services and its impact on auditors' independence, lack of deterrence caused by the structural and regulatory changes affecting the accounting profession and excessive concentration of the audit market are some of the most significant problems inherent in the current audit model. Despite the numerous regulatory reforms, these issues still remain unresolved and have a negative impact on the quality of auditors' work. Whilst chapter four builds on chapter one and provides a further analysis of these problems, chapter six offers a proposal for a complex overhaul of the present regulation of audit.

The objective of the following chapter is to present a theoretical framework that underpins the auditing profession. A theory is considered here as a system of ideas and suppositions

²⁴⁸ Coffee (n 69) p. 298.

intended to explain a particular phenomenon. Accordingly, theories on the demand for auditing provide a general framework for understanding the rationale of the existence of the external audit function. Auditing theories also explain the importance of key concepts of auditing and uncover some of the laws that govern the audit process. This is important for this thesis, as some of the theories presented in chapter two will be used as a theoretical grounding for chapters four and six, which argue that the purpose of audit is to provide assurance for a wide group of stakeholders.

CHAPTER 2. THEORETICAL FRAMEWORK FOR AUDITING

The aim of this chapter is to provide an analysis of various theories suggesting an explanation for the existence and purpose of audit function. The practice of auditing and the public conception of audit have developed without the prior formulation of any theory.²⁴⁹ Despite the social importance of auditing and the fact that it comprises a significant part of the work of the accountancy profession, there is still very little interest in the study of its theoretical underpinnings. There is still no general answer to the question of what the purpose of an audit is, or why the procedures and practices that are adopted are seen to be adequate in relation to the perceived objective. This chapter plays an important role in providing a theoretical underpinning of this thesis, as it goes on to use the theories of Limperg²⁵⁰ and Flint²⁵¹ to argue that audits play an important social function and should be conducted in the public interest.

This chapter consists of five sections. First, agency theory is discussed, according to which audit operates as a tool enabling the principal to monitor the agent's behaviour. Second, the 'Theory of Inspired Confidence' is analysed. It proposes that audits play an important social function of providing confidence in the capital markets. This function is derived from society's need for expert and independent examination of the financial statements. Third, this chapter examines Mautz and Sharaf's 'Philosophy of Auditing' asserting that auditing is a rational process of examination, observation and evaluation of evidence, and that it provides credibility to the financial statements. Fourth, Flint's social

²⁴⁹ Flint (n 3) p. 5.

²⁵⁰ Theodore Limperg, *The Social Responsibility of the Auditor. A Basic Theory on the Auditor's Function by Professor Theodore Limperg (1879-1961) of the University of Amsterdam, with Some Recent Comments.* (Limperg Institute, Amsterdam 1985).

²⁵¹ Flint (n 3)

conception of audit is discussed. It focuses on the need to extend auditors' accountability to various stakeholders in order to protect public interest. The final section of this chapter states that since audits play such an important role in protecting the capital markets, they should be conducted for the benefit of stakeholders with an interest in the financial stability of the markets as a whole.

2.1. AGENCY THEORY

This section deals with agency theory, which is a useful economic theory of accountability that helps to explain the development and purpose of audit.²⁵² This section starts with an explanation of the principal-agent conflict at the heart of the agency relationship, where principals lack reasons to trust their agents because of information asymmetries and diverging motives. This is important for understanding the usefulness and purpose of audit and its development over the centuries. However, this basic model of the audit function, depicted through agency theory, is complicated by other factors presented in this section. For example, auditors are also agents of principals, which can lead to further concerns about trust, threats to objectivity and independence. Moreover,

²⁵² The development of agency theory has resulted in two streams of research known as the positive agency theory and principal-agent theory, in Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, p. 58. Positivist literature has focused on identifying situations where the principal and agent have conflicting aims and then analysing the mechanisms that constrain the agent's self-serving behaviour. The positivists have been most occupied with the governance instruments that solve the agency problem. Among the positivists are Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305, who research the corporation's ownership structure; Eugene F. Fama, 'Agency Problems and the Theory of the Firm (1980) 88(2) *Journal of Political Economy* 288, who writes on the role of efficient capital markets in controlling the management's behaviour; Fama and Jensen, 'Separation of Ownership and Control' (n 32) who investigate role of the board of directors as a monitoring mechanism. The principal-agent research focuses on the general relationships between the principal and the agent and hence it is more applicable to employer-employee, buyer-supplier and other types of agency research. It is also more mathematically orientated than the positive agency research. It involves careful drafting of assumptions, followed by logical deduction and mathematical proof. Its focus remains on determining the optimal contract, behaviour versus outcome, between the principal and the agent, in Kim Ittonem, *A Theoretical Examination of the Role of Auditing and the Relevance of Audit Reports*, (VAASA 2010) p. 13.

audit is also important to other stakeholders such as regulators, potential investors, creditors or employees. From this perspective, a simple agency view of audit is unlikely to provide complete answers as to the purpose of contemporary audit.

An agency relationship is frequently described as a contract under which one or several principals engage another person as their agent in order to perform certain services on their behalf. In order to perform this function, the delegation of some decision-making authority to the agent is required.²⁵³ As both parties aim to derive maximised benefit from the arrangement, there is a possibility that an agent will choose his own self-interest over the needs of the principal, resulting in the conflict of interest. Agency theory is concerned with resolving the problem stemming from the fact that the agent, who is supposed to make unbiased decisions that would best serve the principal, is naturally motivated by self-interest. In other words, the agent's own best interests may be different from principal's best interests.²⁵⁴ Agency theory also attempts to explain a resulting loss of value and or wealth which occurs whenever one party acts as an agent for another. Such is the situation in a typical corporation where shareholders, acting as principal hire a manager-agent to operate a firm.

Agents are likely to have different motives than the principals. They may be influenced by factors such as financial rewards, other market opportunities, or relationships with other parties that are not directly relevant to the principals. This, in turn, can lead to a tendency for the agents to be more optimistic about the economic performance of the entity. The principal-agent relationship is also associated with a problem of information asymmetry.²⁵⁵ In the theory of the firm context, management acting as an agent, have

²⁵³ Jensen (n 24) p. 308.

²⁵⁴ Eisenhardt (n 252) p. 58.

²⁵⁵ According to Stiglitz, information asymmetry takes place when 'different people know different things', in Joseph Stiglitz, 'Information and the Change in the Paradigm in Economics' (2002) 92(3) American

greater involvement in the company and at the same time greater access to information, which may not be available for the principal without cost. The agent has the ability to use this information for his own self-interest.

The core of the principal-agent theory is the balance between the cost of measuring behaviour and the cost of measuring outcomes and transferring risk to the agent. Scapens argues that a state of efficiency, known as 'pareto-optimality', takes place in the contracting relationship between the principal and agent when neither party can enhance their wealth at the expense of the other.²⁵⁶ In order to ensure the pareto-optimality in the process, both parties will incur contracting costs.²⁵⁷

Fama defines agency costs as the costs of structuring, monitoring and bonding a set of contracts among parties with conflicting interests.²⁵⁸ For example, in order to minimize the risk of shirking by agents, principals will incur monitoring costs such as the cost of external audit. Agents, on the other hand, incur bonding costs such as the cost of internal audit, which allows them to prove to the principals that they act responsibly and in accordance with their contract of employment.²⁵⁹ These actions also help managers to secure their positions in the company and protect their remuneration levels. Indeed, Wallace claims that the principal's expenses for monitoring the agent's actions are reflected in the agent's salary. It is therefore in the agent's interest to demand monitoring

Economic Review 460, p. 469. Due to the fact that some information is private, information asymmetries emerge between those who possess the information and those who could make more efficient decisions if they had it. Much of the research on information asymmetry about behaviour and intentions analyses the use of incentives as mechanisms for reducing potential moral hazards that result from an individual's behaviour, e.g. Jensen and Meckling supra note 24 and Stephen Ross, 'The Economic Theory of Agency: The Principal's Problem' (1973) 63(2) *The American Economic Review* 134.

²⁵⁶ Robert Williams Scapens, *Management Accounting: A Review of Recent Developments* (Macmillan Press Ltd, London 1985).

²⁵⁷ Adams (n 31) p. 8.

²⁵⁸ Fama and Jensen (n 32) p.306.

²⁵⁹ Watts suggests that examples of bonding costs include expenditure on audit committees, internal audit and non-executive directors, in Wyatt supra note 129.

services, such as internal auditing, in order to reduce the risk of principals making adverse adjustments to managerial compensation.²⁶⁰

It is important to note that a management's disclosure via financial reports alone does not solve the agency problems that arise from information asymmetry. As management are responsible for reporting on the financial health of a company, they also have the access and authority to adjust figures, particularly if there is a lack of due diligence or oversight of their actions by the owners. Consequently, there is always a risk of inaccurate reporting present when financial information is submitted to the owners. Auditing plays a crucial function in monitoring contracts and reducing information risk. Without an external audit the accounting information used for decision-making lacks credibility. Audit, therefore, plays an important role of adding credibility to the financial statements generated based on the accounting information.²⁶¹

External auditors provide the investing public with the assurance that the audited financial statements conform to Generally Accepted Accounting Principles (GAAP). The fact that share prices are sensitive to earning announcements suggests that overall investors consider accounting information credible.²⁶² Studies on audit effectiveness examine whether audit qualifications increase value for the investing public and whether auditor's actions are independent of their clients' interests. Research shows that capital providers require companies to hire independent auditors as a condition of financing, even when it is not a regulatory requirement.²⁶³ For instance, Leftwich highlights that banks and

²⁶⁰ Wanda Wallace, *The Economic Role of the Audit in Free and Regulated markets* (University of Rochester, Graduate School of Management, New York 1980).

²⁶¹ Paul Healy and Krishna Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Evidence' (2001) 31 *Journal of Accounting and Economics* 405, p.415.

²⁶² S.P. Kothari, 'Capital Markets Research in Accounting' (2001) 31 *Journal of Accounting and Economics* 105.

²⁶³ Healy (n 261) p.415.

investors require firms to present audited financial information. This extends to private companies as well.²⁶⁴ This implies that capital providers perceive auditors as enhancing a company's financial credibility.

Overall, audit plays important monitoring and information-providing functions. It is also used as a means of aligning the interests of the agents with principals and allowing the principals to measure and control the behaviour of their agents and reinforce trust in agents. According to Brown:

The origin of auditing goes back to times scarcely less remote than that of accounting... Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.²⁶⁵

An audit provides an independent check on the work and information provided by the agent, which helps to maintain trust and confidence.

So far, this section has considered the role of audit as a solution to principal-agent conflicts, but this theory is too simplistic to explain current auditing arrangements. There are further complexities that need to be considered beyond those of the shareholder-manager relationship, such as the relationship between auditors and other stakeholders that rely on audit. Since both the UK and USA require a disclosure of financial information, this generates public interest in the information supplied by audits. Whilst auditors who perform statutory audits are accountable to shareholders, there are other stakeholders or third parties who believe that audit serves their interests too.²⁶⁶ The simple

²⁶⁴ Richard Leftwich, 'Accounting Information in Private Markets: Evidence from Private Lending Agreements' (1983) 58(1) *Accounting Review* 23, pp. 23-25.

²⁶⁵ Jack Sturgeon MacKay, Edward Boyd, J.Row Fogo, Alexander Sloan, *A History of Accounting and Accountants* (T.C. & E.C. Jack, 1905), p. 75.

²⁶⁶ The Institute of Chartered Accountants, 'Audit Quality. Agency Theory and the Role of Audit', December 2005, p. 12

model of agency theory fails to address the interests and expectations of these third parties. This thesis argues, in chapter six, that stakeholders such as creditors, lenders, suppliers, or employees should be able to claim an interest in audit, despite the lack of contractual relationship between them and the auditors. This thesis suggests a more focused financial stakeholder model that addresses the financial aspects of these core stakeholders. It recommends extending disclosure and audits so that they include financial information relevant to creditors and employees. This could include, among others, a general level of debt or the information about the total cost of a workforce employed.

Another feature of the existing audit arrangement that cannot be addressed by the simple agency theory is that the appointment of auditors generates a further agency relationship, which in turn impacts on trust and creates new issues relating to auditors' independence. It also prompts questions about who is auditing the auditor. As argued in the previous chapter, auditor independence from the board is of paramount importance in delivering quality audits. However, an audit requires a close working relationship with the board. The fostering of this relationship has led shareholders to question the actual and apparent independence of auditors and to demand tougher controls and standards of independence. As argued in chapter four, auditors lack independence. To start, they are hired and compensated by the very companies they audit, which causes a conflict of interest. They are also allowed to provide certain consulting services, which influences their perceived independence.

In order to address the complexities highlighted in this section, there needs to be a clear articulation and understanding of the purpose of an audit as well as the alignment of interests. These diverging interests have complications for the use of global standards of auditing. If audit has no clear objective, or agreed, consistent purpose, then difficulties

arise when trying to apply and implement universally accepted auditing standards.²⁶⁷ In chapter six, this thesis suggests that establishing an independent agency responsible for hiring and remunerating auditors would protect the interests of stakeholders and eliminate threats to auditors' independence. The new model also suggests redefinition of the purpose of audit, so that it fulfils a social function and enables stakeholders other than shareholders to rely more confidently on audited financial statements.

To move towards that new model the following section provides an analysis of Limperg's 'Theory of Inspired Confidence'. This theory is used throughout the thesis to support the view that audits play the important social function of providing confidence in capital markets and that they should be conducted not only for the benefit of audited companies' shareholders, but also other stakeholders that rely on them.

2.2. THEORY OF INSPIRED CONFIDENCE

This section examines the *Theory of Inspired Confidence*, also known as the *theory of rational expectations*, which was developed in 1926 by Professor Theodore Limperg of the University of Amsterdam. The theory's main assumption is that audit practices need to be tested, revised and developed in order to meet the needs and expectations of an ever-changing and evolving society and market.²⁶⁸ Limperg's theory is crucial for this thesis as it emphasises the importance of audit not only for shareholders, but for society at large. This thesis uses Limperg's theory as a theoretical grounding for a new audit model suggested in chapter six, which advocates that audits should be conducted in the public interest.

²⁶⁷ The Institute of Chartered Accountants (n 266) p. 13.

²⁶⁸ Limperg (n 250) p. 38.

The theory of inspired confidence explains how changes in the needs of society and changes in auditing methods interact to produce changes in the auditor's functions. Limperg based his theory on the science of business economics and viewed the development of the auditing function from an economic perspective.²⁶⁹ He argued that audit function has two branches, one internal as a management control, and the other external as an instrument of accountability to the community that has an interest in the organisation. Importantly, Limperg saw these responsibilities as two branches of the same audit function.

Limperg noticed that the development of the 'community' function is caused not only by efficiencies in the production process, but also by the need for auditors to become confidential agents of the community, or agents of societal confidence.²⁷⁰ As companies grow in size, so the relationship between the companies and the community in which they serve change as well. The financial structure of the production process becomes dependent on society's participation in its financing, for example in the form of savings and loans, which in turn leads to increasing demands for accountability. That accountability is formally provided in the form of corporations' annual reports, in the statements of banks, prospectuses and other information given to lenders, banks, etc. Limperg's theory argues that this accountability and the data provided by managers are not sufficient and so the community requires an additional scrutiny of the information in the form of audit. The Limperg thesis is well stated in the following quotation:

The auditor – confidential agent, derives his general function in society from the need for expert and independent examination and the need for an expert and independent opinion based on that examination. The function is rooted in the

²⁶⁹ Douglas R. Carmichael, 'The PCAOB and the Social Responsibility of the Independent Auditor' (2004) 18(2) Accounting Horizons 127, p. 128.

²⁷⁰ Limperg (n 250) p.40.

confidence that society places in the effectiveness of the audit and in the opinion of the accountant. This confidence is therefore a condition for the existence of that function; if the confidence is betrayed, the function, too, is destroyed, since it becomes useless.

Limperg notes that if the function of the independent auditor is to achieve its objective, then no more confidence should be placed in its fulfilment than is justified by the work carried out, and by the skills and competence of the auditor. Limperg describes the confidence element of his theory as follows:

It is true that confidence plays a part in more or less every function in society; particularly confidence in the proper fulfilment of the function, in the honesty of the holder of the function etc. But in relation to the function of the confidential agent, the significance of the confidence is of a very special kind; it is the essence of the function itself. The function of the confidential agent arises, does it not, precisely because society has little or no confidence in the communication and the opinion of other officials. The confidence in the effectiveness of the audit and in the opinion of the accountant thus forms the *raison d'être* of his function.²⁷¹

Limperg calls auditors 'independent agents of the community at large'²⁷², as they bring independence and impersonal verification of information provided by managers for the benefit of the community of savers. According to the theory of inspired confidence, the social aspect of auditing, i.e. providing accountability for numerous individual savers is the most important function of auditing. It also distinguishes it from the agency theory, discussed in detail in the previous section, which focuses predominantly on the relationship between shareholders and managers.

²⁷¹ Limperg (n 250) p.38.

²⁷² Limperg (n 250) p.11.

Yet the same ‘social’ aspect of the theory has been criticised for placing accountants in a situation of unreasonably high expectations from the society. Limperg responds to this critique in the following way:

Experience teaches that in general there is no question of unreasonably high expectations. I do not deny that, in certain cases, efforts are now and then made to unreasonably saddle the accountant with the blame for a disappointment experienced; but of ten the disappointed party is then not acting in good faith and the ‘expectation’ is construed afterwards. But generally, alas, it is noticeable that expectations are placed lower than is necessary, given the level of ability and technical possibilities of the accountant. It is the more remarkable that there are accountants who systematically try to force down those expectations...But the community is intelligent and reasonable; it does not set standards of confidence which are higher than the competent and cautiously working accountant is able to satisfy. It is that standard which, according to the Theory of Inspired Confidence, defines the purport of that confidence. The expectation we are speaking of is therefore not – see here the second error that is concealed in the argument – some arbitrary standard set by some dumb or irresponsible individual, but a standards of confidence evolved by the needs of the community which the sensible layman builds into the function of the accountant.²⁷³

The theory postulates that the work carried out by auditors should be governed by the expectations of reasonably well-informed audit users, but auditors should not look to raise these expectations by any more than could be justified by the work they carry out.

There are no definite rules regarding the procedure an auditor must perform in a particular case, but the general rule is that auditor should perform enough work to meet the expectations of society. Hence, the most important factor is society’s needs, which are dynamic and evolve over time, just like the auditing methods. In other words, changes in

²⁷³ Limperg (n 250) p.11.

the needs of society and changes in auditing methods result in changes in the auditor's function.²⁷⁴ However, the touchstone of an auditors' work is the provision of assurance that society needs and reasonably expects. This mirrors the trend towards greater corporate social responsibility reporting for the benefit of a wider spectrum of stakeholders than simply the shareholders.²⁷⁵ This is an important argument that this thesis adopts when developing a new auditing model discussed in chapter six.

Another focus of the theory lies in the independence of auditor, which becomes a prerequisite for the effectiveness of his work. In order to serve the community, an auditor must produce an independent and objective opinion on the accounts of the stewardship of the managers. This cannot be delivered if an auditor is in service of the management or 'has to dance to the manager's tune'.²⁷⁶ The requirement of independence does not apply here to the character of the accountant, but to his functional status. Independence is a logical condition for obtaining effective relationships in the audit arrangement.

The topic of auditors' independence is of paramount importance for this thesis, which argues in chapters four and six that the current audit paradigm is flawed as auditors are not sufficiently independent. Auditors have a conflict of interest at the heart of their business. They are hired and compensated by the very companies they ought to provide with independent opinions on financial health. Moreover, an auditors' independence in appearance is impaired whenever they provide consulting and auditing services simultaneously. This thesis uses Limperg's views on auditors' functional independence, while arguing in chapter six that the relationship between auditors and companies, and

²⁷⁴ Carmichael (n 269) p. 130.

²⁷⁵ Justine Simpson and John Taylor, *Corporate Governance, Ethics and CSR* (Kogan Page Limited, London 2013), pp. 155 - 56.

²⁷⁶ Limperg (n 250) p.12.

managers in particular, should be severed and that audits should be conducted by an external body, guaranteeing the independence of the audit process.

The Theory of Inspired Confidence shows that auditing plays an important role in the social framework. Unfortunately, the current audit system is failing in its social function, which manifests itself in the contemporary problem of the ‘expectation gap’ and the tendency towards defensive auditing. This is potentially understandable in the context of damaging litigation, but socially unacceptable as it further frustrates the purpose of audit and undermines its credibility. This thesis adopts Limperg’s ideas on the social importance of audit and argues, in chapter six, that audits should be conducted for the benefit of a wider spectrum of stakeholders. The thesis now turns to the analysis of Mautz and Sharaf’s philosophy of auditing, which was the first attempt to develop a theory of auditing. The following section focuses predominantly on Mautz and Sharaf’s views on auditors’ independence, which is important for the development of the arguments in chapter four, which criticise the lack of the auditors’ independence in current audit arrangements.

2.3. MAUTZ AND SHARAF’S PHILOSOPHY OF AUDITING

This section provides an overview of Mautz and Sharaf’s theory of auditing as presented in a monograph entitled ‘The Philosophy of Auditing’ in 1961.²⁷⁷ Due to its innovative approach, the study is a seminal work regarding the theoretical foundations of audit. It is also one of the first comprehensive attempts to construct a theory of auditing. The majority of the main postulates of the Mautz and Sharaf’s theory relate to the substantive auditing and hence are of lesser importance for this thesis. That is why this section

²⁷⁷ R.K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, Florida 1961).

provides only a general overview of these postulates. The main focus of this section is on Mautz and Sharaf's views on independence, which are then used in chapter four to criticize lack of auditors' independence in the current audit paradigm.

Mautz and Sharaf based their theory on scientific logic, asserting that the auditing process is a rational process of examination, observation and evaluation of evidence.²⁷⁸ According to Mautz and Sharaf:

Auditing is concerned with verification, the examination of financial data for the purpose of judging the faithfulness with which they portray events and conditions. Financial data are mainly assertions of intangible facts. Their verification requires application of the techniques and methods of proof. Proof is a part of the field of logic which has been described by some as the 'science of proof'. Logic is concerned with how we establish facts, conclusions, and inferences as valid or invalid. As such, logic is basic not only to auditing but to law, which inevitably borrows its ideas and theories of proof from logic.²⁷⁹

Broadly, Mautz and Sharaf adopt a scientific approach to auditing, arguing that auditing practice, with its heavy emphasis on probability and scientific approach to evidence, has a lot in common with a scientific method.

Mautz and Sharaf's theory proposes that in order to obtain a comprehensive view of auditing, one should see it as a five-level structure. At the base lies its philosophical foundation, which in turn rests on the most fundamental disciplines: the abstract sciences. The second layer - the postulates, provide a groundwork for the development of essential concepts. Next is the conceptual structure, the main generalisations based on which the bulk of the theory is organized. The following layers constitute the precepts, which are

²⁷⁸ Simpson (n 275) p. 156.

²⁷⁹ Mautz (n 277) p. 18.

directives for the guidance of practitioners. Finally, there is the superstructure of practical applications in which the precepts are applied to actual situations. Practice is concerned directly with the precepts only, but since the precepts are based on other levels of the structure, if practice follows the precepts and if the precepts are appropriately developed, practice also rests on a strong foundation of a theory.²⁸⁰

The core of their theory is based on several ‘postulates’ or factors necessary for audits to achieve desired results. First of all, Mautz and Sharaf claim that financial statements and financial data are verifiable. This means that financial statements and reports must be accepted as being true, until steps are taken to prove otherwise. Verification, however, does not imply proof beyond all doubt. It is enough if it is reasonable. Verification can also take several forms, ranging from the continuous examination of procedures and data performed by an internal auditing staff, to annual examination by an independent auditor or investigation by an Internal Revenue Agent.²⁸¹

To follow, Mautz and Sharaf argue that there is not necessarily a conflict of interest between auditors and management. Managers are concerned with the progress and prosperity of the business they direct, whilst auditors perform a service which is intended to benefit the various interests in the enterprise by providing a certain degree of assurance as to the reliability of the financial data. The interests of auditors and management should therefore be substantially mutual. The authors, however, rightly recognise the possibility of situations in which managers are in short-term conflict with their auditors e.g. where management has a bonus arrangement contingent on the amount of income, but these should be treated in an exceptional way. Any underlying assumption that management

²⁸⁰ Mautz (n 277) p. 19.

²⁸¹ Mautz (n 277) p. 51.

and auditors are in a permanent conflict would require an extremely extensive and detailed scrutiny of management actions, thus making the work of the auditor impossible.

Furthermore, the authors assert that the existence of a satisfactory system of internal controls eliminates the probability of irregularities. It should be noted that the term 'probability' is used instead of 'possibility'. It is unlikely that the possibility of irregularities can ever be eliminated, even though they can be reduced. Irregularities are still possible despite the existence of good internal control, but they are no longer probable. Conversely, if the internal controls are of substandard quality, then errors and irregularities are more than merely possible. Recognition of this postulate helps to emphasise the importance of internal controls to the auditor and the nature of his interest in it.²⁸²

According to the fourth postulate, consistent application of generally accepted principles of accounting result in fair presentation of the financial position and the results of operations.²⁸³ Despite the fact that auditing and accounting are separate but related fields, auditing borrows from the latter's the Generally Accepted Accounting Principles (GAAP) and uses these as a standard for assessing the propriety of the financial data submitted for evaluation. The GAAP provide a benchmark to judge the fairness of financial statement presentations, without which an auditors' opinion would become personal, unsubstantiated and with no value to anyone.²⁸⁴

The fifth postulate asserts that in the absence of clear evidence to the contrary, what was held true in the past for the enterprise under examination will hold true in the future. This constitutes not only the continuity or going concern concept of accounting, but also

²⁸² Mautz (n 277) p. 55.

²⁸³ Simpson (n 275) p. 156.

²⁸⁴ Mautz (n 277) p. 55.

provides a guide to the auditor in the performance of all his verification work, and is therefore a protection against economic and business changes unforeseeable at the time of the verification process. For example, if an auditor finds that management consistently overstates certain assets and understates others, he is obliged to take it into account while performing an audit. If management acts consistently and in accordance with the standards while acquiring plant assets, an auditor can safely assume that it will do so in the future. This postulate places significant limits on the extent of an auditor's responsibilities. It provides a starting point for deducing the extent of his obligation to forecast the future and having his work judged on the basis of hindsight.²⁸⁵

According to the next postulate the professional status of the independent auditor imposes commensurate professional obligations. Despite the increasing regulation of the profession by the state due to the scandals such as Enron, auditors still claim their professional status.²⁸⁶ The public recognition of their professional status requires that auditors accept that they have a professional responsibility towards society, to their clients and to their fellow auditors. This postulate provides a basis for the professional concept of due care, which emphasises the importance of providing an objective service above self-interest, and adherence to certain standards of professional conduct and efficiency.²⁸⁷

Finally, Mautz and Sharaf argue that auditors' independence is one of the cornerstones of auditing theory. This part of their theory is particularly important for this thesis, which criticises auditors' lack of independence in the current audit arrangements. The writers quote E.B Wilcox according to whom:

²⁸⁵ Mautz (n 277) p. 55.

²⁸⁶ The issues of self-regulation and increasing state regulation of the auditing profession are discussed in detail in chapter three.

²⁸⁷ Mautz (n 277) p. 55.

Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily the representations of management. If the accountant were not independent of the management of his clients, his opinion would add nothing. Those who rely on the credibility he furnishes are apt to be creditors or investors, or sometimes employees, customers, or government agencies. It is for their assurance that the independent expert opinions are provided, and the accountant incurs a profoundly professional obligation to this unseen audience even though he does not know who they are. He must fulfil this obligation even when it means opposing and denying the wishes of those who have employed him, and who, he knows, may cease to do so.²⁸⁸

Carman Blough adds another useful thought in this area:

Since one's usefulness as an auditor is impaired by any feeling on the part of third parties that he is likely to lack independence, he has the responsibility of not only maintaining independence in fact but of avoiding any appearance of lacking independence.²⁸⁹

These authors not only stress the importance of real independence of the individual practitioners in the performance of their work, but also emphasises the apparent independence of auditors as a professional group. Mautz and Sharaf refer to these as 'practitioner-independence' and 'profession-independence' respectively.²⁹⁰

Practitioner-independence is concerned with the appropriate execution of an auditor's duties, such as the planning of the audit program, the verification of the financial statements and the preparation of the report. Carey sees practitioner-independence as the self-reliance and a lack of subordination of auditor's judgements to that of others. He claims that auditors should be free of any self-interest that might even subconsciously

²⁸⁸ E.B. Wilcox, *CPA Handbook* (The American Institute of Accountants, New York 1952), p. 8.

²⁸⁹ Carman G. Blough, 'Responsibility to Third Parties' (May 1960) *The Journal of Accountancy* 58.

²⁹⁰ Mautz (n 277) p. 247.

cloud their judgment regarding the reporting process. Auditors should also be free of any relationships with their clients, as they can give rise to subconscious bias. Independence in this context means objectivity or lack of bias in forming auditing judgements.²⁹¹

Profession-independence on the other hand implies that individual auditors and the profession as a whole must avoid any appearance of lacking independence. Mautz and Sharaf argue that importance of profession-independence ‘is essential to any substantial expansion of auditing as a means of accomplishing public policy’.²⁹² In order to add credibility to the financial statements, auditors must not only conduct audits with independent minds, but must also be perceived to be independent. This implies that they should not engage in any other activities that could raise doubts about their objectivity. The authors make an interesting comparison of the auditing profession to the judiciary by stating:

Auditing, unfortunately, does not have any ‘built-in’ characteristics that assure the sceptic of its integrity and independence. The structure of the judiciary, for example, in which judges are appointed by the state, may be cited in contrast. Judges are in no way dependent on ‘clients’ for income or continuance in office, and except in their official capacity, have no connection with those whose cases come before them. This creates an impression of as nearly complete independence as can be obtained. In addition, we have a hierarchy of courts so that the decisions of lesser judges may be subjected to the scrutiny of those who, by dint of long service, have attained positions surrounded by an aura of such calm, clear justice that to question their independence seems almost sacrilegious. Nothing like this exists in auditing.²⁹³

²⁹¹ John L. Carey, *Professional Ethics of Certified Public Accountants* (The American Institute of Accountants, New York 1956), pp. 20-21.

²⁹² Mautz (n 277) p. 252.

²⁹³ Mautz (n 277) p. 252.

The authors argue that there are numerous features in the current audit model that cast a shadow over the auditors' independence. One of the drawbacks of the model is that the profession has a very close relationship with business. Auditors are directly dependent on their clients for the greater part of their revenues, which makes it difficult to view the profession as sufficiently neutral and independent. Mautz and Sharaf also criticise the tendency toward the emergence of a limited number of large firms, which is an even more profound problem now, with only four big auditing firms, than at the time when their monograph was written. They argue that as a public accounting firm grows larger, its overheads increase alongside its responsibility to hold together a substantial staff. These increased costs require a considerable volume of business, which forces the accounting profession to be business-like in the way it operates its policies. Even though business-like procedures are not in any way improper or unprofessional, they might well give the appearance of a business operation rather than a professional type of service.²⁹⁴

Mautz and Sharaf also express their concern with regard to the simultaneous provision of audit and managerial services and how this impacts on auditors' independence. They acknowledge that some of the managerial services are well within the province of auditors, but there are no standards for judging the performance of the services supplied. The provision of consulting services can potentially affect both profession-independence and practitioner-independence. This is the reason why the performance of managerial services and auditing for the same client by the same accountant is an 'incompatible combination', which leads to no other solution than the desirability and indeed the necessity for a separation of these two types of services.²⁹⁵ Mautz and Sharaf argue that

²⁹⁴ Mautz (n 277) p. 258.

²⁹⁵ Mautz (n 277) p. 270.

If auditing is to continue to enjoy the respect of numerous stakeholders who rely on audit, it must be and must appear to be quite independent. If auditing is to take its place as part of the mechanism of social control, it must be accepted as thoroughly independent.²⁹⁶

In order for auditing to be impartial and independent, steps must be taken to separate auditing from consulting. This would protect practitioners against unrecognised pressures and influences, and would provide some solid assurances of independence for the profession. This in turn would create a higher level of trust and acceptance from outsiders and enable auditors to reach their full potential for the provision of social service.²⁹⁷ Mautz and Sharaf arguments related to the issue of independence are particularly important for this thesis, which qualifies the lack of auditors' independence as one of the biggest flaws of the current audit model. This is discussed in detail in chapter four. Chapter six, in turn, provides an overview of a new audit model, which suggests creating a public body in charge of hiring and remunerating auditors, and introduces a ban on the provision of consulting services.

Although the key assumptions of Mautz and Sharaf's 'Philosophy of Auditing' are useful in many ways, there are certain issues of fundamental importance that their theory lacks. First of all, they fail to analyse the crucial concept of accountability between parties, e.g. accountability of the entity to the public or to investors.²⁹⁸ Following on from this, the basis of their approach is founded in scientific method, which entails evidence-gathering processes, the testing of hypotheses, and probability theory. According to some authors, auditing is an expression of an opinion, a judgement and experience, thus something that the scientific method does not allow.²⁹⁹ Furthermore, their approach does not provide an

²⁹⁶ Mautz (n 277) p. 270.

²⁹⁷ Mautz (n 277) p. 279.

²⁹⁸ The issue of accountability is considered in detail by David Flint.

²⁹⁹ Power (n15) p. 28.

examination of the relationships between auditing concepts, failing at the same time to develop a general framework of auditing.³⁰⁰

Mautz and Sharaf, in their work, are primarily concerned with the audit of business corporations and not with the concept of audit in a wider sense. They pay very little attention to the concept of auditing as a social phenomenon, which according to this thesis is of paramount importance. This dimension was developed over twenty years later by Professor David Flint, who sets auditing in a social context and stimulates the discussion over the wider social objectives of auditing. The following section looks at Flint's theory of auditing and his rationale for the economic and social benefits of audit.

2.4. DAVID FLINT'S PHILOSOPHY AND PRINCIPLES OF AUDITING

This section focuses on David Flint's audit theory that places audit in the context of the institutions of society and the social, political and economic environment.³⁰¹ Auditing is presented as part of the public and private control mechanism of monitoring and securing accountability. This section provides a general overview of the main postulates of the theory, with particular emphasis on the economic and social benefits of audit. This is important for this thesis, which argues that audit should be conducted not only for the benefit of shareholders, but also other stakeholders and general public.

Flint bases his theory of auditing on a number of postulates, which incorporate fundamental principles and describe the intrinsic characteristics of audit essential in the development of the theoretical structure. Firstly, Flint argues that the primary conditions for an audit are the existence of a relationship of accountability and that the subject matter

³⁰⁰ Simpson (n 275) p. 159.

³⁰¹ Flint (n 3) p.3.

of accountability is of such great importance that the discharge of the duty has to be audited.³⁰² He claims that in the early days of business enterprises the conduct and performance of directors could be judged by honesty, conformity to the law, and the quantum of profits and dividends. In the intervening period of over one hundred years, corporate structures and directors' duties have become more complex, capital markets more sophisticated, and the composition of shareholders has not only grown, but has changed with the development of investment trusts, finance companies and pension funds, meaning that the rights and interests of other stakeholders have become more widely recognised. There has been a rapid change in the perception of the responsibilities of corporate businesses towards society. As a result, the concept of accountability has become more complex and has resulted in an increased expectation of the auditing function. This, in turn, has contributed to the 'expectations gap', discussed in detail in chapter four, which explains the gap between public expectations and needs, and the expected accomplishment of auditors.³⁰³

Flint argues that the way in which public and private organisations discharge their duties is important not only for their effect on their own constituencies but also for their impact on the wider community. The quality of company accounts and the scope of disclosed information are important for any judgement on management performance, investment, or credit decisions. The accounts are also required for assessment for taxation and wage purposes and judging social performance. This type of information is so important that its reliability and credibility must be assessed independently and without reservation.³⁰⁴

The validity of this postulate can be illustrated by the way in which the state has used

³⁰² Flint (n 3) p.26.

³⁰³ Gary S. Monroe and David R. Woodliff, 'An Empirical Investigation of the Audit Expectation Gap: Australian Evidence' (1994) 34(1) *Accounting and Finance* 47, p. 62.

³⁰⁴ Flint (n 3) p. 28.

audit as an instrument of social control in organisations with a certain degree of public accountability, such as incorporated companies, banks, regional and district governments, or public utilities. It is perhaps curious that the auditing of unincorporated organisations is not yet required by law. Flint suggests that all organisations in society need a greater degree of accountability and its public manifestation. This is due to the increasing complexity and substantial influence that organisations have on society.³⁰⁵

The independence of an auditors' status and his freedom from investigatory and reporting constraints is another postulate proposed by Flint. In order for an audit to fulfil its social purpose it should be fully independent in every sense, from the organisation itself and members who represent it. This means that audit judgement should be completely objective and free from any limitations on the freedom of investigation and pursuit of evidence or restrictions on the freedom of reporting. This proposition is well illustrated in practice. The directors have a statutory duty to present accounts which give a true and fair view of the financial affairs of a company, and are in breach if they fail to do so. The value and authority of auditing is derived entirely from the fact that auditors are independent while expressing their opinion. If they were not independent, this opinion would be of no value. The concept of audit independence is so central to the meaning of the audit concept itself that it forms a separate element in Flint's theoretical structure.

According to another postulate, the subject matter of an audit is susceptible to verification by evidence and it is a matter of personal skill and judgement of an auditor as to the amount and type of evidence necessary to express his opinion. There must be, what Mautz and Sharaf call, sufficient 'competent evidential matter'.³⁰⁶ The theory of audit evidence is central to audit theory. Development of a theoretical framework demands identification

³⁰⁵ Flint (n 3) p. 28.

³⁰⁶ Mautz (n 277) p. 43.

and analysis of audit evidence and an application of probability theory and statistical inference in order to assign value to audit evidence. It is the only possible way to test the validity of audit practices and procedures.³⁰⁷

A further postulate of Flint's theory presupposes the existence of standards of accountability, which can be set for those who are accountable. In other words, the actual conduct, performance or quality must be measured and compared with these standards by reference to a known criteria, and this comparison requires special skills and the exercise of judgement. If auditors were to set their own standards on each occasion for each organisation, the general utility of audit would be minimal, since there would be no uniformity between comparable clients. Moreover, Flint argues that the meaning, significance and intention of financial statements and data subject to audit must be sufficiently clear. The purpose of audit is to add value and authority to that information. Accordingly, if there is uncertainty or ambiguity about information in the financial statements, it will not be possible to audit them. The intention of the information and data must be clarified before it can be audited.³⁰⁸

The final postulate of Flint's theory implies that audit is a social phenomenon producing both economic and social benefit. This thesis uses this argument in chapter six, which suggests an alternative audit system. For centuries auditing has been concerned with the honest and accurate accounting for money and property in the affairs of the state.³⁰⁹ The same rationale was then applied to the audit of corporations. As time has passed the concept and scope of accountability has expanded to affect the affairs of more than just the managers and shareholders of a corporation. Flint rejects the classic definition of audit

³⁰⁷ Flint (n 3) p. 32.

³⁰⁸ Ibid, pp. 37-39.

³⁰⁹ Mautz (n 277) pp. 2-3.

suggested by Mautz that the role of auditing in an advanced economic society can be, and has been stated in very simple terms – to add credibility to financial statements.³¹⁰ He claims rather that preoccupation of auditors with lending credibility to financial statements is by no means a definitive statement as to the scope of auditing, as it fails to acknowledge the social function of audit.

The social concept of audit denotes a special kind of examination. A proper understanding of its meaning requires an appreciation of its dynamic function. In a fast-changing society the interpretation of the practical implementations of the audit concept must be the result of a constant interaction between the relevant groups and auditors. It is crucial that auditors remain sensitive to the changing expectations of the relevant groups, while at the same time containing these expectations within the constraints of what is possible.³¹¹ The practices, procedures and specific objectives may change, but the purpose of the observations and investigations remain constant. This minimum continuing constant element is identified as audit. But a scientific approach requires also the investigation of the societal factors – the changing cultural, economic, historical, political influences which conditions society's perception of audit and which make audit a social and dynamic phenomenon.³¹² A failure on the part of auditors or audit policy-makers to recognise the dynamic nature of auditing or to respond to legitimate societal pressure leads to frustration of the social purpose and the emergence of the expectation gap, which remains one of the most contentious issues in the current audit model. The issue of the expectations gap is analysed further in chapter four.

³¹⁰ Mautz (n 277) p.17

³¹¹ Flint (n 3) p. 15.

³¹² Flint (n 3) p. 10.

While it is important to have well-defined lines of responsibility, too stringent a perception of the purpose of audit may inhibit progress and development in a changing society. In light of increasing risk of litigation, there is an understandable resistance on the part of auditors to voluntarily assume new responsibilities. It is necessary, however, to create a system whereby relevant groups can secure the reassurance and protection they desire without exposing auditors to excessive risks.

In the private sector, corporations have always had a primary duty of accountability to shareholders, and the audit responsibility has been defined by law to monitor that duty. As corporations have grown in size, influence and importance, both economically and socially, so have social structures and public expectations changed. The duty of accountability has expanded in its scope and terms. The state has a stronger than ever responsibility to protect public interest; employee groups have an interest in expanding employment opportunities, shareholders may no longer be the only effective group to exercise the function of owners, and all the while there is a duty of accountability to all of these. According to Flint, auditors who perceive the company or its shareholders as their only 'client', and refuse to recognise other stakeholders as being legitimately entitled to be directly addressed, understand neither the nature of the concept of accountability nor the social function of the audit.³¹³

Flint proposes a cost-benefit test as a social justification for auditing. He suggests that audit performs a wholly utilitarian function. It only satisfies a social need if the benefit it provides is greater than the sacrifice made to receive it. This implies that financial statements and other data that are audited must have an added utility which exceeds the cost of auditing. The benefit of audit is frequently intangible and difficult to measure. The

³¹³ Flint (n 3) pp.15-16.

audit process is not under the control of either party, as this would imply lack of independence. Society is therefore dependent on auditors to create a benefit at the minimal social cost. The economic cost is observable by society, but the benefit has to be assessed subjectively.³¹⁴

As far as the audit of financial statements is concerned, obtaining and evaluating evidence is a substantial part of the work. Auditors hardly ever achieve certainty about any proposition and must form their opinion based on probability, according to the strength of evidence. There is, however, a minimum level of confidence that auditors must achieve in order to produce an opinion. Flint claims that at a certain stage, the cost of further evidence and the resulting increase in confidence which the auditor obtains as a consequence, must be measured against the enhanced social benefits this additional evidence would produce.³¹⁵ This is also explained by Mautz and Sharaf:

... cost and time are important: it would be unreasonable to incur substantial costs to ascertain the existence of assets of inconsequential amounts. It might be unreasonable to incur substantial costs to prove the existence of assets of even significant amounts if other types of evidence are sufficiently persuasive and more readily available. The difference between compelling evidence and very persuasive evidence may not be sufficiently important to warrant the added cost of obtaining the former.³¹⁶

Overall, Flint argues that there are numerous interests that need to be taken into account in most audits. It is therefore the total social benefit against social cost which has to be compared in considering the social justification for audit.

³¹⁴ Flint (n 3) p.39

³¹⁵ Ibid, p. 40.

³¹⁶ Arrunada (n 162) p. 85.

2.5. CONCLUSIONS

The expanding role of the audit function in contemporary corporations raises numerous questions regarding auditors' responsibilities towards different market participants. Is there a potential conflict within the audit function? Are the auditors ultimately responsible to the party that pays their fees or to other parties that use their reports? The aim of this chapter has been to analyse the theoretical underpinnings of audit in order to understand the purpose and role that audit plays in society. This is important for this thesis, which argues that audit in the current model is flawed and fails to serve the interests of stakeholders such as creditors and employees.

According to agency theory, audit became necessary because of the separation between the directors and other interested parties, such as capital providers, lenders, suppliers, who found themselves at risk as a result of the introduction of limited liability.³¹⁷ Originally corporate auditing was concerned with the investigation of improper conduct such as error and fraud in accounting. More recent emphasis has been on verifying and lending credibility to the information presented in the annual accounts. Mautz and Sharaf seem to follow this line of argument suggesting that the main role of auditing in an advanced economic society is to add credibility to financial statements.³¹⁸

But as corporations have grown in size, importance and influence, and as social structures and public expectations have changed, an expectation has emerged that audit is now wider in its scope and more varied in its terms. It can no longer be perceived only as a rational process of examination, observation and evaluation of financial evidence.³¹⁹ The current concern with the expectations gap between auditors and users, and the public anxiety

³¹⁷ Jensen and Meckling (n 24) pp. 305 - 10.

³¹⁸ Mautz (n 277) p.17.

³¹⁹ Flint (n 3) p.5.

about the audit of corporate management, which emerged as a result of numerous financial scandals, are indicative that the audit function is by no means as narrowly conceived as it was previously. The theoretical concept of social audit, suggested by Limperg and developed by Flint, implies that audits fulfil a wider function of protecting capital markets and at the same time the prosperity of society as a whole, and that 'lending credibility to financial statements is only one manifestation of the social function of auditing, although, no doubt, a very important one'.³²⁰

Social accountability of business organisations is not a new idea, but the concept of a social audit is a relatively new one.³²¹ This thesis uses Flint's ideas on social audit as a theoretical grounding for chapters four and six and argues that audits should be conducted for the benefit of numerous stakeholders, such as creditors, employees, suppliers - all of whom rely on audited financial statements. Chapter four also adopts Limperg's views on independence, whilst criticising the current audit model, which allows auditors to not only to be hired and paid by their clients, but also to provide their clients with consulting services, which impairs the auditors' independence in appearance.

The following chapter examines the current regulatory framework for auditing. Firstly, it presents various theories on the need for regulation in general, and applies these theories in the auditing context. In the second section the long-standing debate on rule- versus principle-based regulation is discussed. The third section deals with the parties involved in the regulation of audit. These include private and state regulators at national and international level. These will provide a basis for a discussion in chapter four, which examines the most pervasive problems inherent in the present audit framework.

³²⁰ Flint (n 3) p. 6.

³²¹ Flint (n 3) p. 6.

CHAPTER 3. THE REGULATION OF AUDITING

This chapter examines the regulatory framework for auditing. The literature on the regulation of auditing is embedded in financial reporting literature. Although the latter is extensive, it focuses predominantly on accounting rather than auditing studies. Moreover, the majority of financial reporting studies remain in the sphere of political science or business, focusing either on the political dimension of regulation³²², or its organisational concept.³²³ Even though events such as Enron's collapse and the financial crisis of 2008 encouraged some attention to the regulatory framework of audit, the debate focused predominantly on the role of enforcement agencies and the standards-setting process.³²⁴ The regulatory framework of auditing has not received sufficient attention.

This chapter attempts to fill this gap by considering why, how and by whom audit is regulated.³²⁵ It is divided into three sections. This will allow for a detailed and comprehensive analysis of the regulatory framework. The first section seeks to clarify why there is a need for audit regulation. To that end, various general theories of regulation are examined and applied in the auditing context. Here, two main schools of regulation are analysed. First, the free market approach, according to which no regulation is

³²² Michael Power, 'The Politics of Financial Auditing' (2005) 64(3) *The Political Quarterly* 272, Prem Sikka, 'The Politics of Restructuring the Standard Setting Bodies: The Case of the UK's Auditing Practices Board' (2002) 26(2) *Accounting Forum* 97.

³²³ Ian Dewing and Peter Russell, 'The Role of Private Actors in Global Governance and Regulation: US, European and International Convergence of Accounting and Auditing Standards in a post Enron World' Workshop Paper, Amsterdam Research Centre for Corporate Governance Regulation, Vrije Universiteit Amsterdam Inaugural Workshop, 17-18 December 2004; Julia Black, 'Forms and Paradoxes of Principles-Based Regulation' (2008) 3(4) *Capital Markets Law Journal* 425; Eva Hupkes, 'Regulation, Self-Regulation or Co-Regulation' (2009) 5 *Journal of Business Law* 427.

³²⁴ Humphrey *supra* note 2; Christopher Humphrey, 'In Pursuit of Global Regulation: Changing Governance and Accountability at the International Federation of Accountants' (2006) 19(3) *Accounting, Auditing and Accountability Journal* 428.

³²⁵ Kandemir, Hatice, Kubra (2014) *Understanding External Auditing and Its Regulation in the EU and in Turkey: A Way to Convergence?* Durham theses, Durham University, p 61.

necessary as the market regulates itself, is examined. Second, the pro-regulation approach is presented alongside the analysis of public interest theory, capture theory, economic interest group theory and ideology theory. It is submitted that none of the general theories of regulation fully explain the reasons for the regulation of audit, which is usually enacted as a response to accounting scandals. The second section answers the question as to how audit is regulated and provides an analysis of the long-standing debate of rules versus principles-based regulation. The third section analyses the players involved in the regulation of audit, inclusive of private and public regulators at national and international levels. To follow, this section provides an account of the range of global institutions which increasingly participate in the audit practice and contribute to audit ideology.

The analysis of regulation of the auditing framework plays a central role in this thesis, which criticises the current auditing arrangements. The critical analysis in this chapter reveals that there is no normative theory justifying audit regulation. This contributes to problems with the very definition of audit and raises questions about the addressees and purpose of audits. The analysis also shows that the debate as to the prominence of principle-based rather than rules-based approach to regulation should refocus on improving the quality of audits and enhancing auditors' accountability. Furthermore, the analysis shows that there are numerous parties who, either directly or indirectly, are involved in or exert influence on, the regulatory framework of audit.

The critical analysis is then continued in chapter four, which focuses on the most egregious problems of the current audit model, such as lack of auditors' independence and accountability, and excessive concentration of the audit market. These problems hinder the production of good quality audits. This thesis argues that it is essential to rethink the theoretical grounding of audit and provide a comprehensive overhaul of its

regulation. To that end, chapter six suggests an alternative regulatory model that shifts the focus of audit away from satisfying the needs of management to providing assurance in audited financial statements for the benefit of multiple stakeholders.

3.1. WHY DO WE NEED AUDIT REGULATION?

The need for regulation has been extensively debated for many decades. Those who believe that the market will efficiently allocate resources on its own argue that regulation is not necessary. Others, however, claim that markets do not always work in the best interests of society and that certain forms of intervention in regulating are essential to keeping an order (e.g. road rules for drivers) or protecting societies from undesirable activities (e.g. drug smuggling). The following sections look at the arguments for and against the regulation in general, and audit regulation in particular. This analysis will reveal that there is no single, comprehensive theory of regulation which would justify the regulation of audit.

3.1.1. THE FREE MARKET PERSPECTIVE

The basic assumption underlying a free market perspective on the regulation of accounting is that accounting information should be treated just like other goods, and the forces of demand and supply should produce an optimal amount of information about an entity. According to Jensen and Meckling, entities should be able to produce sufficient information about their performance through the private economics-based incentives, eliminating the need for any regulation.³²⁶

This argument, however, causes some controversy as, in the absence of information about an entity's performance, shareholders might assume that managers are guided by self-

³²⁶ Jensen and Meckling (n 24) pp. 305-10.

interest and personal gain. Also potential lenders might expect managers to be opportunistic with the funds that lenders supply, and therefore charge a higher price for their funds.³²⁷ These increase the operating costs of the firm and the cost of capital, leaving negative implications for the value of the firm. In order to counteract this, managers enter into contracts with lenders and shareholders that aim at preventing them from opportunistic behaviour or shirking. These involve agreements with bondholders that keep debt levels below a certain percentage of total assets, service contracts including bonus schemes, which are tied to the organisation's profits, and share options.³²⁸ These contractual arrangements are tied to accounting numbers, hence the 'free-market' argument is that in the 'absence of regulation there are some private incentives to produce accounting information'.³²⁹ Any potential conflicts between investors and managers should then be solved through private contracting and associated financial reporting. Those who do not produce information will have to bear the higher costs of attracting capital.

According to the assumption that managers tend to act in their own self-interest, it is desirable that financial statements are audited by an external party. This increases the objectivity of accounting information and decreases potential risks of stakeholders and the cost of capital.³³⁰ Even though audits are now a regulatory requirement, there is some

³²⁷ Jensen and Meckling (n 24) pp. 305-10.

³²⁸ Craig Deegan and Jeffrey Unerman, *Financial Accounting Theory. European Edition* (McGraw-Hill Education, Maidenhead, Berkshire 2006), p. 58.

³²⁹ Craig Michael Deegan, *Financial Accounting Theory* (3rd edn, McGraw-Hill, North Ryde, N.S.W 2009), p. 61.

³³⁰ The argument in favour of reducing regulation makes sense in the presence of a limited number of contracting parties, assuming that various items of financial information are provided in a contract and then subjected to an independent audit. The assumption, however, fails in the presence of many parties. According to Scott, 'If the firm manager were to attempt to negotiate a contract for information production with every potential investor, the negotiation costs alone would be prohibitive. Also given the disparate information needs of different investors, this process would be extremely time-consuming and costly, if indeed, it was possible at all. Hence, the contracting approach only seems feasible when there are few parties involved.' In William R. Scott, *Financial Accounting Theory* (3rd edn, Prentice Hall, Toronto 2003), p. 416.

evidence that many organisations had their statements voluntarily audited before the laws on mandatory audits were introduced.³³¹

Arguments, other than the private contracting view, supporting elimination of regulation in the sphere of accounting are based on various market-related incentives. Firstly, the 'market for managers' argument relies on the assumption that in the absence of regulation relating to the managers' behaviour, managers will act in the best interests of the company and supply an optimal amount of information, as their compensation either present or future is linked to the results of the firm. Hence in the absence of contractual arrangements, managers will adopt strategies that aim at maximising the value of their corporations, which in turn provide an optimal amount of financial accounting information. This argument, however, is based on the assumption that information about the past performance of the managers is widely available and that their compensations fully reflect their achievements. It also assumes that capital markets are efficient in determining the value of the corporation and that the effective strategy of the management will always increase the share value. In reality, markets will not always be efficient and hence these assumptions will not always materialise.³³²

The 'market for corporate takeovers' argument, on the other hand, is based on the assumption that an underperforming firm will be taken over by another one and new management will be appointed. Facing such a threat, managers would be motivated to increase firm value and diminish the risk that outsiders take control of the organization.

³³¹ Richard D. Morris, 'Corporate Disclosure in a Substantially Unregulated Environment' (1984) 20(1) *Abacus* 52, p. 52.

³³² Fama, 'Agency Problems and the Theory of the Firm' (n 32) p. 293.

This motivates the management to produce information that minimises the cost of capital and increase the value of the firm.³³³

There is also an argument that firms should produce information irrespectively of weather if it is good or bad. This is often referred to as the Akerlof's theory of the market for lemons, which is used to explain how the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and seller, leaving only low quality goods behind.³³⁴ In the absence of information the capital markets assume that the firm is a 'lemon', which implies that the lack of information will be treated in the same way as bad information. In the absence of regulation, this can provide an incentive for managers to disclose information even though it is bad.

Kaplan et al. applied Akerlof's theory of the market for lemons to the market for the audit reports in the Enron case.³³⁵ Their reasoning was that Andersen repeatedly issued 'lemon' audit reports (i.e. low quality audit reports). Due to the structure of the audit report market, it usually takes some time for buyers to realize the quality of the service they receive. Auditing, as a control mechanism, is used to reduce such information asymmetry. Drawing upon the 'market for lemons' argument, it is necessary to notice that the failure to disclose bad news by managers in a timely manner could also cause serious reputational loss. According to Skinner, 'managers who acquire a reputation for failing to disclose bad

³³³ Deegan (n 329) p. 62.

³³⁴ According to Akerlof 'Suppose (for the sake of clarity rather than reality) that there are just four kinds of cars. There are new cars and used cars. There are good cars and bad cars (which in America are known as "lemons"). A new car may be a good car or a lemon, and of course the same is true of used cars. The individuals in this market buy a new automobile without knowing whether the car they buy will be good or a lemon. ... After owning a specific car, however, for a length of time, the car owner can form a good idea of the quality of this machine; i.e., the owner assigns a new probability to the event that his car is a lemon. This estimate is more accurate than the original estimate. An asymmetry in available information has developed: for the sellers now have more knowledge about the quality of a car than the buyers. But good can and bad cars must still sell at the same price- since it is impossible for a buyer to tell the difference between a good car and a bad car', in George Akerlof, 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism' (1970) 84(3) *Quarterly Journal of Economics* 488, p. 489.

³³⁵ Steven E. Kaplan, Pamela B. Roush, and Linda Thorne, 'Andersen and the Market for Lemons in Audit Reports' (2007) 70(4) *Journal for Business Ethics* 363, p. 430.

news are less likely to be followed by analysts and money managers, thus reducing the price and/or liquidity of their firms' stocks.³³⁶

According to the above arguments, supporting elimination of regulation such as private contracting, market for managers, market for takeovers, and market for lemons, organizations will still have incentives to make disclosures. Different waves of financial scandals discussed in chapter one, however, prove that market forces are often not enough to prevent fraud and market manipulation, and that a certain amount of regulation is needed to provide efficiency and greater investor protection. The next section discusses major classic theories which encourage regulation. These theories are then applied to the auditing context.

3.1.2. THE 'PRO – REGULATION' PERSPECTIVE

There are certain arguments which assume that accounting information should not be treated like other goods as it is a 'public good' and the market forces of supply and demand are not always reliable. As the users of financial information can obtain information and pass it on to others at zero cost, they are often referred to as 'free-riders'.³³⁷ Whenever free-riding occurs, the true demand is understated, as people can obtain goods or services from others without paying for it. This leads to a situation where the incentives to pay for the goods are very low, as people realise they are able to obtain goods for free. This causes a lack of incentive on behalf of the producers of the goods and in turn leads to underproduction of information. In order to counteract this

³³⁶ Douglas J. Skinner, 'Why Firms Voluntarily Disclose Bad News' (1994) 32(1) *Journal of Accounting Research* 38, p. 39.

³³⁷ George J. Stigler, 'Free Riders and Collective Action: An Appendix to Theories of Economic Regulation' (1974) 5(2) *The Bell Journal of Economics and Management Science* 359, p. 360.

underproduction, regulation is introduced to reduce the impacts of market failure.

According to Cooper and Keim:

Market failure occurs in the case of a public good because, since other individuals (without paying) can receive the good, the price system cannot function. Public goods lack the exclusion attribute, i.e. the price system cannot function properly if it is not possible to exclude non-purchasers (those who will not pay the asked price) from consuming the good in question.³³⁸

There are counter arguments to the idea that the supply of free goods should be regulated.

According to some economists, the outcome of regulation can lead to the overproduction of goods, e.g. the users of information can overstate their need for some information.³³⁹

This example could be applied to investment analysts lobbying for more regulation and disclosure. There is a possibility that the cost of production of additional information will exceed the benefits stemming from its availability. This could contribute to the problem known as ‘accounting standards overload’, causing an extra cost for companies in terms of compliance. In the presence of free-riders, however, lack of regulation may imply underproduction of important accounting information.

Another argument justifying regulation in the sphere of financial reporting is the creation of a ‘level playing field’, which implies providing access to the same information for all market participants in order to prevent insider trading. Greater disclosure regulation has the potential for increasing the confidence of stakeholders in believing that they are on the same ‘level playing field’. That in turn builds confidence in the capital markets and is considered to operate in the ‘public interest’. The question of what is the right, or optimal,

³³⁸ Kerry Cooper and Gerald Keim, 'The Economic Rationale for the Nature and Extent of Corporate Financial Disclosure Regulation: A Critical Assessment' (1983) 2(3) *Journal of Accounting and Public Policy* 189, p. 190.

³³⁹ Deegan and Unerman (n 328) p. 63.

amount of information, however, is difficult to answer with any level of certainty.³⁴⁰ The following subsections provide the analysis of various theories of regulation and their significance to the regulation of financial audit.

PUBLIC INTEREST THEORY.

According to public interest theories, regulation is adopted in order to improve economic efficiency and to protect social values by correcting market failures.³⁴¹ The notion of public interest can be described here as ‘the best possible allocation of scarce resources for individual and collective goods’³⁴² and the main method of achieving efficiency in this allocation would be through government regulation. There are typically four areas where government regulation is essential (as market forces cannot deal with the efficient allocation of resources on their own): natural monopolies, externalities, asymmetric information and excess competition. Any of these four forces legitimate regulation.³⁴³

Under the natural monopoly argument, regulation is justified as the monopolist raises his tariffs and costs by charging above-marginal-cost prices in order to maximize profits, irrespectively of the economic efficiency. The role of regulation is to constrain the natural monopolist by securing fair pricing. Examples of companies that are considered natural monopolies are gas and oil pipelines, railways and telecommunication networks. They are usually put under the control of the state or are indeed highly regulated in order to bar entry to the market and enforce the price rules that would promote efficient allocation.³⁴⁴

³⁴⁰ Deegan and Unerman (n 328) p. 63.

³⁴¹ Arthur Cecil Pigou, *The Economics of Welfare* (AMS Press, New York 1978).

³⁴² Johan den Hertog, *Encyclopedia of Law and Economics* (Economic Institute/ CLAV, Utrecht University 1999), p. 225.

³⁴³ Stephen Breyer, *Regulation and Its Reform* (Harvard University Press, Cambridge, MA 1982), p. 23.

³⁴⁴ Ronald Braeutigam, *Optimal Policies for Natural Monopolies, Handbook of Industrial Organization* (Amsterdam 1989), p. 123.

The natural monopoly reasoning is unlikely to explain the regulation of accounting standards since it is difficult to enforce their above-marginal-cost pricing. According to Sunder, the cost of excluding non-payers from utilizing already developed accounting standards is destined to be high.³⁴⁵ Furthermore, it would not be beneficial for standard-setters to exclude potential users by charging monopoly prices, since standards become more valuable as more users adopt them.³⁴⁶

Moreover, according to the natural monopoly reasoning, in the event of lack of regulation a private accounting setter will emerge and charge monopoly prices for its accounting standards. In the US, there is no evidence of a private standard-setting body before the emergence of the SEC and in the UK numerous accounting bodies of the first half of the twentieth century did not charge monopoly prices for the use of their accounting recommendations.

According to the externalities argument for regulation, the price of a product does not reflect its real cost. This is either because in order to produce a product a manufacturer has to use public resources or because the product is 'non-excludable'.³⁴⁷ If a product uses public resources, e.g. it contributes to air pollution, and the producer does not include in his calculations the costs of elimination of these socially detrimental effects, market will need some sort of regulation to introduce efficiency.³⁴⁸ It is implausible that the production of accounting standards depletes public resources, making the externalities argument an unlikely justification for regulating accounting.

³⁴⁵ Shyam Sunder, 'Political Economy of Accounting Standards' (1988) 7 *Journal of Accounting Literature* 31, p. 36.

³⁴⁶ S.P. Kothari, Karthik Ramanna, and Douglas J. Skinner, 'What Should Gaap Look Like? A Survey and Economic Analysis' (2009) Working Paper University of Chicago, Harvard and MIT, p. 60.

³⁴⁷ It implies that the cost of excluding the non-paying consumers from using the product will be greater than the product's benefits to these consumers, in Kothari supra note 346

³⁴⁸ James Meade, *The Theory of Economic Externalities* (Leiden, Sijthoff 1973), p. 25.

Markets are also characterised by hidden information, or asymmetric distribution of information, in relation to prices, quality and quantities of goods.³⁴⁹ This can lead to a situation where parties misuse their information advantage, which in turn can lead to a moral hazard. Primary examples would be lawyers who give unfounded advice or auditors who fail to give an objective opinion on financial statements. The problems of asymmetric information and moral hazard may explain the existence of various licenses, certificates and other regulations for professional groups, such as building contractors, lawyers and auditors. These regulations set out minimum standards of the professional skills and knowledge leading to the decline in the transaction costs and information problems.³⁵⁰ At times, when it is difficult to set the minimum standards and the risk of moral hazard is high, professionals tend to be able to self-regulate.³⁵¹

Furthermore, the information asymmetry argument is based on the assumption that the buyers demand a discount on a quality product from sellers. The sellers of high quality products decide to exit the market, as the discount is so big that it makes the production of their products unprofitable. In the absence of high quality products, buyers expect more discounts at the same time as driving more sellers out of the market. The process continues until there are no buyers and sellers. The role of regulation is to fix this market failure by requiring quality disclosures from the vendors.³⁵²

³⁴⁹ Jack Hirshleifer and John Riley, 'The Analytics of Uncertainty and Information' (1979) 17(4) *Journal of Economic Literature* 1375, p. 1380.

³⁵⁰ Hertog (n 342) p. 228.

³⁵¹ Problems of information asymmetry and moral hazard are particularly noticeable in the insurance industry. Insured parties have superior knowledge with regards to the incidence of risks, but they do not possess information with respect to the independence and quality of intermediaries. Social legislation and rules governing intermediaries are frequently introduced to counteract these problems, in Michael Rothschild and Joseph Stiglitz, 'Equilibrium in Competitive Insurance Markets' (1976) 90(4) *Quarterly Journal of Economics* 629, p. 640.

³⁵² Rothschild (n 351) p.640.

Since the information asymmetry argument applies where potential buyers do not have sufficient information about the quality of a product, it is difficult to advance it as an explanation for the regulation of accounting standards. According to Kothari, it would be a self-destructing argument for the regulators to assume that accountants do not possess the necessary knowledge to choose among numerous private accounting standards.³⁵³

The excess competition argument for regulation is based on the assumption that in the absence of market-entry regulation, sellers can flood the market with their products. This overproduction drives down prices and decreases quality and innovation. By regulating the number of market participants, the market becomes more stable. Even though the excess competition is not extensively discussed in economic studies as it is not a long-term optimal level, it can have some merit if the adjustment to the optimal level is time-consuming and costly. This is possible for capital intensive products. Accounting standards-setting, however, has relatively low capital intensity³⁵⁴, hence excessive competition is unlikely to justify the regulation of standards-setting.

The public interest theory is most often applied to explain regulation as an answer to market failures, or correcting inefficient or inequitable market practices.³⁵⁵ It is also considered to explain the efficient management of scarce resources. Public interest theory, however, has been widely criticised. First of all, it has been proved that the market itself can often compensate for inefficiencies. For example, problems associated with adverse selection are often dealt with by the companies themselves with the use of brand names or advertising campaigns, or issuing of guarantees.³⁵⁶ Secondly, government regulation

³⁵³ Kothari (n 346) p.61

³⁵⁴ The costs of funding a standard setting body are low, e.g. the total FASB expenses throughout the early 2000s were under 40 million dollars in an economy with multi-trillion dollar stock market, in Kothari (n 346) p.61.

³⁵⁵ Richard Posner, 'Theories of Economic Regulation' (1974) 5(2) *Bell Journal of Economics and Management Science* 335, p. 341.

³⁵⁶ Hertog (n 342) p. 232.

is not always effective and it is usually costly.³⁵⁷ Some of the theoretical research emphasises that the information available to regulators can at times be flawed. Consequently, regulated businesses are often unable to produce to minimal costs as they have to adhere to laws drafted and enforced based on inaccurate information.³⁵⁸ This occurs frequently in health and safety sectors where regulators apply inefficient safety standards, which are based on inaccurate data.³⁵⁹ Thirdly, assuming that regulation is introduced in order to achieve economic efficiency, the public interest theory fails to explain why, on certain occasions, other objectives, such as fairness or redistribution, become the priority at the expense of economic efficiency.³⁶⁰ In the absence of generally applicable standards of justice³⁶¹ and insight into the relationship between justice and efficiency, it becomes impossible to conduct empirical testing of the public interest theory as an explanatory theory of regulation.³⁶²

According to Posner, the public interest theory is incomplete, as it fails to indicate how a given point of view on the public interest translates into legislative actions that maximize economic welfare³⁶³. It is also based on an assumption that the regulator is an incorruptible and infallible entity. It provides no room for lobbying and its potential effect on the regulatory processes. This assumption is addressed in the capture theory, discussed in the next section.

CAPTURE THEORY.

³⁵⁷ Susan Rose-Ackerman, *Rethinking the Progressive Agenda: The Reform of the American Regulatory State* (Free Press, New York 1992).

³⁵⁸ David Sappington and Joseph Stiglitz, *Information and Regulation, Public Regulation: New Perspectives on Institutions and Policies* (MIT Press, Cambridge, MA 1987), pp. 3 - 43.

³⁵⁹ Kip Viscusi, 'Market Incentives for Safety' (1985) 63(4) *Harvard Business Review* 133, pp.133-138.

³⁶⁰ Hertog (n 342) p. 233.

³⁶¹ Ronald Dworkin, 'What Is Equality?' (1981) 10(4) *Philosophy and Public Affairs* 283.

³⁶² Hertog (n 342) p. 234.

³⁶³ Posner (n 355) p. 351.

The public interest theory's main assumption that governments are benevolent and competent is the focus of the capture theory of regulation.³⁶⁴ The capture theory contends that organizations, subject to regulation, will ultimately control or 'capture' the regulator. The regulators act as self-interested agents that seek to maximise their own utility functions.³⁶⁵ Even though regulation is often explained in terms of 'protecting the public', it is difficult for the regulator to remain independent of the industries as the survival of the regulatory agency frequently depends on satisfying the industry's needs.³⁶⁶

The capture theory explains the connection that exists between regulators and the industry. Industry representatives lobby politicians for favourable regulation. Politicians provide them with such regulation in return for a certain form of a bribe,³⁶⁷ and as long as it does not affect their re-election chances. Individuals are not able to halt the collusion between regulators and producers, because of the free rider problem, which implies that the benefit for an individual citizen from stopping the wealth transfer is lower than the cost of informing and organizing other citizens to act on the issue.³⁶⁸

It has been argued that the accounting and auditing standards-setting process has been captured by large accounting firms in various jurisdictions. For example, according to Walker, the Australian Standards Review Board was captured by the accounting profession. Walker establishes that:

The profession had managed to influence the procedures, the priorities and the output of the Board. It was controlling both the regulations and the regulatory

³⁶⁴ George Stigler, 'The Theory of Economic Regulation' (1971) 2(1) *Bell Journal of Economics and Management Science* 3, pp. 3-7.

³⁶⁵ Sam Peltzman, 'Towards a More General Theory of Regulation' (1976) 19(2) *Journal of Law and Economics* 211, pp. 239 - 40.

³⁶⁶ Deegan (n 329) p. 52.

³⁶⁷ This can take many forms such as cash, perks, post-public-service employment, in Kothari (n 346) p. 65.

³⁶⁸ Mancur Olson, *The Logic of Collective Action: Public Groups and the Theory of the Groups* (Schocken Books, New York 1965), p. 135.

agency; it had managed to achieve coordination of its activities and it appears to have influenced new appointments so that virtually all members of the Board might reasonably be expected to have some community of interests with the professional associations.³⁶⁹

Baxter justifies the capturing process on the grounds that the accounting profession needs regulation to insure itself against the risk of producing poor quality accounting standards.³⁷⁰ The emergence of the generally accepted accounting standards in the US in the 1930s, a period subsequent to the 1920s during which accountants were criticized for poor accounting practices, is consistent with this hypothesis.³⁷¹

From the accountants' perspective the costs of producing poor quality standards can be twofold: the loss of reputation, and legal liability. If the accounting judgement turns out to be erroneous, accountants can lose their credibility as experts and be sued. Legal liability is also one of the reasons why accountants prefer to rely on authoritative regulation rather than their professional judgement. The increase in accountants' demands for regulation is consistent with the increase in the litigation levels against them.

The increase in litigation and regulation can also be observed in the aftermath of major scandals. The most prominent examples being the establishment of the Securities Exchange Commission in 1934, as a response to the Wall Street Crash of 1929; the establishment of the UK Accounting Standards Steering Committee in the early 1970s following accounting failures of the late 1960s; the creation of the Accounting Standards Board in 1990, as a response to major accounting frauds in the late 1980s in the UK and

³⁶⁹ Robert Graham Walker, 'Australia's ASRB: A Case Study of Political Activity and Regulatory Capture' (1987) 17(67) *Accounting and Business Research* 269, p. 282.

³⁷⁰ William T. Baxter, *Accounting Standards: Boon or Curse?*, The Emanuel Saxe Distinguished Lectures in Accounting 1978-1979 (New York: The Bernard M. Baruch College, 1979), pp. 25 - 40.

³⁷¹ At first, the US accountants issued non-binding 'research bulletins' under the CAP, then 'opinions' under the APB and now 'standards' under the FASB. In Kothari (n 346) p. 68.

the stringent regulations introduced in many jurisdictions following the accounting failures at Enron, WorldCom or Parmalat. Most of the members of these post-crisis institutions were recruited from within the accounting profession, which shows that there is some merit in the regulatory capture theory.³⁷²

ECONOMIC INTEREST GROUP THEORY OF REGULATION.

The economic interest group theory is a refinement of the capture theory of regulation and suggests that regulation is a mix of policies driven by the forces of supply and demand. The government is situated on the supply side while industry is that on demand. The theory suggests that regulation is developed and operated primarily for the benefit of the industry concerned, without any external mechanisms involved.³⁷³

Stigler contends that the primary benefit of the regulation of a branch of industry is the industry's freedom to establish its own rules, which are subsequently enforced by the government. For example, the government can grant direct subsidies to an interest group, or introduce quotas, or restrict entry to the profession by means of licensing requirement. He suggests that every industry, or occupation that has enough political power to utilize the state, will seek to control entry.³⁷⁴ Various branches of industry would then be able to exploit the political decision-making process for their own benefits for two reasons. Firstly, interest groups exercise political influence more easily than individuals. This helps save time, energy and money. Also the political influence gained by individuals would most likely be negligible.³⁷⁵ Secondly, Stigler assumes that politicians are self-

³⁷² This also relates to the International Accounting Standards Board, which despite its claims of independence and objectivity in setting the standards, appoints previous members of the accounting profession.

³⁷³ Stigler (n 364) p. 3.

³⁷⁴ Stigler (n 364) p. 5.

³⁷⁵ Hertog (n 342) p.236.

interested, and just like business executives or consumers they seek to increase their wealth and maximise votes. The regulated branches can supply the resources by campaign contributions or employment of party workers. The increase in the number of votes is achieved by educating members of the industry.³⁷⁶ Stigler claims that regulation does not aim at remedying market failures, but it sets up income transfers in favour of the industries in exchange for political support.³⁷⁷

As far as accounting standards setting is concerned, numerous industry groups lobby the standard setters to enact industry-beneficial accounting arrangements. Deegan gives an example of how a small number of aerospace companies successfully influenced the enactment of the UK accounting standard on research and development in favour of their private interests. The companies argued that in special circumstances they should be allowed to ‘treat development expenditure as a form of capital expenditure, and charge it as an expense in future years by matching it against the income that it eventually generated’.³⁷⁸ This treatment resulted in higher net assets being reported in a balance sheet of these companies.

Watts and Zimmerman analyse the lobbying patterns of the US corporations regarding the introduction of general price level accounting, an accounting method leading to a reduction in reported profits during the periods of inflation. They show that large politically sensitive firms favour this method, even though it leads to reduced profits. They suggest that if these firms show abnormally high profits, they are likely to be subject to a negative public sentiment, probably in the form of government intervention,

³⁷⁶ Stigler (n 364) p.12.

³⁷⁷ Hertog (n 342) p.237.

³⁷⁸ Deegan (n 329) p. 85.

consumer boycotts or claims for higher wages. By reporting lower profits, they are actually able to avoid negative wealth implications for the organizations.³⁷⁹

Stigler's theory of economic regulation is criticized for not being able to explain why in many situations regulation significantly favours particular consumer groups. For instance, the supply of water to schools or fire services free of charge or below cost; free travel for government officials and so on. This phenomenon is known as cross-subsidization and is explained by Sam Peltzman.³⁸⁰

Peltzman claims that politicians tend to choose the policy of regulation in order to increase their political support; hence it is not likely that only one particular industry branch benefits from regulation. Consumers are also able to organize themselves and benefit from it. As the lower prices work to the advantage of consumers and higher prices are favoured by industry, the core issue for policy makers is to introduce regulations that balances out the needs of both groups and maximises their votes.³⁸¹ Efficient regulation should set prices on such a level that the gain in votes from the income transfer to the industry is balanced out with the loss of votes resulting from the increase in prices.³⁸² Not only does this theory explain cross-subsidization, it also enables us to predict which branches are going to be regulated. According to the economic interest theory, one can expect the most regulation in the competitive branches such as agriculture, independent professions and the monopolistic industries, such as telecommunications or rail transport.³⁸³

³⁷⁹ Ross L. Watts and Jerold L. Zimmerman, 'Towards a Positive Theory of the Determination of Accounting Standards' (1978) 52(1) Accounting Review 112, pp. 112 - 34.

³⁸⁰ Peltzman (n 365) p. 211.

³⁸¹ Peltzman (n 365) pp. 212-215

³⁸² Hertog (n 342) p. 238.

³⁸³ Hertog (n 342) p. 238.

Another criticism levelled at the Chicago theory of regulation is that it pays no attention to the motivation and behaviour of different political constituencies, such as legislators, voters, government workers and agencies. It is also considered to be indifferent to the interactions between the players in the regulatory process and the mechanism through which regulators fulfil the wishes of the organised partial interests.³⁸⁴ Further critique comes from the Virginia School of Public Choice, which challenges the Chicago theoreticians' notions that democracies are efficient and that the cost of redistribution does not exceed the normal cost of government.³⁸⁵ The central role is played here by the term 'rent seeking' coined by Ann Krueger.³⁸⁶ 'Rent seeking' is defined as the political activity of individuals or groups to earn income by capturing economic rent through manipulation or exploitation of the economic or political environment, rather than earning profits through economic transactions and the production of added wealth.³⁸⁷ This implies that there are significant welfare costs to the activity of the government.

IDEOLOGY THEORY OF REGULATION.

The ideology theory of regulation is based on the premise of market failures, much like the public interest theory. The model of regulators in the ideology theory, however, is neither as benevolent as in the public interest theory, nor as self-serving as suggested in the capture theory. Regulation is the result of both political ideologies, which vary across many dimensions, and industry lobbyists, who influence the activities of the regulators.³⁸⁸ It is appealing as it explains the relation between interest-group lobbying and politicians' votes on regulation. The central point that distinguishes this ideology theory from other

³⁸⁴ Hertog (n 342) p. 241.

³⁸⁵ Charles K. Rowley and Friedrich Schneider, *The Encyclopedia of Public Choice*, vol. 2 (Kluwer Academic Publishers, 2004), pp. 15 - 16.

³⁸⁶ Ann Krueger, 'The Political Economy of the Rent-Seeking Society' (1974) 64(3) *American Economic Review* 291, p. 291.

³⁸⁷ Krueger (n 386) p.291.

³⁸⁸ Kothari (n 346) p. 69.

theories is the fact that it treats lobbying not as a form of bribery, but as a process through which politicians are informed about policy issues. Accordingly, industries lobby regulators not because of their self-interest, but in order to convey their knowledge on the issues subject to regulation.

The ideology theory of regulation attempts to explain the accounting standards setting process. Regulators have certain ideologies, such as balance-sheet primacy or fair-value basis, but they are open to lobbying from industries with specific knowledge. Since politicians are not omniscient or benevolent, the resulting regulation is not always socially optimal.³⁸⁹ According to the theory, regulation arises to counteract market failures, but the political ideologies and manipulative lobbying can actually lead to the destruction of welfare. Thus, the optimality of regulation is a case sensitive assessment.

According to the ideology theory, the key policy implication is to create a standards-setting institution that minimizes the effect of conflicting ideologies and industry lobbying. One way to achieve this is to encourage competition among standards setters,³⁹⁰ which in turn can promote competition among ideologies, leading to the survival of the most efficient GAAP. Accordingly, competition can also diminish the effects of industry lobbying. If a standard setter is seen as being prone to the industry lobbying, it may lose its credibility.

There are some potential drawbacks to competition as a solution to regulating standard setting. Firstly, competition can at times induce a 'race to the bottom'. In this instance, instead of competing on quality, standard setters will supply favours to the interest groups,

³⁸⁹ Kothari (n 346) p. 70.

³⁹⁰ Shyam Sunder, 'Regulatory Competition among Accounting Standards within and across International Boundaries' (2002) 21(3) *Journal of Accounting and Public Policy* 219, p. 219.

decreasing the efficiency of the GAAP. Furthermore, in case of the demise of some of the standard setters due to the production of poor standards, the remaining standard setters might collude. Such collusion might inhibit innovation and encourage the self-interest of industry groups.³⁹¹

There are, however, certain advantages to the competition between standard setters. First of all, an increasing body of evidence suggests that the nature of accounting standards is country-specific and depends on accountants' and auditors' training, effectiveness of enforcement, rule of law, culture and history.³⁹² It is therefore unlikely that one unified set of accounting standards would provide optimal regulation and efficient capital allocation decisions. Secondly, there is some evidence of political influence in the setting of accounting standards.³⁹³ Due to this fact, it is unclear whether the political forces that influence the setting of local accounting standards will accept the IASB standards. Thus, initially internationally harmonised rules are likely to devolve into standards designed according to local political conditions, suggesting that any attempts to converge the accounting standards are doomed to failure.³⁹⁴

CONCLUSION

³⁹¹ According to Kothari, the current 'convergence' towards uniform accounting standards between FASB and IASB is consistent with this observation, in Kothari (n 346) p. 75.

³⁹² Ray Ball, 'Market and Political/Regulatory Perspectives on the Recent Accounting Scandals' (2009) 47(2) *Journal of Accounting Research* 277, p. 300; Douglas J. Skinner, 'The Rise of Deferred Tax Assets in Japan: The Role of Deferred Tax Accounting in the Japanese Banking Crisis' (2008) 46(2-3) *Journal of Accounting and Economics* 218, p. 218; Ray Ball, Ashok Robin, and Joanna Shuang Wu, 'Incentives Versus Standards: Properties of Accounting Earnings in Four East Asian Countries' (2003) 36 (1-3) *Journal of Accounting and Economics* 235, pp. 260 - 61.

³⁹³ Watts and Zimmerman (n 379); Stephen A. Zeff, 'The Evolution of US GAAP: The Political Forces Behind Professional Standards' (2005) 75(1) *CPA Journal* 18, pp. 18 - 27.

³⁹⁴ At the beginning of the financial crisis, the IASB permitted financial institutions to suspend mark-to-market accounting and avoid costly impairment. According to Leone, this decision was the outcome of the political pressure from the European Union, in Marie Leone, 'Spineless?' UK Pressure Targets Fair Value Weakening' available via <http://ww2.cfo.com/accounting-tax/2008/11/spineless-uk-pressure-targets-fair-value-weakening> accessed 14 February 2016.

So far this chapter provided an analysis of various theories of regulation and their application in the auditing context. It was argued that none of the theories provides a comprehensive explanation for the existing regulation of the audit model. Indeed, Watts and Zimmermann claim that the market for auditing theory is a 'market for excuses' and that the concepts in the auditing literature are altered in order to adapt to changes in political issues and institutions.³⁹⁵ They argue that auditing theory simply changes in the aftermath of government regulation enacted as a response to accounting scandals.³⁹⁶ In their view,

Instead of providing an underlying framework for the promulgation of sound financial reporting practices by standards setting boards, accounting theory has proven a useful tactic to buttress one's preconceived notions... The predominant function of accounting theories is now to supply excuses which satisfy the demand created by the political process; consequently accounting theories have become increasingly normative.³⁹⁷

Following Watt and Zimmerman, this thesis agrees that the current regulation of audit lacks strong theoretical grounding and is reactionary. This thesis asserts that in order to build an effective audit system one needs to start with the coherent theoretical underpinning of audit and proceed with building regulation around it. This is elaborated in chapter six, where it is argued that since audits play the important public function of providing confidence in the capital markets, they should be conducted for the benefit of multiple stakeholders that have an interest in the audited financial statements. To that end, the scope of audits should be extended to include financial information that is relevant to stakeholders such as creditors and employees. Moreover, audits should be moved into the

³⁹⁵ Ross L. Watts and Jerold L. Zimmerman, 'The Demand for and Supply of Accounting Theories: The Market for Excuses' (1979) 54(2) *Accounting Review* 273, p. 289.

³⁹⁶ Watts and Zimmerman (n 395) pp. 290 - 300.

³⁹⁷ Watts and Zimmerman (n 395) p. 300.

public sector and be supplied by a public agency. This would allow a close relationship between management and auditors to be severed and to introduce genuinely independent and autonomous auditors with strong incentives to provide good quality audits.

The following section looks at how the auditing universe is regulated. It focuses on the debate around the efficiency of the rule- and principle-based types of regulation of standard setting. It concludes that rules and principles should not be seen as alternatives, but should instead be applied as supplementary to each other. Accordingly, regulators should aim to include both in the optimal regulation of audit.

3.2. HOW: RULES VERSUS PRINCIPLES

The previous section presented theories of regulation in general, and their application to the regulation of audit in particular. This section focuses on how auditing is regulated, by referring to the concepts of rule- and principle-based regulation of auditing standards, which has been the subject of an extensive debate since the 1990s.³⁹⁸ The UK's comparative success in avoiding large corporate scandals, such as Enron or WorldCom, has prompted scholars and regulators to favour the UK principle-based approach to regulation over the US rules-based approach, with detailed and complex rules.³⁹⁹ This section is important for this thesis, as it explores the nature of such regulation, arguing that it is difficult to favour one approach over another due to the cultural, historical and regulatory differences between countries. It also argues that the debate should refocus on

³⁹⁸ David Alexander and Eva Jermakowicz, 'A True and Fair View of the Principle/Rules Debate' (2006) 42(2) *Abacus* 132; David Satava, Cam Caldwell, and Linda Richards, 'Ethics and the Auditing Culture: Rethinking the Foundation of Accounting and Auditing' (2006) 64(3) *Journal of Business Ethics* 271

³⁹⁹ David Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation', (2005) 68 (4) *The Modern Law Review* 594, p. 594.

delivering real improvements in audit quality and the need to balance the promotion of professional judgement with the need for greater auditors' accountability.⁴⁰⁰

According to Black, different types of norms can be categorized as bright-line rules, principles, and detailed rules.⁴⁰¹ Bright-line rules are usually very clear and their application is straightforward, but they can fail to achieve their purpose (e.g. fair treatment of customers). This is due to the fact that bright-line rules are usually very general and it is easy to manipulate or 'creatively comply' with them.⁴⁰² The principles, on the other hand, are focused on the substantive objective. The principle announces a broad objective in the expectation that 'regulatory particulars will derive from law-to-fact applications over time.'⁴⁰³ In theory, norms constructed in this way keep regulators in closer touch with ultimate regulatory objectives, even though they permit variations in the facts of the cases. On the other hand, the rule-based system is tilted toward formalism. The specificity of rules can allow a user, such as an auditor, to report a transaction in formal compliance with the rules without paying due regard to the spirit or objective underlying such rules; the reason why it was introduced in the first place.⁴⁰⁴ The table below provides the examples of these three types of norms.⁴⁰⁵

⁴⁰⁰ ICAEW, *Audit Quality, Fundamentals - Principles-based Auditing* (ICAEW, 2006) available via <http://www.icaew.com/~media/corporate/files/technical/ethics/audit%20quality%20fundamentals%20principles%20based%20auditing%20standards.ashx> accessed 14 February 2016.

⁴⁰¹ Black (n 323) p. 437.

⁴⁰² Creative compliance takes place when a person applies a rule according to its formal approach, but disregarding its overall purpose. See Julia Black, 'Using Rules Effectively' in Christopher McCrudden (ed), *Regulation and Deregulation: Policy and Practice in the Utilities and Financial Services Industries* (OUP, Oxford 1999), p.106

⁴⁰³ William W. Bratton, 'Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents' (2003) 48 *Villanova Law Review* 1023, p. 1037.

⁴⁰⁴ Kershaw (n 399) p. 596.

⁴⁰⁵ Kandemir (n 325) p.74.

Table 1 provides examples of three types of norms (bright-line rules, principles, detailed rules).

| Regulations | Examples | |
|-------------------------|--------------------------|---|
| Audit Regulation | Bright-line rules | All statutory auditors and audit firms shall be subject to public oversight. ⁴⁰⁶ |
| | Principles | The overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. ⁴⁰⁷ |
| | Detailed rules | Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years. ⁴⁰⁸ |

Table 1. Levels of regulation and examples.⁴⁰⁹

Rules-based regulation is usually detailed and precise and attempts to anticipate all the cases. In this respect, such rules provide a high degree of certainty and predictability. However, they are also likely to create gaps in application, since it is not possible to

⁴⁰⁶ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on Statutory Audits and Annual Consolidated Accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87 (Statutory Audit Directive), Article 32(2).

⁴⁰⁷ ISA 200, para. 11(a), available via <http://www.ifac.org/system/files/downloads/a008-2010-iaasb-handbook-isa-200.pdf> accessed 14 February 2016.

⁴⁰⁸ Directive 2006/43/EC (n 406), Article 42(2).

⁴⁰⁹ Kandemir (n325) p. 74.

elaborate on all the conditions or factors that need to be taken into account while creating a rulebook. A new rule is usually required whenever a new circumstance arises. This, in turn, may lead to overproduction of new rules and laws.⁴¹⁰ Moreover, rules-based regulation tends to be more costly than principles-based regulation, due to its high formulating costs.⁴¹¹

Rules are considered to afford better protection against liability and hence the litigation risk that may have induced auditors to lobby for ‘rules-oriented’ rather than ‘principles-based’ accounting and auditing standards.⁴¹² Furthermore, detailed rules are also more difficult to adjust to changing market circumstances.⁴¹³ Kershaw argues that detailed rules are ‘fashioned in a proximate relationship to existing economic and financial practices’.⁴¹⁴ This is why they are frequently more difficult to apply to innovative financing structures. Principles, on the other hand, tend to be more dynamic, they are not fashioned by specific practices and are, therefore, more flexible to apply to new financing practices.

There has been an upward global trend towards principle-based regulation. This has been particularly noticeable following several high profile corporate and audit failures in the US, such as Enron and WorldCom. The UK’s comparative success in avoiding such large-scale failure has prompted regulators and scholars to enquire whether this comparative

⁴¹⁰ Surendra Arjoon, ‘Striking a Balance between Rules and Principles-Based Approaches for Effective Governance: a Risks-Based Approach’ (2006) 68(1) *Journal of Business Ethics* 53, p. 77.

⁴¹¹ The various costs of regulation can be summarized as formulating legal rules (formulating costs), litigation costs (application of these rules in courts), compliance costs (interpretation of these rules by the public, in Louis Kaplow, ‘General Characteristics of Rules’ in John M. Olin (ed), *Encyclopaedia of Law and Economics* (Edward Elgar 2000) p.502 .

⁴¹² George J. Benston, ‘Accounting Doesn’t Need Fixing (Just Reinterpreting)’ (2003) 15(3) *Journal of Applied Corporate Finance* 83, pp.83-96; Coffee (n 69); Shyam Sunder, ‘Rethinking the Structure of Accounting and Auditing’ (2003) Yale ICF Working Paper No.03-17, available at <http://ssrn.com/abstract=413581> accessed 15 September 2015; Wyatt (n 40).

⁴¹³ Financial Services Authority, ‘Principle-based regulation: Focusing on the outcomes that matter’, April 2007, p.6

⁴¹⁴ Kershaw (n 399) p. 596

success is the product of the UK principle-based ‘lighter touch’ regulation.⁴¹⁵ The claim about the superiority of the UK’s principle-based approach has been made repeatedly in the post-Enron era both in the UK, and in the US.⁴¹⁶ The Institute of Chartered Accountants in England and Wales (ICAEW) has argued that ‘the United States financial reporting model places far more emphasis on extensive rules and regulations. This focus on detailed rules can encourage compliance with the letter of the law rather than the spirit’.⁴¹⁷ The Association of British Insurers in a Memorandum to the Treasury Committee on the Financial Regulation of Public Limited Companies, submitted that ‘UK practice differs from that of the US in that it is more flexible and less rules-bound’.⁴¹⁸ Similarly, the Chairman of the US SEC - Harvey Pitt, in his testimony to the US House of Representative’s Committee on Financial Services, argued that the accounting standards ‘encourage auditors to check the boxes to ascertain whether there is technical compliance with applicable accounting standards’ and that US GAAP should move toward a ‘principles-based set of accounting standards, where mere compliance with technical prescriptions is neither sufficient nor the objective’.⁴¹⁹

According to Gray, however, there is no major difference between the UK and US accounting standards, and that in fact they are ‘almost identical’.⁴²⁰ Kershaw also argues that the UK standards cannot be distinguished in any meaningful way from the US ones

⁴¹⁵ The regulatory policy of the FSA was described as ‘light touch’ or ‘principle-based’ regulation. See Joanna Gray, ‘Is It Time to Highlight the Limits of Risk-Based Financial Regulation?’ (2009) 4(1) Capital Markets Law Journal 50.

⁴¹⁶ Kershaw uses the term ‘superiority’ to denote the comparative claim about the difference between UK and US accounting regulation, in Kershaw (n 399) p. 595.

⁴¹⁷ Memorandum submitted by the ICAEW to the Treasury Committee, in Kershaw (n 399) p. 597.

⁴¹⁸ Memorandum submitted by the Association of British Insurers to the Treasury Committee Inquiry into the Financial Regulation of Public Limited Companies (Treasury Committee Sixth Report of Session 2001-2002), in Kershaw (n 399) p.597.

⁴¹⁹ Harvey Pitt, ‘Testimony Concerning the Corporate and Auditing Accountability, Responsibility and Transparency Act before the US Committee on Financial Services, House of Representatives, available via <https://www.sec.gov/news/testimony/032002tshlp.htm> accessed 15 September 2014.

⁴²⁰ Gray (n 415) p. 50.

on the basis that the UK has a principles-based, as opposed to rules-based approach.⁴²¹ In the context of Enron, the form of regulation was not a reason for the audit failure. Kershaw claims that the regulatory climate in which the benefits of acquiescing to management's accounting demands outweigh the potential costs of such acquiescence were the underlying cause of the audit failure.⁴²² The benefits of an auditor compromising his independence through the provision of consulting services went up, whilst the costs decreased as a result of declining exposure to liability for audit failure.⁴²³ Also Bratton convincingly argues that the crisis of the auditing profession in the US is 'not for the most part a problem concerning the relative merits of rules and standards in the drafting of statutes. It is instead a problem of professional practice in a regulatory system made up of both'.⁴²⁴ The combination of sham transactions and lucrative consulting contracts created an environment where auditors were no longer independent and could not deliver good quality audits.

To conclude, it is not possible to universally favour one approach over another; rule- or principle-based regulation may work better in some countries but not suit others due to cultural or regulatory differences. In fact, according to Black, standards combining both rules and principles might just be the optimal solution for the regulation of audit ('tiered approach').⁴²⁵ However, both principles and rules can always be manipulated in favour of the presentation that suits management interests, and so no amount of rules and principles will be able to counteract fraud if auditors fail to exercise their professional judgement and ethical decision-making. It has been argued that auditors should be required to stand back and assess whether they have in fact done everything that is

⁴²¹ Kershaw (n 399) p. 624.

⁴²² Kershaw (n 399) p. 595.

⁴²³ Coffee (69) pp. 288-293.

⁴²⁴ Bratton (n 403) p.1055.

⁴²⁵ Black (n 323) pp. 429-430.

necessary to achieve the objectives of audit.⁴²⁶ This thesis supports a view that the present regulatory environment should be amended in order to firstly eliminate the pervasive auditors' incentives to acquiesce to managers' demands, such as provision of consulting services, and secondly to encourage auditors to use their judgement transparently and with integrity. This will provide a true independence for auditors and increase the quality of audits.

The next section examines players involved in the regulation of audit. These include the auditing profession, national enforcement agencies, international regulators and the biggest audit firms. It critically evaluates the role and relations between different regulators and emphasises an increasing role of the state in the regulation of audit. The aim of the following section is to provide a comprehensive answer as to who regulates audit, and what are the weaknesses in the current regulatory arrangements.

3.3. WHO REGULATES AUDIT?

This section examines the numerous parties involved in the regulation of audit. The first subsection looks at the governance of the auditing profession and industry self-regulation. It argues that as a result of accounting scandals, such as Enron, and the inability of the profession to effectively regulate itself, the nation states had to introduce tougher measures and increase their oversight. The second subsection examines the role and structure of the state enforcement agencies, which complement audit in providing the accuracy and reliability of financial reports.⁴²⁷ The following subsection discusses the role of international financial institutions and the biggest audit firms in the regulation of auditing. This is important due to the increasing role that the latter two play in the

⁴²⁶ ICAEW (n 400) p.19.

⁴²⁷ Jochen Zimmermann, Jorg W. Werner, Phillip B. Volmer, *Global Governance in Accounting: Rebalancing Public Power and Private Commitment, Transformations of the State* (Palgrave Macmillan, Basingstoke 2008), p. 103.

interpretation and implementation of audit practices and their powerful position as lobbyists.

3.3.1. INDUSTRY SELF-REGULATION

Private players, alongside state players, play a role in the regulation of audit. Private regulation, or in other words industry self-regulation, co-exists with state regulation. The influence of private and state regulators might vary at national, regional and international levels with regards to their legislative power and political influence. Industry self-regulation can have certain advantages, for instance, the profession might be able to identify weaknesses in industry where the state regulators may lack sufficient expertise and information on the subject matter. On the other hand, private regulators are likely to be motivated by gaining financial benefits⁴²⁸ and can eventually disregard public interest.⁴²⁹ The following subsections look at the decreasing role of industry regulation in the UK and the US.

The UK followed the model of self-regulation in auditing for many years. At first, audits were conducted by accountants registered with one of the chartered accountancy associations, which created their own audit regulations. This model was established at the end of the 19th century and served the profession for almost a century. In some cases, self-regulation can be considered as good or even superior to government regulation, due to the fact that industry participants benefit from their superior expertise, increased efficiency in the rule-making process, and an improved flexibility to adapt rules to changing circumstances.⁴³⁰ This is not necessarily in conflict with Stigler and Peltzman's

⁴²⁸ Michael Clarke, *Regulation: The Social Control of Business Between Law and Politics* (Macmillan, New York 1999), p. 49

⁴²⁹ Robert Baldwin and Martin Cave, *Understanding Regulation Theory, Strategy, and Practice* (2nd, OUP 2012), p.9.

⁴³⁰ Christopher Humphrey and Peter Moizer, 'From Techniques to Ideologies: An Alternative Perspective on the Audit Function' (1990) 1(3) *Critical Perspectives on Accounting* 217.

assumption that industries demand government regulation to help control the costs of free-riding and to disguise the self-interested nature of the regulation. Stigler and Peltzman's assumption makes sense when there are strong incentives for individuals to shirk, or when there are ineffective deterrent instruments within the profession. If the industry is able to detect and selectively punish shirkers and those who breach professional codes of conduct, the cost-benefit equation shifts enough to make the industry-controlled rules quite feasible. Hence, where the expected value of cooperation is high, professional discipline effective, and transaction costs and commitment problems fairly low, self-regulation is not only probable, but also consistent with the theory of regulatory capture, and the theory of economic interest.⁴³¹ The auditing industry's long reign of self-regulation, however, turned out to be unsustainable.

One of the first changes to the model of a self-regulating accounting profession was introduced by the Companies Act 1989. The Act required the DTI to monitor company audit work. The regulation coincided with the implementation of the Seventh (83/349/EEC)⁴³² and Eighth (84/253/EEC)⁴³³ Council Directives into UK law, which established the minimum state regulation. Subsequent monitoring was undertaken by professional institutes such as the ICAEW or the ICAS. Professional bodies hence acted both as professional associations, and as supervisory organisations.

The regulation of the profession in 1989 led to the creation of the Auditing Practices Board (APB) in 1991. The role of the APB was to establish unified standards of auditing. The APB was in charge of promulgating Statements of Auditing Standards (SAS) that

⁴³¹ Carmichael (n 269) p. 10.

⁴³² Seventh Council Directive of June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts OJ No L 193/1 (Directive 83/349/EEC).

⁴³³ Eighth Council Directive of April 1984 based on the Article 54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents OJ No L 126/10 (Directive 84/253/EEC).

contained principles and procedures that all the auditors had to comply with. The APB consisted of sixteen voting members; half of them were audit practitioners, the other half were chosen from among users and preparers of financial reports. There were concerns raised that the APB was too closely involved with the profession and hence a new remodelled APB was established. The new APB was created in 2001 and was moved under the umbrella of the Accountancy Foundation as an independent oversight body. The majority of the voting rights were held outside the profession.⁴³⁴ The Board adopted the existing framework of International Standards on Auditing (ISA) for the UK in 2004.

As a response to the accounting scandals that shook the US in the early 2000s, the DTI introduced further institutional changes. The Accountancy Foundation became part of the Financial Reporting Council (FRC).⁴³⁵ Also the Professional Oversight Board for Accountancy (POBA) was established to replace the Accountancy Foundation's Review Board.⁴³⁶ Following the enactment of the Companies (Audit, Investigations and Community Enterprise) Act, the POBA was given more rights to oversee the activities of professional bodies. It was renamed as the Professional Oversight Board (POB), becoming at the same time responsible for the actuarial profession. The newly created Audit Inspection Unit (AIU) was charged with the monitoring of listed companies' audits.⁴³⁷

In July 2012 the structure and functions of the Financial Reporting Council changed conspicuously again following parliamentary approval of the proposed reform. As a result of the reform, the Auditing Practices Board was replaced by the Audit and Assurance

⁴³⁴ Zimmermann (n 427) p.112.

⁴³⁵ Available via <http://www.frc.org.uk/apb/>. accessed 16 February 2016.

⁴³⁶ Stella Fearnley and Vivien Beattie, 'Auditor Independence and Audit Risk: A Reconceptualization' (2005) 4(1) *Journal of International Accounting Research* 39, p. 42.

⁴³⁷ Zimmermann (n 427) p. 112.

Council.⁴³⁸ The FRC has taken over a number of responsibilities that were previously delegated to its various operating subsidiaries. Most importantly, the FRC has been responsible for issuing and amending UK accounting, auditing and actuarial standards, as well as updating the UK Corporate Governance and Stewardship Codes. The FRC is supported by three committees: the Codes and Standards Committee (CSC), the Conduct Committee and the Executive Committee.⁴³⁹

Fig.1. provides an overview of the structure of the Financial Reporting Council.

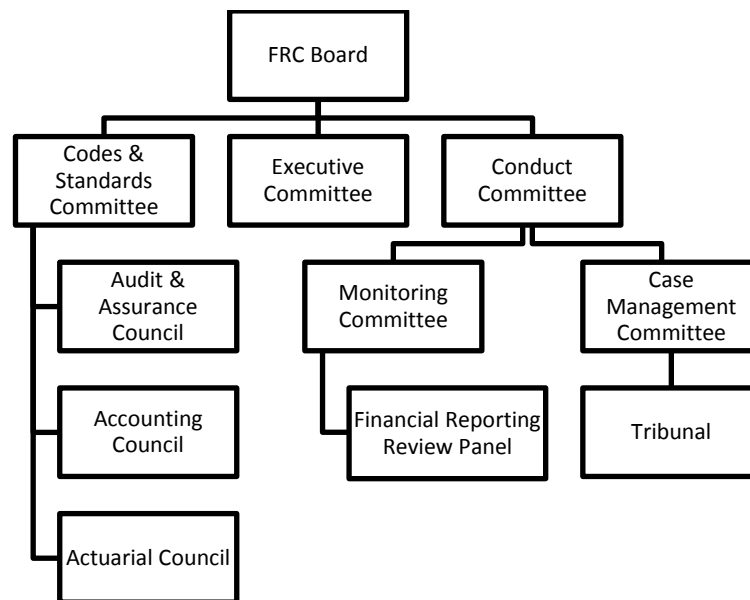


Figure 1. An overview of the structure of the Financial Reporting Council. ⁴⁴⁰

When deciding on standards the FRC board is supported by the Codes and Standards Committee (CSC). The work of the CSC covers the areas previously covered by the Accounting Standards Board, Auditing Practices Board, Board for Actuarial Standards

⁴³⁸ ICAEW, Knowledge Guide to UK Auditing Standards, available via <http://www.icaew.com/en/library/subject-gateways/auditing/knowledge-guide-to-uk-auditing-standards>, accessed 24 August 2015.

⁴³⁹ Financial Reporting Council, Who We Are What We Do, available via <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Who-we-are-What-we-do.pdf> accessed 24 August 2015.

⁴⁴⁰ Financial Reporting Council (n 439).

and the Corporate Governance Committee. The CSC advises the FRC board on the steps that need to be taken to maintain an effective framework of UK codes and standards. The CSC itself is supported by three councils: the Accounting Council, which covers accounting and narrative reporting, the Audit and Assurance Council and the Actuarial Council. As far as the sphere of auditing standards is concerned, the Audit and Assurance Council advises the FRC board and the CSC on draft codes and auditing standards and their amendments. It also comments on proposed developments in relation to international standards and regulations.⁴⁴¹

Over the years the accounting profession in the UK had lost its self-regulatory powers. A shift towards an increased state involvement has been noticeable. The UK has enhanced the role of the Financial Reporting Council and incorporated a uniform auditing standard created by the IFAC. As chapter one showed, in the past decades the accounting profession had undergone many changes which made it unable to self-regulate successfully. Auditors had taken the roles of highly paid consultants, neglecting at the same time their duty to be independent. The profession had become increasingly commercialised and in the wake of Enron and WorldCom scandals, their reputation was severely damaged. In order to maintain the credibility of financial reports, nation states had to introduce tougher measures and increase state oversight.

As far as the US is concerned, major changes in the regulation of the auditing profession resulted from the Sarbanes-Oxley Act (SOX) 2002.⁴⁴² Before the enactment of the SOX, auditors were overseen by the AICPA through the ASB, Ethics Board, the SEC Practice Section and a peer-review system. The AICPA was setting standards on auditing, quality control, independence and ethics. The audit quality and quality of firms conducting these

⁴⁴¹ Financial Reporting Council (n 439).

⁴⁴² Sarbanes-Oxley Act of 2002, PL 107-204, 116 Stat 745.

audits were reviewed by the private POB, which did that under the remit of the SEC. The SEC set requirements for quality control and required peer review for audit firms. According to Zimmermann:

as with the development of US GAAP, the federal government used listed firms to intervene in the audit governance, and a role model evolved that was eventually applied for all firms throughout the country, thus circumventing the states' powers in company law.⁴⁴³

The SOX led to major changes in the governance of the auditing profession, effectively ending the period of the profession's self-regulation. While the overall regulatory oversight remains the responsibility of the SEC, the organizational responsibilities were shifted to the Public Company Accounting Oversight Board (PCAOB). The PCAOB was established by Congress as a non-profit corporation in charge of overseeing the audits of public companies. The board of the PCAOB is composed of five members appointed to staggered five-year terms by the SEC.⁴⁴⁴ The Board is funded by accounting support fees paid by the issuers.⁴⁴⁵ Any domestic or foreign public accounting firm, which provides audit for US-listed companies, has to register with the PCAOB. Apart from registering firms, it sets up and alters current standards regarding auditing, corporate control, business ethics and independence. It is also in charge of conducting annual inspections of accounting firms and in case of violations it conducts investigations and disciplinary proceedings. The PCAOB is under statutory oversight and enforcement authority of the SEC. Its rules come into force only after the SEC's approval.⁴⁴⁶

⁴⁴³ Zimmermann (n 427) p. 170.

⁴⁴⁴ About PCAOB, available via <http://pcaobus.org/About/Pages/default.aspx>, accessed 12th January 2011.

⁴⁴⁵ Sarbanes-Oxley Act of 2002, PL 107-204, 116 Stat 745, Section 109.

⁴⁴⁶ Zimmermann (n 427) p. 170.

According to Zimmerman, the function of audit standard setting is very strongly US focused. The Standing Advisory Group, which advises the PCAOB on the development of auditing and related professional practice standards, is a purely national make-up of auditors, investors and public company executives. Out of eight organisations which have observer status, only one is denominated as international: the International Auditing and Assurance Standards Board (IAASB). The other observers are the Auditing Standards Board of the AICPA, the Department of Labour, the Financial Accounting Standards Board, the Financial Industry Regulatory Board, the Government Accountability Office, the Securities and Exchange Commission and the US Federal Financial Institution Regulatory Agencies.⁴⁴⁷ Over the past years, however, the AICPA Auditing Standards Board (ASB) has aligned its agenda with the IAASB in the Clarity Project, redrafted the standards for clarity and converged the standards with the International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB).⁴⁴⁸ The result made GAAS easier to understand and apply for non-public companies as well as more consistent across international borders, while avoiding unnecessary conflict with auditing standards for public companies issued by the PCAOB.⁴⁴⁹ While the PCAOB has been silent on this issue, Morris believes that the globalisation of auditing standards by the ASB might be viewed as a predecessor of the same type of project by the PCAOB.⁴⁵⁰ Even though the auditing profession increasingly internationalises its procedures and the US-focused regulation of the auditing standards

⁴⁴⁷ PCAOB, Standing Advisory Group, available via <http://pcaobus.org/Standards/SAG/Pages/default.aspx> accessed 14 February 2016.

⁴⁴⁸ American Institute of Certified Public Accountants website, available via <http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ImprovingClarityASBStandards.aspx> accessed 24 August 2015.

⁴⁴⁹ Jan Taylor Morris, 'Clarified Auditing Standards: The Quiet Revolution', *Journal of Accountancy*, June 2011, available via <http://www.journalofaccountancy.com/issues/2011/jun/20113792.html> accessed 24 August 2015.

⁴⁵⁰ Jan Taylor Morris and C. William Thomas, 'Clarifying Auditing Standards. Redrafting Brings Both Significant and Subtle Change', *Journal of Accountancy*, June 2011, available via <http://www.journalofaccountancy.com/issues/2011/jun/20113792.htm> accessed 23th August 2015.

might be seen as an obstacle in reaping economies of scale, it remains to be seen whether the PCAOB decides to take a step towards globalisation of auditing standards for public companies.

Conclusion

Historically, the audit profession governed the majority of the regulation of auditing. Recent developments, however, saw important changes in this sphere. Professional associations remained largely intact, but some of their competencies were shifted towards state oversight agencies as national governments have decided to increase intervention and enhance supervisory responsibilities. The US system is built around the PCAOB, which is placed under statutory oversight and enforcement authority of the SEC. It relies mainly on national solutions and is reluctant regarding transnational arrangements. In the UK, recent reform created a more simplified structure of the FRC, enabling it to operate as a unified regulatory body with enhanced independence and a more proportionate range of sanctions.⁴⁵¹ The FRC is responsible for setting the UK's standards and guidance for auditing, as well as monitoring and enforcing the application of these auditing standards.

Having discussed the governance of the statutory audit in the UK and US, the following subsection turns to discuss other actors involved in the regulation of audit, namely the enforcement agencies. They play an important role of overseeing the quality of conducted audits and independence of auditors. Accordingly, they address society at large by furthering the interests of investors, stabilizing market confidence and providing consumer protection.

⁴⁵¹ Zimmermann (n 427) p.120.

3.3.2. ENFORCEMENT AGENCIES

An enforcement agency is defined as a policing arrangement which takes the form of institutionalised check-ups of previously audited financial reports.⁴⁵² These enforcement mechanisms are conducted by one or more institutions and serve as an additional safeguard in financial reporting. As audits and lawsuits deal with particular financial reports, enforcement agencies address the community at large.

Enforcement agencies in the UK

In the UK, self-regulation was favoured by the UK government for many decades and hence the enforcement area was left to be regulated by the profession itself. Self-regulation, however, proved to be inefficient in tackling misleading and fraudulent statements in the 1980s. An institutional reform was introduced with the enactment of the Companies Act 1989, which also transposed the Seventh and Eighth Council Directives into UK legislation.⁴⁵³ As a result of that, the Financial Reporting Council was created in 1990. It was incorporated as an independent company limited by guarantee and funded mainly by the DTI, the profession, and the supervised firms. A year later the Financial Reporting Review Panel was established as one of the regulatory bodies under the FRC umbrella.⁴⁵⁴ Previously to the establishment of the FRC, there was no systematic policing of reports in place. In cases of misstatements, individual auditors would face disciplinary proceedings in their accountancy bodies, but there was no institutionalised mechanism to correct the financial reports. From an enforcement point of view, the creation of the FRRP constituted a significant institutional overhaul.⁴⁵⁵

⁴⁵² Zimmermann (n 427) p.120.

⁴⁵³ See (n 432) and (n 433).

⁴⁵⁴ Zimmermann (n 427) p.126.

⁴⁵⁵ Zimmermann (n 427) p.126.

The FRRP reviewed accounts for compliance with accounting standards and law. It dealt with the accounts of public and large private companies and it also reviewed directors' reports. The Panel did not duplicate the role of auditors, it enquired into cases where it appeared that rules had not been followed. When a bad accounting practice was found, the Chairman appointed a group, normally comprising of five members, to conduct an enquiry. The Panel tried to reach an agreement with the company through the exchange of correspondence and persuasion. If the Panel was satisfied with the company's explanation, the case was closed. If it was not, than the Panel could, under the threat of lawsuit, force a company or auditor to restate the accounts, making a public announcement regarding the case. In more serious cases, the Panel could obtain from court a legally binding decision regarding restatement.⁴⁵⁶ The overall sanctioning powers of the FRRP relied on cooperation, adverse publicity, or the courts. They were therefore minimal, similar to the connection of the Panel with the state sector.⁴⁵⁷

As a result of the reforms, the FRRP was succeeded by the Conduct Committee of the Financial Reporting Council. In its Corporate Reporting Review work, the Conduct Committee aims to ensure that the provision of financial information by public companies complies with the relevant reporting requirements. The Conduct Committee reviews the director's reports and accounts of public and large private companies for compliance with law. Moreover, it also reviews the interim reports of all listed issuers and the annual reports of non-corporate listed entities.

The Corporate Reporting Review does not duplicate the work of directors and auditors. Directors are responsible for preparing accounts, and for their accuracy, while auditors audit and report on them. The role of the Conduct Committee is to make an enquiry into

⁴⁵⁶ At <http://www.frc.org.uk/frfp/index.cfm>. accessed on 13th January 2011.

⁴⁵⁷ Zimmermann (n 427) p. 127.

cases where it is possible that the requirements have not been followed, particularly where it is questionable whether the director's reports and accounts comply with the Companies Act 2006.⁴⁵⁸ The Conduct Committee can ask directors for an explanation on the potential departures from reporting requirements. If the Conduct Committee is not satisfied with the directors' explanations, it can persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily revise the accounts. Depending on the circumstances, the Conduct Committee may accept another form of remedial action such as a correction of the comparative figures in the next set of annual financial statements. If the directors fail to revise the accounts voluntarily, the Conduct Committee can secure the necessary revision of the accounts through a court order.

The institution with stronger sanctioning powers in an enforcement area was the Financial Services Authority (FSA), which exercised statutory powers awarded to it by the Financial Services and Market Act 2000.⁴⁵⁹ The FSA was an independent, non-governmental body responsible for the supervision of commercial banks, insurance companies, stock exchanges, mortgage business, and general insurance intermediaries. Even though it fulfilled public functions, it was a non-profit private limited company. It was directly responsible to the Treasury, and its budget consisted of fees charged to all authorised firms that carried out activities they regulated and recognised investment exchanges. It was completely independent financially from the government, which made it similar in structure to the SEC.

⁴⁵⁸ FRC, Corporate Reporting Review, available via <http://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review.aspx> accessed 1 August 2013.

⁴⁵⁹ The FSA's predecessor the Securities and Investment Board (SIB) supervising various Self Regulating Organizations (SRO), such as the LSE, the SFA, Personal Investment Authority could no longer cope with the amount of innovative products in the financial services industry. The accompanying scandals in the 1990s, with the seminal example of the collapse of the Barings Bank, led to the end of self-regulation and consolidation of the regulatory responsibilities which had been split amongst various regulators.

The FSA had various legislative, executive and judicial competences. It could enact rules, give guidance and issue codes. It was capable of creating binding regulations to improve market confidence, public awareness, protection of consumers, and to reduce financial crime. As far as its executive functions were concerned, it authorised and supervised capital market issuers and maintained the Official List consisting of all securities traded on the UK regulated market, which was a function that had traditionally been performed by the LSE. The FSA required publication of audited financial statements as well. It did not, however, check the material accuracy of disclosed financial information: the prospectus approval, for instance, was only subject to completeness, and the figures were not checked by the Authority. The FSA also dealt with all the offences relating to the FSMA 2000 and its own rules. It was capable of imposing civil and penal sanctions, such as the publishing of a Statement of Misconduct, alteration and suspension of listing, imposing financial penalties and even directing the case to the court for injunction.⁴⁶⁰

In April 2013, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) took over the responsibilities of the Financial Services Authority via amendments to the Financial Services Act.⁴⁶¹ However, the new Act does not provide for any substantial changes regarding the general functions of regulatory bodies. The Act determines the objectives of the FCA as stabilising market confidence (the strategic objective) and consumer protection (the operational objective). In addition, two new objectives of efficiency and choice, and integrity, replaced the reduction of financial crime objectives.⁴⁶²

⁴⁶⁰ Zimmermann (n 427) p. 129.

⁴⁶¹ The Financial Services Act 2012 (came into force in 1 April 2013) amended the Bank of England Act 1998, The Financial Services and Markets Act 2000 and the Banking Act 2009.

⁴⁶² Graeme Baber, 'A new approach to financial regulation: a step into correct direction?' (2012) 33(1) Company Lawyer 3, p.6

Enforcement agencies in the US

As far as the structure of the US enforcement agency is concerned, the Securities Act of 1933 and the Securities Exchange Act of 1934 served as a legal basis for the establishment of the SEC in 1934. The federal government took over competences of the states for listed companies and placed them in the hands of a public regulator for the first time.⁴⁶³ The SEC is responsible exclusively for securities trade. It is a federal regulatory agency, which is controlled by the US Government Accountability Office. It consists of five Commissioners appointed by the President on five-year terms. The agency's responsibilities are organized into five divisions and sixteen offices.⁴⁶⁴

Figure 2 presents the structure of the SEC.

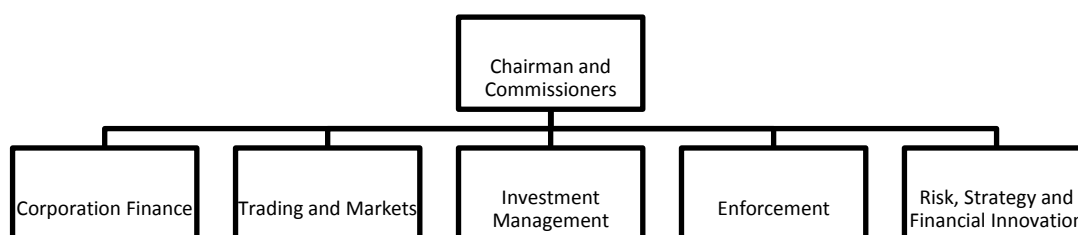


Figure 2. The organisational structure of the Securities Exchange Commission.

The Commission has extensive legislative, executive, and judicial competences with regards to securities regulation. It issues, interprets, and amends all of the rules in its domain, published as the Code of Federal Regulations.⁴⁶⁵ These legislative competences

⁴⁶³ John Cioffi, 'Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany' (2006) 7(6) German Law Journal 533, p. 538.

⁴⁶⁴ US Securities and Exchange Commission website, available via <http://www.sec.gov/about/whatwedo.shtml#org>. accessed on 24 August 2015.

⁴⁶⁵ Fred Skousen, *An Introduction to the SEC* (South Western Publishing, Cincinnati 1991), p. 27.

are accompanied by its executive powers related to overseeing the inspection of securities firm, brokers, investment advisors, rating agencies. It is also in charge of overseeing private regulatory organisations in the securities, auditing and accounting areas.⁴⁶⁶ Finally, among its judicial competences there is an ability to set up an internal tribunal, dealing with administrative proceedings that could impose sanctions and financial penalties on self-regulatory organizations or its members.⁴⁶⁷

The US enforcement system is focused on listed companies, due to its interstate commerce clause roots. It fully relies on the SEC. Almost every area of enforcement is regulated by the SEC. Its powers of scrutiny extend to both prospectuses and regularly filed statements. Even though the accounting standards and listing rules are issued by the FASB and stock exchanges, these bodies are nevertheless supervised by the SEC.⁴⁶⁸

The modus operandi of the Commission had been unchanged for many decades until 2002 and the enactment of the SOX. The SOX further strengthened the role of the already dominating SEC. In order to police financial reports, the SEC was allowed to introduce risk-based assumptions and requirements of a periodical check within every three years. The frequency of reviews is based on the firm's recent restatements of financial reports, market capitalisation and stock price volatility.⁴⁶⁹ The US enforcement model, relying on a strong public agency - the SEC, implies a strong influence of the state. This is different to the UK system, with its independent private regulator-the FRC, cooperating closely with the public sector.

⁴⁶⁶ See (n 464).

⁴⁶⁷ Thomas Lee Hazen, *The Law of Securities Regulation*, (4th edn, West Group, St.Paul, Minnesota 2002), pp. 350 - 85.

⁴⁶⁸ Zimmermann (n 427) pp. 124-125.

⁴⁶⁹ Zimmermann (n 427) p.125.

None of the enforcement powers was transferred to supranational or transnational bodies. Enforcement agencies still remain country specific and are significantly influenced by nation states. According to Zimmermann, there are two reasons that make state involvement in this area more likely. Firstly, capital markets have become extremely important beyond the pure provision of finance, for example in locating funds for retirement. A collapse of the markets would have severe consequences on the citizens' economic wealth, for which the nation state is responsible. Secondly, Zimmerman claims that regulation has become contagious and regulatory regimes cross-fertilize. For example, if one country introduces regulation that aims at preventing crisis, other countries will introduce similar regulatory arrangements in order to ensure the citizens that all possible safeguards, including those existing elsewhere, have been applied to avert the crisis.⁴⁷⁰

State intervention in the sphere of audit should not be considered as a negative phenomenon though. Interventions are generally introduced in order to strengthen audit quality, for instance, through regulation of the auditors' independence. According to Streeck, state intervention is more about 'market-backing' rather than 'market-braking'.⁴⁷¹ Historically, interventions usually took place as a response to accounting scandals. The scope and intensity of regulation, however, differed across countries. Vieten pictured the sources of regulation on an axis between the state and the profession.⁴⁷² He observed that the British system evolved away from its traditional

⁴⁷⁰ Zimmermann (n 427) p. 21.

⁴⁷¹ Wolfgang Streeck, *From Market-Making to State-Building? Reflections on the Political Economy of European Social Policy*, in Stephan Leibfried and Paul Pierson (eds), *European Social Policy: Between Fragmentation and Integration* (The Brookings Institution, Washington, D.C 1995), p. 389.

⁴⁷² Holger Vieten, 'Auditing in Britain and Germany Compared: Professions, Knowledge and the State' (1995) 4(3) *European Accounting Review* 485, pp. 485-511.

laissez-faire approach towards the increasing role of the state in the auditing regulation.

A similar pattern can also be noticed in the US.⁴⁷³

A discussion about the nature and the regulatory arrangements governing auditing practice would not be complete without the analysis of what is commonly known in the field of global governance, as the international financial architecture.⁴⁷⁴ It is argued that audit research should include the analysis of a wide range of global institutions with whom 'the auditing profession interacts and the ways in which such bodies increasingly set the boundaries for audit practice and the thought processes that shape this practice'.⁴⁷⁵ These institutions, such as the World Bank or large multinational audit firms, remain powerful and influential, but there is relatively little known about their *modus operandi*, which can leave scope for abuse and for lack of accountability. This is important for this thesis, as it argues that lack of accountability is one of the biggest problems inherent in current auditing arrangements. In order to counteract this problem, the thesis suggests that audits should be conducted by the public sector agency, and for the benefit of society at large.

3.3.3. INTERNATIONAL FINANCIAL ARCHITECTURE

There are three influential groupings within the context of international financial architecture that contribute to auditing developments. These are: the International Federation of Accountants (IFAC); a group of international regulators comprising World Bank, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Basel Committee on

⁴⁷³ Vieten (n 472) pp. 485 - 87.

⁴⁷⁴ Humphrey (n 2) p. 811.

⁴⁷⁵ Humphrey (n 2) p. 811.

Banking Supervision (BCBS) and the European Commission (EC) and large multinational audit firms.⁴⁷⁶

Figure 3 shows the interlocking relationships between International Regulators, IFAC and large firms in global audit regulation.⁴⁷⁷

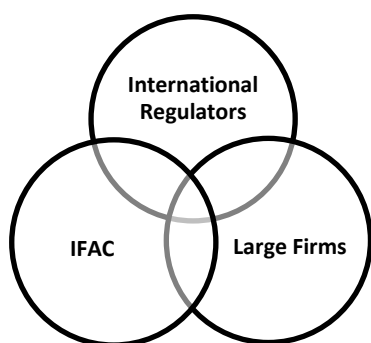


Figure3. Interlocking relationships in global audit regulation.

IFAC is an international private organisation that serves public interest by ‘strengthening the profession and contributing to the development of strong international economies’.⁴⁷⁸ It also contributes to the development of strong professional accountancy organisations and accounting firms. IFAC comprises of 175 members and associates, which are professional accountancy organisations, from 130 countries and jurisdictions.⁴⁷⁹ IFAC contributes to the development of the International Financial Reporting Standards (IFRS)

⁴⁷⁶ Humphrey (n 2) p. 812-813.

⁴⁷⁷ Humphrey (n 2) p. 813.

⁴⁷⁸ International Federation of Accountants, at <http://www.ifac.org/about-ifac> accessed 3 January 2015

⁴⁷⁹ See (n 478).

as a member of the IFRS Advisory Council and comments on strategy, governance, and activities of the IASC Foundation and the International Accounting Standards Board.⁴⁸⁰

International regulators began their cooperation with IFAC and then the Big Five audit firms when the International Forum on Accountancy Development (IFAD) was created in 1999. IFAD was established as a result of the criticisms of the accounting profession at the onset of the Asian crisis. Its goal was to improve accounting capacity in emerging and developing economies. Despite the fact that the IFAD initiative was subsequently terminated, it stimulated contact between these organisations and encouraged the use of ISAs as the world standards, improving audit quality and enhancing the role of IFAC as an entity serving the global public interest. In 2003 the international regulators became IFAC's Monitoring Group.⁴⁸¹

Other members of the Monitoring Group include IOSCO, which has produced several documents regarding auditor independence and audit quality; the BCBS, which regularly issues guidelines on the external audits of banks⁴⁸², and the European Commission which has produced Recommendations and Directives in that area. In addition, the US Public Company Accounting Oversight Board (PCAOB), which although not in the Monitoring Group, also boasts a strong international regulatory influence. The PCAOB, among other tasks, is responsible for carrying out inspections of audit work. It has the controversial powers of broad extraterritorial reach for foreign auditors of US listed companies.⁴⁸³

Finally, the last group of the international financial architecture is the large audit firm network. The most important being the Big Four firms: EY, Deloitte, KPMG and PwC.

⁴⁸⁰ See (n 478).

⁴⁸¹ Humphrey (n 2) p. 813.

⁴⁸² Bank for International Settlements, at <http://www.bis.org/press/p140331a.htm> accessed 24 August 2015.

⁴⁸³ Humphrey (n 2) p. 813.

As mentioned in chapter one, these are large multinational professional service firms which dominate the global market for the auditing of listed companies.⁴⁸⁴ These firms are organised as networks of member bodies, which constitute independent legal entities under the global firm e.g. PricewaterhouseCoopers International Limited. Even though they are legally separate entities, they increasingly act as one, following closely the policies of the global firm.⁴⁸⁵

It is indisputable that multinational accounting firms play a vital role in regulation. They have significant involvement in the standard setting process. Former partners of the big four firms frequently sit on the standard setting bodies (e.g the FASB), which is consistent with the regulatory capture theory. Their knowledge, attitudes and business connections ensure that these big firms have their say both domestically and internationally.⁴⁸⁶ These accounting firms are also linked to international systems of regulation, promoting flexible manufacturing, privatisation and trade liberalisation. Their advice can be powerful and influential. According to Neu et al., the advice of the accounting firms has affected education reform in several countries, and the way the governments have dealt with indigenous peoples.⁴⁸⁷ There is also evidence that audit firms have close connections with international lending agencies, such as the World Bank, which recommend audit and consulting services of these firms on development projects.⁴⁸⁸

⁴⁸⁴ The mid-tier companies such as Grant Thornton or BDO are significantly smaller.

⁴⁸⁵ Humphrey (n 2) p. 813.

⁴⁸⁶ Constantinos Caramanis, 'The Interplay between Professional Groups, the State and Supranational Agents: Pax Americana in the Age of "Globalisation"' (2002) 27(4) *Accounting, Organisations and Society* 379.

⁴⁸⁷ Dean Neu and Monica Heincke, 'The Subaltern Speaks: Financial Relations and the Limits of Governmentality' (2003) 15(1) *Critical Perspectives on Accounting* 179.

⁴⁸⁸ Patricia J. Arnold and Christine Cooper, 'A Tale of Two Classes: The Privatisation of Medway Ports' (1999) 10(2) *Critical Perspectives on Accounting* 127, p. 135.

Audit firms also play a significant role in the interpretation and implementation of accounting rules. Overall, there is surprisingly little research on how accounting and audit decisions are made. There are, however, studies that show how the implementation of 'standardised' audit procedures by multinational audit firms may vary depending on national characteristics, partner ambitions, and specifics of the local unit being audited. All rules, no matter how detailed, require interpretation, leaving at the same time scope for abuse for the preparer and auditor.⁴⁸⁹ For this reason, the role of audit firms in contributing to the audit process should not be understated.

Cooper and Robson also emphasise the continuing limited understanding of the involvement of multinational audit firms in international regulatory processes. They claim that it is impossible to discuss the work of IASB, IFAC, FRC, FASB, IOSCO or the EU without considering the complexity of alliances and agreements that exist between these agencies and big audit firms.⁴⁹⁰ They argue that research has neglected to see the firms as the significant agents that they really are, claiming that the Big Four are 'important sites where accounting practices emerge, become standardized and are regulated, where accounting rules and standards are translated into practice, and where professional identities are mediated, formed and transformed'.⁴⁹¹

There is also relatively little known about the Big Four firms' modes of association between each other. One of the first 'associational bodies' – the European Contact Group was created in Europe in the 1990s. It was essentially established to coordinate the opinions of the firms, so that they could present a united view to the European

⁴⁸⁹ Michael Barrett, David Cooper, and Karim Jamal, 'Globalization and the Coordinating of Work in Multinational Audits' (2005) 30(1) *Accounting, Organisations and Society* 1, pp. 3-4.

⁴⁹⁰ David Cooper and Keith Robson, 'Accounting, Professions and Regulation: Locating the Sites of Professionalization' (2006) 31(4) *Accounting, Organisations and Society* 415, p. 431.

⁴⁹¹ Cooper (n 490) p.416.

Commission on a number of audit regulatory proposals. At the time of the Asian crisis, the accounting profession was strongly criticised by organizations such as the World Bank for poor quality audits. This prompted the accountants to establish a Global Steering Committee (GSC), which aimed to enhance audit quality and strengthen the IFAC as a self-regulatory body for the international profession, and as a global standard setter. In 2002, as a result of the Enron scandal, the GSC was transformed into the new Global Public Policy Committee (GPPC), with the six largest accounting firms as its members. It comprises of two groups: a regulatory, and a standards working group. Since 2004 the GPPC has organised numerous annual meetings under the name of the Global Public Policy Symposia (GPPS) and gradually opened up to a larger group of participants including not only the profession, but also the world's top regulators in the field and academics.⁴⁹²

3.4. CONCLUSIONS

This chapter is important for this thesis as it has delivered a comprehensive analysis of the current regulatory framework of auditing. It provided answers to why audit regulation is needed, how audits are regulated, who the main parties are in regulating audits. The first section addressed the question about why there is a need for audit regulation. It explored the reasons for regulation in general, and audit regulation in particular. According to the theories presented above, audit regulation is needed in order to deal with issues such as information asymmetries, expectations gaps, or the protection of public interest. It is submitted, however, that none of these theories provide a comprehensive

⁴⁹² Humphrey (n 2) p. 814.

theoretical underpinning to audit regulation and that audit regulation is reactionary and changes in the aftermath of auditing scandals.⁴⁹³

The second section addressed the question of how audits are regulated. It analysed the degree of audit regulation by referring to the debate on rules versus principles-based regulation. Despite the common argument on the supremacy of the UK principles-based regulation⁴⁹⁴, (as opposed to the US rules-based one), the thesis argued that neither of the approaches should be favoured, as both have potential to achieve the same result. Instead, the debate should refocus on creating a regulatory environment, where auditors have fewer incentives to acquiesce to management's demands. This issue is further discussed in chapter six, which suggests a new regulatory audit model, which would eliminate the close relationship between auditors and managers. This is achieved by establishing a public agency responsible for appointing and remunerating auditors.

The third section identified multiple players that have played a role in audit regulation. The evidence shows that alongside the general increase in regulation, the role of the state has also been transformed. A shift towards an increased state involvement is noticeable in the area of audit governance in both countries. The US system is centred on a strong public institution – the PCAOB and relies wholly on national solutions with relatively small involvement of international accounting organisations. The UK extended the role of the FRC and incorporated uniform auditing standards created by the IFAC. As far as enforcement agencies are concerned, both countries have different institutional set-ups. The US system is based around a strong public agency – the SEC, while in the UK, the enforcement powers belong to the FRC.

⁴⁹³ Keith A. Houghton, Christine Jubb, Michael Kend, Juliana Ng, *The Future of Audit: Keeping Capital Markets Efficient* (The Australian National University, 2010) p. 501.

⁴⁹⁴ Kershaw (n 399) p.624.

A common position in accounting literature is to examine the financial reporting regulation in the context of professional associations, standards setting bodies and regulatory agencies of national governments and supra-national regulatory bodies. This thesis suggests, however, that while looking at the sites of regulation, in terms of production, transmission and enactment, one should also consider other entities within the international financial architecture, particularly large audit firms.⁴⁹⁵ It is indisputable that audit firms play a significant role in the interpretation and implementation of accounting and audit procedures. They are also powerful lobbyists, capable of exerting influence on governments and international financial institutions. If accounting firms are so central to the issues of regulation, the public and politicians should be concerned about these relatively unaccountable and opaque centres of power. It looks as though the boundaries between the regulator and regulated have been changing and this can have major effects on the audit quality and auditing model.⁴⁹⁶

This chapter provides a basis for chapter four, which further analyses the regulatory status quo, focusing on three specific areas, such as lack of auditors' independence, accountability deficits, and excessive concentration of the audit market. The thesis argues that these areas contain some of the most egregious problems in the current audit arrangements and that they negatively affect the quality of audits. This in turn prompts the discussion upcoming in chapter six, which suggests a new model of audit regulation, which aims to provide solutions to these problems. In the proposed model audits are conducted by an autonomous agency for the benefit of multiple stakeholders.

⁴⁹⁵ Humphrey (n 2) p. 810.

⁴⁹⁶ Cooper (n 490) p. 436.

CHAPTER 4. INDEPENDENCE, ACCOUNTABILITY DEFICITS, AND CONCENTRATION OF THE AUDIT MARKET

So far chapter one presented an account of the existing literature on the structural and regulatory changes that occurred within the auditing profession between the 1950s and 2016. The evidence showed that the increasing use of consulting services transformed auditing firms into money-driven businesses which then had a negative impact on the profession's perceived independence. Numerous regulatory concessions decreased the deterrent function of litigation leading to the decrease in auditors' accountability; and the frequent use of mergers left the profession dangerously consolidated.⁴⁹⁷ The thesis also argued that the practice of audit developed without any prior theoretical grounding and hence audit regulation is usually reactionary and occurs in the aftermath of major accounting scandals. The thesis then analysed the regulatory framework of audit and considered why, how and by whom audit is regulated. The finding showed that there is now an increased state involvement in the area of audit regulation and that the accounting profession has lost its regulatory powers.

In order to expand the analysis of the regulatory status quo of the auditing system, this chapter will focus on the three most pervasive problems inherent in the current audit arrangement; such as lack of auditors' independence, accountability deficits and excessive concentration of the audit market. This will provide a continuation of the analysis contained in chapter one. The first section of this chapter will look at the problem of auditors' independence. It will juxtapose numerous threats to auditors' independence, such as being hired and paid by the clients or providing consulting services; with the incentives to remain independent, such as disciplinary sanctions or reputational damage.

⁴⁹⁷ See chapter one.

The evidence will show that in the current system auditors have more incentives to acquiesce to managers' demands than to remain independent. The following section will examine the issue of auditors' lack of accountability, focusing on the legal, professional and social spheres of accountability. Section three will describe the problem of increased concentration of the audit market, which limits the client's choice of auditors.

This chapter is important for the thesis as it shows fundamental problems in the present auditing model. It also argues that despite various regulatory reforms, such as the Sarbanes-Oxley Act of 2002, the current audit system remains fundamentally flawed, and there is a pressing need to change it in order to make audits more effective. These changes are then suggested in chapter six, which proposes a new auditing model based on a public agency which hires and remunerates auditors, alleviating problems of conflict of interest and concentration of the audit market. In the suggested model auditors are also banned from providing consulting services, which enhances their independence. There, it is also recommended that audits should fulfil a public interest role by ensuring integrity and public confidence in the market, and protecting the interests of stakeholders. To that end, the model suggests that auditors should conduct audits not only for the benefit of the companies they audit, but also for other stakeholders who have an interest in the high quality accounts.

4.1. INDEPENDENCE

The issue of auditors' independence and how different conflicts of interest can affect auditors' judgement is a major problem within current audit arrangements. As external auditors are hired to provide a company with an independent, outside opinion on its financial statements, their independence is of paramount importance. According to some authors, it is the sole justification for the existence of audit firms, as otherwise the audit

function could have been performed by a company's internal accountants.⁴⁹⁸ Allen claims that:

Our capital markets are the envy of the world and are an important component to the efficiency of our economy. The capital markets work on information, including financial statements audited by independent professionals. We believe that the attestation of the competent, independent auditor adds value. There is unanimous agreement that the independent judgement of expert auditors and the perception of that independence is the condition of the utility of the auditors' attestation.⁴⁹⁹

Many constituencies such as shareholders, investors, lenders, employees rely on audited statements, which should be accurate and free from any bias. Despite its importance, the issue of independence still remains an elusive promise, due to the close relationship between auditors and management, and auditors' wishing to develop a 'constructive relationship with their clients'.⁵⁰⁰

To begin with, it is necessary to explain the meaning of independence. The concept of independence has proved difficult to define precisely but there are a few definitions that can be found in the literature:

- the conditional probability that given a breach has been discovered, the auditor will report the breach⁵⁰¹
- lack of collusion between the auditor and the manager⁵⁰²

⁴⁹⁸ Don Moore, Phillip Tetlock, Lloyd Tanly, Max Bazerman, 'Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling', (2006) 31(1) *Academy of Management Review* 1, p. 13.

⁴⁹⁹ Sean O'Connor, 'The Inevitability of Enron and the Impossibility of 'Auditor Independence' under the Current Audit System, available at SSRN.com/abstract=303181, p. 41, accessed 10 September 2015.

⁵⁰⁰ Solomon Jill and Aris Solomon, *Corporate Governance and Accountability* (John Wiley & Sons Ltd, 2004), p. 139.

⁵⁰¹ De Angelo (n 47), p. 116.

⁵⁰² Rick Antle, 'Auditor Independence' (1984) 22(1) *Journal of Accounting Research* 1, p. 2.

- an attitude / state of mind⁵⁰³
- the ability to resist client pressure⁵⁰⁴
- an absence of interests that create an unacceptable risk of bias⁵⁰⁵
- lack of independence implies that an auditor's decisions are not consistent with his or her beliefs about a reporting policy⁵⁰⁶.

One can also find in the literature a distinction between independence *in fact* and independence *in appearance*. The former is often referred to as independence of mind or objectivity and it denotes a state of mind that is 'free from influences that would compromise judgement and which has regard to all the considerations relevant to the task, but no other'.⁵⁰⁷ As it occurs in the internal sphere of mind and decision-making, it is difficult to prove it. Independence in appearance implies that an auditor should avoid 'circumstances where a reasonable and informed third party would question the auditors' ability to act objectively'.⁵⁰⁸ This resonates with the Mautz and Sharaf's distinction on practitioner-independence having the same meaning as independence in fact, and profession-independence signifying independence in appearance.

Power stresses the need to distinguish between the operational and organizational senses of independence.⁵⁰⁹ Operational independence has more to do with the audit process itself

⁵⁰³Peter Moizer, 'Review of Recognised Supervisory Bodies: A Report to the Department of Trade and Industry on the Audit Monitoring Process' (1994), p. 19; Walter P. Schuetz, 'A Mountain or a Molehill?' (1994) 8(1) Accounting Horizons 69, p. 69.

⁵⁰⁴ Michael C. Knapp, 'Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure' (1985) 60(2) The Accounting Review 202, p. 203.

⁵⁰⁵ AICPA, *Serving the Public Interest: A New Conceptual Framework for Auditor Independence*, (American Institute of Certified Public Accountants, New York 1997).

⁵⁰⁶ Magee Robert and Mei - Chiun Tseng, 'Audit Pricing and Independence' (1990) 65(2) The Accounting Review 315, p. 322.

⁵⁰⁷ Stella Fearnley and Vivien Beattie, 'The Reform of the UK's Auditors Independence Framework after the Enron Collapse: An Example of Evidence-Based Policy Making' (2004) 8(2) International Journal of Auditing 117, p. 120.

⁵⁰⁸ Fearnley (n 507) p.120.

⁵⁰⁹ Power (n 15) p. 132.

and relates to the question of whether auditors can ever truly be independent. It can be further subdivided into informational and epistemic independence. The former refers to the problem of asymmetrical information between the regulator and the regulated. The auditor will always be dependent on the representations made by senior management and other internal sources of information. The auditing process will be epistemically independent of the auditee, whenever clear rules of auditee conduct and techniques for determining compliance or breach of these rules exist. Despite the fact that the auditor might be dependent on some information from the auditee, the process of drawing conclusions will be independent. In other words, epistemic independence implies having a knowledge base which is independent of the inspected party.⁵¹⁰

Independence in the organisational sense, which is adopted in this thesis, relates to the way in which the auditor is appointed, ethical rules which are supposed to ensure his impartiality and the controversial problem of providing consulting services. Overall, the concept of organisational independence is seen as continuum, rather than an absolute, and it is a balancing act between the threats to auditor's independence and the effectiveness of the safeguards available. Threats and incentives to remain independent are subjects of the following sections. This is important for the thesis, which argues that the balance between incentives to remain independent and threats to auditors' independence remain tilted towards the latter. As independence is of paramount importance for the auditing system, this thesis suggests regulatory reforms that would restore the true independence of auditors. This involves creating a public agency in charge of appointment and remuneration of auditors, which would alleviate the problem of financial conflict of

⁵¹⁰ Power (n 15) p. 133.

interest stemming from the fact that auditors are hired and paid by their clients; and banning auditors from providing consulting services simultaneously with audits.

4.1.1. THREATS TO AUDITORS' INDEPENDENCE

Despite the fact that regulation requires from auditors objectivity and independence, it allows them to have financial conflicts of interest that tie them to the company rather than investors or the public. The mother of all conflicts is considered to be the fact that an auditor is hired and paid by the company he audits.⁵¹¹ Furthermore, the auditor is not prohibited from having other 'business' relationships with the company.⁵¹² By its very nature, managers have strong interests in the financial statements. First of all, they want to show the positive contribution they have made to the company. Secondly, as was mentioned in chapter one, their compensation is usually tied to the company's performance, making them even more keenly interested in the financial reports. As companies have freedom to choose their auditors, the likelihood that they choose an auditor that would deliver a positive audit opinion is very high.⁵¹³ Also according to Levinthal and Fichman, there is a probability that a client would be willing to switch auditors, if there was a chance of receiving a negative audit opinion. It also works the other way around; the auditor may hesitate to issue a negative audit opinion, knowing that it can lead to the loss of the client.⁵¹⁴ This can lead to a cosy relationship between the

⁵¹¹ Kaplan (n 7) p. 366.

⁵¹² Kershaw (n 163) p. 390.

⁵¹³ Moore (n 498) p.15.

⁵¹⁴ Daniel A. Levinthal and Mark Fichman, 'Dynamics of Interorganizational Attachments: Auditor- Client Relationships' (1988) 33 Administrative Science Quarterly 345, p. 346.

auditors and managers, and the acquiescence of both parties in risky accounting treatments.

One practice that auditors use to flag up their willingness to acquiesce to a client's wishes is referred to as 'low-balling', which is the provision of audit at an understated cost in order to develop a relationship with management and to get 'a foot in a door' for providing non-audit services, or to subsequently increase audit fees.⁵¹⁵ Low-balling has been under scrutiny for many years and it also became a subject of the Commission on Auditors' Responsibilities in the US, known as the Cohen Commission in 1978, which took a negative view of the practice.⁵¹⁶ It was stated in the report that 'low introductory pricing' impairs auditors' independence and is a signal to the manager that the auditor is ready to be pliant.⁵¹⁷

The literature on that subject, however, provides inconclusive results. According to DeAngelo, the Cohen Commission failed to establish a causal link between low-balling and impaired independence. She claims that this pricing practice is a competitive response to the 'expectation of future quasi-rents to incumbent auditors and that the initial fees reductions are sunk in future periods and therefore do not impair auditor independence'.⁵¹⁸ Lee and Gu, on the other hand, claim that the Cohen Report completely ignored the issue of auditors' liability to shareholders. They remind us that the auditor serves as a gatekeeper and watchdog for shareholders in the first place and it is the shareholders who possess statutory rights to fire the auditor and sue him for damages, even though in practice it happens that auditor is hired by the managers. They show in

⁵¹⁵ Moore (n 498) p.15.

⁵¹⁶ Cohen Commission (n 46) p.121.

⁵¹⁷ Chi - Wen Jevons Lee and Zhaoyang Gu, 'Low Balling, Legal Liability and Auditor Independence' (1998) 73(4) *The Accounting Review* 533, p. 535.

⁵¹⁸ De Angelo (n 47) p. 113.

their model that the combination of low-balling and auditors' legal liability actually preserve the auditor's independence.⁵¹⁹

Another threat to the auditors' independence lies with auditors taking jobs with their clients.⁵²⁰ There are many advantages of hiring the staff of a public accounting firm, especially those who have already worked in the team auditing the company's financial statements. These people are already familiar with the corporation's financial activities, have industry experience and expertise, which are valuable while taking up employment. This phenomenon, however, seriously impairs the concept of auditor 'independence'. Thompson, in his study on partisanship and involvement has shown that even the most insignificant affiliation with the partisan leads individuals to interpreting ambiguous information in accordance with the partisan's interests.⁵²¹ This is well illustrated by the Enron case, where a number of ex-Andersen staff worked for Enron and the relationship between the two became too cosy. Auditors could no longer provide objective opinions on Enron's accounts, which contributed, not only to the fall of Enron, but of Arthur Andersen itself.

As a result of Enron's failure, the Sarbanes-Oxley Act introduced a restriction on client hiring. According to Section 206 of the Act:

It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public

⁵¹⁹ Lee (n 517) p. 535.

⁵²⁰ Moore (n 498) p. 15.

⁵²¹ Leigh Thompson, 'They Saw a Negotiation': Partisanship and Involvement' (1995) 68(5) *Journal of Personality and Social Psychology* 839, p. 840.

accounting firm and participated in any capacity in the audit of that issuer during the one year period preceding the date of the initiation of the audit.

The Act's one-year waiting period, however, does not seem to be sufficient to counteract coziness and possible corruption.⁵²² Perhaps the only solution would be a total ban on hiring any personnel from a company's auditing firm, including people who did not directly work on the audit team. The restrictions on personnel rotation required by the Sarbanes-Oxley Act section 206 seem insufficient, taking into account the high frequency with which auditors continue taking jobs with audit clients.⁵²³

Another issue that poses a threat to auditors' independence is the audit partners' long association with the audit engagement. In general, the academic literature favours the arguments for mandatory rotation. The Institute of Chartered Accountants in England and Wales (ICAEW) study reveals that mandatory rotation would improve audit quality by avoiding over-familiarity between the client and management, it would provide the company with a fresh look on its financial statements and the benefits of competition.⁵²⁴

Rules governing the rotation of audit partners are very similar in the UK and the US. According to section 3.11 of the Revised Ethical Standard audit partner should not be engaged with the same client for longer than five years:

In the case of listed companies, (...), the audit firm shall establish policies and procedures to ensure that:

- a) no one shall act as audit engagement partner for more than five years; and

⁵²² Kaplan (n 7) p. 372.

⁵²³ Moore (n 498) p. 16.

⁵²⁴ ICAEW, Mandatory Rotation of Audit Firms. Review of Current Requirements, Research and Publications, available at <https://www.icaew.com/~media/Files/Library/collections/ICAEW%20archive/mandatory-rotation-of-audit-firms-review-of-current-requirements-research-and-publications.pdf> accessed 15 September 2015.

b) anyone who has acted as the audit engagement partner for a particular audited entity for a period of five years, shall not subsequently participate in the audit engagement until a further period of five years has elapsed.⁵²⁵

In special circumstances, when it is necessary to safeguard the quality of audit and an audit firm agrees, the audit engagement partner may continue in this position for another two years. In such circumstances, special safeguards, like quality control review and disclosure to the shareholders must be introduced.⁵²⁶

As far as the US situation is concerned, Section 203 of the Sarbanes – Oxley Act states:

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

These provisions on audit partner rotation leave a lot of scope for abuse. What about the other auditors on the audit team for the past four years? What if one of them is promoted to partner, would it be possible for him to serve as the ‘lead’ partner for the following five years?⁵²⁷ Also five years ‘time out’ period seems to be a long time in the current business world. Five years would allow a controversial accounting treatment to potentially evolve into disaster. Timely detection of financial irregularities is critical for the prosperity, or even survival of companies. Accordingly, some authors claim that rotation periods should not exceed two or three years.⁵²⁸

⁵²⁵ Financial Reporting Council, Revised Ethical Standard 2016, June 2016, available at <https://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Revised-Ethical-Standard-June-2016.pdf>

⁵²⁶ See (n 525) Sections 12-13.

⁵²⁷ Kaplan (n 7) p.369.

⁵²⁸ Kaplan (n 7) p.370.

Following Imhoff, mandatory rotation of accounting firms every three years would be the most effective solution to the threats to auditors' independence. Firstly, the rotation of auditors every three years would eliminate the problem of low-balling, as audit firms would not be able to under-price audits hoping that the cost would be offset during many years of engagement. Secondly, frequent changes of auditors would increase the quality of audit, as auditors would be careful not to overlook weaknesses and errors in clients' books which could then later be discovered by the following audit. Failure to report omissions or errors could be very costly in terms of loss of reputation and potential litigation. Thirdly, as a response to the argument that the rotation of auditors increases the cost of audit, as the new audit team lacks familiarity with the client's business, Imhoff suggests that higher costs lead to the increase in amount and quality of audit work. These costs in turn are passed on to the shareholders, who surely do not mind paying more for an independent, high quality opinion on financial statements.⁵²⁹

It is worth noting that in 2014, legislation regarding the reform of the audit market within the EU was published.⁵³⁰ It requires all EU public interest entities to rotate their statutory auditors after a maximum period of tenure. The maximum period was set at twenty years in the UK, with a mandatory tender at the ten year midpoint. The process of implementing the EU regulation in the UK was concluded in July 2016.

Auditors' independence is also considered to be threatened by providing consulting services, but again this issue seems to be far from clear-cut.⁵³¹ The increasing use of non-

⁵²⁹ Imhoff (n 160) pp. 124-125.

⁵³⁰ The legislation has two components: Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audit of annual accounts and consolidated accounts and Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

⁵³¹ Non-audit services (NAS) constitute any services other than audit provided to an audit client by an incumbent auditor. Such services may be referred to in the professional and academic press as management advisory services (MAS) or consulting, in Beattie (n 436).

audit services can lead to an audit firm becoming economically dependent on the audit client. An audit firm, providing both audit and MAS, and receiving considerable income from the latter, would not want to lose that client. This can result in a lack of willingness on behalf of auditors to challenge the client's financial practices, leading to lower financial reporting quality.⁵³² Also, according to the Metcalf Committee Staff Study, when an audit company, for example, installs a management information system and subsequently audits the reliability and accuracy of its own work, it inevitably leads to a conflict of interest. In this case, an accounting firm acting as both auditor and consultant may be willing not to report consulting deficiencies noticed during the audit, in order not to erode its 'brand name'. Generally, any situation which contributes to the fact that an auditor does not truthfully report the results of audit can be considered as posing a threat to independence.⁵³³ Also, Frankel et al. find that auditor independence is compromised when clients pay high consulting fees in relation to total fees. Their research provides evidence that 'non audit fees are positively associated with small earnings surprises and the magnitude of discretionary accruals, while audit fees are negatively associated with these earnings management indicators'.⁵³⁴

An opposing view of possible threats to the auditors' independence was taken by the Cohen Commission, where it was stated that 'no significant relationship between the provision of management services and substandard audits can be found'.⁵³⁵ The Commission also mentioned that there might be some advantages associated with providing both services. For instance, when consulting services can be purchased from

⁵³² William Kinney, Zoe-Vonna Palmrose, and Susan Scholz, 'Auditor Independence, Non-Audit Services, and Restatements: Was the US Government Right?' (2004) 42(3) *Journal of Accounting Research* 561, p. 565.

⁵³³ US Senate (Metcalf Committee), 'Subcommittee on Reports, Accounting and Management of the Commission on Government Operations, A Staff Study (Washington D.C.1977), pp. 50 - 52.

⁵³⁴ Frankel (n 159) p. 71.

⁵³⁵ See (n 516) p. 95.

the auditor, the costs of searching for a good consultant would be reduced.⁵³⁶ Moreover, the aforementioned Panel on Audit Effectiveness 2000, and some academics, claimed that providing consulting services can actually improve audit effectiveness through a 'knowledge spill-over'.⁵³⁷ An auditor with knowledge of a client's computer systems or tax accounting can then use this knowledge in order to produce a better quality audit.⁵³⁸

Moreover, according to Dopuch et al. providing consulting services to high quality clients (those for whom material misstatement risk is small) can actually increase the audit firm's reputational capital. Reputation capital, in turn, should increase incentives to conduct audit in a diligent and thorough manner, thereby increasing audit quality.⁵³⁹ The high quality registrants would purchase more consulting services in order to improve the quality of reporting or to lower costs.⁵⁴⁰

Overall, the academic literature provides inconclusive evidence as to whether providing consulting services impairs auditors' independence. According to Beattie and Fearnley, this is for two reasons. Firstly, independence in fact is not possible to be observed and hence there is no valid measure that might be applied in order to determine it. Secondly, there is no publicly available data that would be relevant to the study. Even if the amount of consulting services is disclosed, there is no information on the split across the services. Also, firms fail to disclose sufficient information with regards to different lines of business.⁵⁴¹ In general, there is little evidence to support the view that providing

⁵³⁶ See (n 516) p. 95.

⁵³⁷ See (n 156) and Simunic (n 159) p. 680.

⁵³⁸ Kinney (n 532) p. 566.

⁵³⁹ Nicholas Dopuch, Ronald R. King, and Rachel Schwartz, 'Independence in Appearance and Fact: An Experimental Investigation' (2003) 20(1) Contemporary Accounting Research 79, p. 80.

⁵⁴⁰ Kinney (n 532) p. 566.

⁵⁴¹ Beattie (n 436) p. 40.

consulting services impairs independence in fact.⁵⁴² It can, however, negatively affect perceptions – the appearance of auditor independence.⁵⁴³

In order to counteract the independence problems, regulation aims at providing limitation of the likelihood that auditors would succumb to the pressure from managers. One of the steps in this direction was the provision in the Sarbanes-Oxley Act of prohibiting accounting firms from providing certain non-audit services to companies they audit, and approval of the audit committee of the services that are not on a prohibited list.⁵⁴⁴ The Sarbanes-Oxley Act, in Section 201, lists non-audit services, which companies are not allowed to undertake simultaneously with audit. This seems to be a step in the right direction; however, it does not go far enough. The Act enables the Public Company Accounting Oversight Board to exempt any accounting firm from this prohibition, leaving the independence provision in danger of being overridden.⁵⁴⁵

It seems that it would be more reasonable to introduce a total ban on the provision of consulting services by accounting firms. These services can be easily obtained from various sorts of non-accounting firms, while audit can only be delivered by accounting firms. Following this approach, it would not be necessary for the audit committee to approve of non-audit services and for the PCAOB to exempt accounting firms from the ban on certain consulting services.⁵⁴⁶

⁵⁴² Mark L. DeFond, K. Raghunandan, and K. R. Subramanyam, 'Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions' (2002) 40(2) *Journal of Accounting Research* 1247; Hollis Ashbaugh-Skalfe, Ryan Lafond, and Brian Mayhew, 'Do Non-Audit Services Compromise Auditors' Independence? Further Evidence', February 2003 at SSRN.com/abstract=305720; Kannan Raghunandan, William Read, and Scott Whisenant, 'Are Non-Audit Fees Associated with Restated Financial Statements?', April 2003, available at SSRN.com/abstract=394844, accessed 7 August 2014.

⁵⁴³ Beattie (n 436) p. 40.

⁵⁴⁴ Max Bazerman, George Loewenstein, and Don Moore, 'Why Good Accountants Do Bad Audits?' (2002) 80(11) *Harvard Business Review* 96, p. 102.

⁵⁴⁵ Sarbanes-Oxley Act (n 445) section 201.

⁵⁴⁶ Kaplan (n 7) p. 378.

The regulatory framework of the provision of the non-audit services in the UK could be characterized by the following features. First of all, companies must disclose in their financial statements the amount of consulting fees paid to their auditors.⁵⁴⁷ Secondly, the UK Corporate Governance Code places the burden of developing and implementing a company's non-audit services policy on audit committees. For years the auditor's decision as to whether to engage in providing consulting services remained the auditor's self-assessment.⁵⁴⁸ The standard remained focused on the theme that it was the nature and the surrounding circumstances of the consulting services provision rather than the financial benefits that had the ability to compromise independence.⁵⁴⁹

The probability of losing an audit relationship as a result of failure to acquiesce is small, but that does not guarantee retaining the lucrative non-audit fees. According to Coffee, non-audit services provide managers with a 'low-visibility' sanction.⁵⁵⁰ The decision to enter into a non-audit contract is a discretionary decision of the management, so if auditors do not comply with the managers' demands, they might not be granted these contracts. Management would easily be able to explain the choice of different consulting service providers. Accordingly, management can hold auditors to ransom by not giving

⁵⁴⁷ The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 amended by the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2011.

⁵⁴⁸ Kershaw (n 163) p. 395.

⁵⁴⁹ This approach has now been restricted by the new EU Audit Framework, see note 530. As the new European Audit Framework came into force shortly before the submission of the thesis, some of the sources used in the thesis which pre-date this legislation may be irrelevant, or may become irrelevant in due course. This refers, in particular, to statements such as that it is the auditor's self-assessment as to whether to engage in providing consulting services. This is no longer relevant due to the ban on certain consulting services imposed by Article 5 of the Regulation. Also, sources that claim that the amount of consulting services provided by audit firms simultaneously with audit services remains high, may become irrelevant in the coming years. See for example note 554.

⁵⁵⁰ John C. Coffee, 'Understanding Enron: 'It's About the Gatekeepers, Stupid' (2002) 57(2) Business Lawyer 1403, p. 1411.

them the opportunity to earn high fees from consulting. This threat of cutting down auditors' consulting income remains very credible.⁵⁵¹

According to Beattie and Fearnley, the aim of the auditors' independence regulation is to ensure that threats to independence are balanced against the effectiveness of the safeguards available.⁵⁵² The evidence above suggests that the balance has not been achieved either in the UK or the US.⁵⁵³ Auditors are still capable of providing non-audit services to their audit clients and the revenue from these services remain high.⁵⁵⁴ Also, changes in managerial compensation, discussed in chapter one, increase the probability that managers will continue exerting pressure on auditors to adopt managers' accounting preferences. On the other hand, disincentives for auditors to acquiesce have diminished. The litigation risk that auditors face has diminished due to a combination of judicial and legislative developments, which will be examined further on in the accountability deficits sections of this chapter. It would seem logical that litigation deterrence shortfall should be compensated by the market for reputation, and by self-regulatory sanctions administered by professional bodies, but these mechanisms, as the next section shows, remain highly underdeveloped and ineffective.⁵⁵⁵

⁵⁵¹ Kershaw (n 163) p. 398.

⁵⁵² Beattie (n 436) p.57.

⁵⁵³ Kershaw (n 163) p. 388.

⁵⁵⁴ Liz Loxton, 'How the Big Four Have Returned to Consulting With a Bang', *Accountancy Age*, 27 September 2015, available at <http://www.accountancyage.com/aa/feature/2427739/feature-how-the-big-four-have-returned-to-consulting-with-a-bang> accessed 24 June 2016; Kadhim Schubber, 'PwC Tops Deloitte to Lead Big Four Auditors', *Financial Times*, 6 October 2015, available at <http://www.ft.com/cms/s/0/ba7f08fa-6b61-11e5-aca9-d87542bf8673.html#axzz4CXB9FOxD> accessed 24 June 2016; Harriet Agnew, 'Big Four Push Forward in Consulting', *Financial Times*, 29 December 2015, available at <http://www.ft.com/cms/s/0/6463f1f4-a8ad-11e5-9700-2b669a5aeb83.html#axzz4CXB9FOxD> accessed 24 June 2016.

⁵⁵⁵ John C. Coffee, 'The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting', Columbia Law School, The Centre for Law and Economic Studies. Working Paper No. 191 (2001), p. 21.

4.1.2. INCENTIVES TO REMAIN INDEPENDENT

Following Kershaw, the aim of auditor independence regulation is to ensure that the threats to independence are outweighed by the incentives to remain independent. If there are more incentives for the auditors to acquiesce to the management pressure, the likelihood of audit failure increases.⁵⁵⁶ In the UK and the US, the revenue of the accounting firms has been increasing over the past twenty years, making audit firms more dependent on their clients and their relations with management increasingly cosy. On the other hand, neither regulatory nor market deterrents such as litigation, reputation costs or disciplinary sanctions do not counterbalance the benefits of acquiescence. The issue of litigation will be analysed in the following section, in the context of auditors' accountability deficits. This thesis will now discuss the disciplinary sanctions, which should prevent auditors from acquiescing to managers' demands.⁵⁵⁷

As far as the US professional discipline is concerned, before the enactment of the SOX, any of the three following bodies could sanction an individual CPA who engaged in audit misconduct: the AICPA, the SEC, or a state board of accountancy in a jurisdiction where the CPA was licensed. Even though the AICPA would seem the most appropriate body to bring disciplinary actions, in reality it hardly ever disciplined, or censored its members.⁵⁵⁸ According to one survey, over the period of eleven years, the AICPA disciplined less than 20 per cent of accountants that had already been sanctioned by the SEC.⁵⁵⁹ The AICPA explained its laxity by referring to a lack of resources to investigate members'

⁵⁵⁶ Kershaw (n 163) p. 389.

⁵⁵⁷ John L. Carey, 'The Independence Concept Revisited' (2008) 20 *Research in Accounting Regulation* 295, p. 299.

⁵⁵⁸ Coffee (n 51) 156.

⁵⁵⁹ David Hilzenrath, *Auditors Face Scant Discipline*, *Washington Post*, 6 December 2001.

misconducts and that it would have been subject to counter lawsuits, if it acted without due process or good cause.⁵⁶⁰

According to Coffee, state boards of accountancy turned out to be even less helpful in holding the accountants to account. They have shown limited interest in cases of professional misconduct, even when alerted by a formal SEC investigation.⁵⁶¹ The SEC in turn took actions against individual accountants, but the overall number of cases was relatively small in relation to the size of the profession or the number of audits criticized by the SEC.

Also, the peer review system left much to be desired. According to the AICPA rules, each audit firm was supposed to have its quality control system reviewed by a peer firm every three years. The peer reviewer issued a report, to which a subject firm responded, and both documents were sent to the Peer Review Committee of the SEC Practice Section of the AICPA. In theory, the Peer Review Committee could require corrections of the quality control deficiencies. In practice, however, the Panel on Audit Effectiveness in its 2000 report discovered that the process was 'toothless', with no meaningful sanctions being imposed on subject firms. Audit firms conducting peer reviews were lenient and mindful that they might have been examined in a similar fashion. Today, peer review is defunct and was replaced by the PCAOB.⁵⁶²

Currently, rules that govern the performance of professional services by members of the AICPA and state CPA societies participating in the Joint Ethics Enforcement Program can be found in the Code of Professional Conduct. It consists of two parts: the Principles

⁵⁶⁰ George Benston, 'The Regulation of Accountants and Public Accounting before and after Enron' (2003) 52(3) Emory Law Journal 1325, pp.1345 - 46.

⁵⁶¹ Coffee (n 51) 156.

⁵⁶² Coffee (n 51) 158.

and the Rules. It was adopted to provide guidelines to all members in the performance of their professional responsibilities. Compliance with the code depends predominantly on members' understanding and voluntary actions, secondarily on public opinion, and thirdly on reinforcement by peers. Disciplinary proceedings, conducted by the Professional Ethics Division, against members who fail to comply with the rules are used as a method of last resort.⁵⁶³ Sanctions that could be administered when the respondent is found guilty of charges brought by the ethics committee are: expulsion or suspension from the AICPA or state society, admonishment or fulfilling of an additional requirement (such as completion by a respondent of professional educational courses), requirement to submit by a respondent a work product for review or a ban on performing peer reviews for a specified period of time.⁵⁶⁴

According to the recent statistical report of the disciplinary activity of the AICPA, out of 819 cases at the beginning of 2012 only 88 accountants were expelled or suspended, 161 were admonished, 244 required corrective action and in 182 cases no action was required. Dismissal happened in 36 cases and subsequent monitoring was completed satisfactorily in 32 cases.⁵⁶⁵

Another mechanism that can deter an auditor from acquiescing to a managers' demands and inform the market about an auditor's compromised reputation is financial statement and audit review, conducted by the regulatory bodies in charge of supervising financial statement and audit quality. In this area, investigative and disciplinary powers are vested

⁵⁶³ AICPA website, available at <http://www.aicpa.org/catalogs/masterpage/Search.aspx?D=4294963876:4294963826||1> accessed 22 August 2013.

⁵⁶⁴ Annual Report of AICPA Disciplinary Activity, available via January 1 – December 31, 2012 and 2011, available at <http://www.aicpa.org/interestareas/professionalethics/resources/ethicsenforcement/downloadabledocuments/annualreportofaicpadisciplinaryactivity.pdf> accessed 22 August 2013.

⁵⁶⁵ See (n 564).

in the SEC and the PCAOB. The SEC conducts auditors' investigations into possible violations of the federal securities laws and prosecutes the SEC's civil suits in the federal courts, and in administrative proceedings. The PCAOB investigates auditors for possible violations of any provisions of the Sarbanes-Oxley Act, any professional standards, any rule of the PCAOB or the SEC, or any provisions of the US securities laws relating to the preparations and issuance of audit reports. Section 105 of the Sarbanes-Oxley Act 2002 gives the PCAOB broad investigative and disciplinary authority over registered firms and their associated persons.⁵⁶⁶ Sanctions imposed by the PCAOB may include suspension or revocation of a firm's registration, suspension or bar of an individual from associating with a registered public accounting firm, and civil money penalties. The Board may also require improvements in a firm's quality control, training, independent monitoring of the audit work of a firm or individual, or other remedial measures.⁵⁶⁷

The PCAOB seems motivated to behave in a more activist fashion. It has extensive powers, discussed in the previous chapter, one of them is the ability to supersede any AICPA rule. There is no doubt, however, that the accounting profession will aim at marginalizing the PCAOB's role in standards-setting and policing rogue accountants. There is already a lot of scepticism among public accountants over the ability of the board to understand the technical, practical and political realities of accounting at the global firms, as none of the board members can have any simultaneous connection to any accounting firm.⁵⁶⁸ The aggressiveness and tenacity of the PCAOB in disciplining accountants remains to be seen.

⁵⁶⁶

Available

via

<http://www.aicpa.org/interestareas/centerforauditquality/resources/pcaob/enforcement/pages/enforcement.aspx> accessed 22 August 2013.

⁵⁶⁷ PCAOB website, available via <http://pcaobus.org/Enforcement/Pages/default.aspx> accessed 22 August 2013.

⁵⁶⁸ Brewster (n 94) p. 284.

As far as the UK is concerned, many parties who make business and investment decisions based on the audited financial statements of the company have no legal claim against auditors. They can, however, make a complaint to the relevant professional body about an auditor's conduct.⁵⁶⁹ Responsibility for conduct and discipline is split between the professional conduct branch of the applicable professional association such as the ICAEW,⁵⁷⁰ and the Financial Reporting Council.

The professional Code of Ethics sets out fundamental principles, which guide members' behaviour. In the event of a complaint, the case is assessed and, if compliance with the fundamental principles is compromised, it is referred to the Investigation Committee (IC). The IC may either: take no further action, issue a non-publicized caution, agree the terms of the sanction with the member through a consent order, or refer the complaint to the Disciplinary Committee.⁵⁷¹

If a case involves a significant public interest, it is dealt with by the FRC's Conduct Committee as opposed to an individual accountancy body.⁵⁷² The Conduct Committee is supported by two subcommittees: the Monitoring Committee, which ensures the consistency and quality of the FRC's monitoring work, and the Case Management Committee, which advises on the handling of disciplinary cases.

The FRC's predecessor, the Joint Disciplinary Scheme (JDS), also investigated the matter only if it raised the issue of 'public concern'.⁵⁷³ Consequently, only the highest profile corporate failures and frauds such as Maxwell Group, BCCI and Polly Peck were subject

⁵⁶⁹ Kershaw (n 163) p. 413.

⁵⁷⁰ This analysis uses the ICAEW as a representative professional association.

⁵⁷¹ ICAEW, How We Investigate Complaints, available via <http://www.icaew.com/~media/Files/About-ICAEW/What-we-do/protecting-the-public/complaints-process/how-we-investigate-complaints-booklet.pdf> accessed 23 August 2015.

⁵⁷² Formerly the Accountancy and Actuarial Discipline Board (AADB).

⁵⁷³ Joint Disciplinary Scheme, Clause 6 (b).

to JDS investigations. It can be expected that the 'public interest' test will result in similar referrals to the FRC. Currently, the FRC is investigating only 20 high-profile cases, such as Presbyterian Mutual Society, and Tesco PLC.⁵⁷⁴ It seems logical that since the FRC investigates only the most egregious cases, it will not be a reliable source of information about the auditor acquiescence and lack of independence.⁵⁷⁵

Theoretically, severe sanctions could act as a deterrent factor. In both jurisdictions, sanctions are similar and potentially burdensome. The most serious ones are an unlimited fine on the accounting firm, the prohibition from using the term 'Chartered Accountant' or withdrawal of a licence. In practice, however, sanctions imposed are very low, when one compares them with the earning capabilities of the audit firms. For example, a Touche Ross partner was fined only £115,000 and reprimanded for his part in the Barlow Clowes accounting scandal. Coopers & Lybrand were fined £1.2 million and £2.1 million in costs for the audit of the Maxwell Group. This fine constituted only a small percentage of the £25 million that Coopers & Lybrand received from Maxwell Group in audit fees in the period under investigation.⁵⁷⁶ As sanctions imposed on both audit firms and individual auditors are lenient, it is hard to imagine that they can potentially act as a meaningful deterrent to an auditor who is willing to acquiesce in earnings management and compromise his independence.

Criminal liability could potentially act as another source of deterrence. The extent of deterrence, however, would differ in the UK and the US. The Companies Act 2006 introduces criminal liability for auditors who knowingly or recklessly provide an audit

⁵⁷⁴ Financial Reporting Council, available via <https://frc.org.uk/Our-Work/Conduct/Professional-discipline/Present-cases.aspx> accessed 3 January 2016.

⁵⁷⁵ Kershaw (n 163) p. 414.

⁵⁷⁶ Prem Sikka, 'Maxwell Auditors and Self-Regulation: The Verdict', available at <http://projects.exeter.ac.uk/RDavies/arian/scandals/classic.html>. accessed 15 February 2016.

opinion that is misleading, false or deceptive. The Act, however, provides only for an unlimited fine on conviction on indictment; this means that the sanction once again is not sufficiently severe to deter an acquiescent auditor.⁵⁷⁷ In the US, on the other hand, the Sarbanes-Oxley Act in the Title ‘Corporate and Criminal Fraud Accountability’ introduces severe penalty of fine and imprisonment of up to 20 years for those who destroy, alter, and falsify audit records. This regulation has the real potential of deterring auditors, due to severity of the sanctions.

According to Kershaw, however, criminal liability of auditors is not an effective deterrent, mainly due to the fact that the risk of the discovery of irregularities, and the risk of being caught, are low. Furthermore, as auditors apply certain accounting standards while conducting audits, it would be extremely difficult to prove that they knew, or were reckless to the fact, that the standard was incorrectly applied. Also, the burden of proof in criminal proceedings is beyond reasonable doubt, hence only the most egregious activities would fall under this provision.⁵⁷⁸

Finally, the cost of reputational damage does not seem a plausible threat either.⁵⁷⁹ The theory of reputational capital states that rational auditors would never risk their reputation by compromising their independence for financial gain. This would lead to the loss of existing and future clients and this loss would outweigh any potential gains from one client for compromised independence.⁵⁸⁰ This theory, however, is based on two assumptions. Firstly, it is very probable that the wrongful behaviour of auditors will be discovered, and secondly this discovery will be communicated to the market. As this is not always the case, the primary example of which were the Enron and Arthur Andersen

⁵⁷⁷ Companies Act 2006, Section 507.

⁵⁷⁸ Kershaw (n 163) p.419.

⁵⁷⁹ Kershaw (n 163) p.388.

⁵⁸⁰ DeAngelo (n 164) pp. 189 - 90.

scandals, the effectiveness of a reputation for independence as a disincentive for the auditors to acquiesce can be easily undermined.⁵⁸¹

Moreover, according to Coffee, potential reputational penalties, which could possibly deter the whole audit firm, do not necessarily work well in the case of individual partners.⁵⁸² He claims that it is the firm that has a reputational capital not an individual and hence a partner cannot really suffer any significant reputational loss. The partner that gets his firm involved in the scandal is likely to be fired. But he is also likely to be fired if he refuses to acquiesce and the client decides to switch to a different auditor. In the absence of harsh disciplinary sanctions for acquiescent individual partners in audit firms (the withdrawal of licence hardly ever takes place), it is hard to imagine that the potential reputational loss would motivate, discipline, and deter them from participating in risky accounting practices.⁵⁸³

Despite regulations enacted as a response to the Enron scandal, independence of auditors still remains a controversial issue. The evidence above shows that auditors in the UK are allowed to provide consulting services, with the only restriction being the self-assessment test.⁵⁸⁴ In the US, the Sarbanes-Oxley Act provides the PCAOB with the ability to exempt audit firms from the restriction of providing non-audit services. True auditor independence requires, as a start, complete separation of audit and non-audit services. But even then, a fundamental problem persists, as the auditors are hired, paid and fired by the companies they audit, leaving them in a position of ‘possibly casting negative judgements on those who hired them – and who cut them loose’.⁵⁸⁵ Consequently, the sole elimination

⁵⁸¹ Kershaw (n 163) p.409.

⁵⁸² Coffee (n 555) p.22.

⁵⁸³ Coffee (n 555) p.22.

⁵⁸⁴ See n 549.

⁵⁸⁵ Bazerman (n 544) p. 102.

of consulting will not suffice. Based on the evidence above, this thesis argues that there is a need to design a new model, which would provide true independence for the auditing profession. This is suggested in chapter six, which advocates delegating the appointment and remuneration of auditors to an external body, severing, at the same time, a close relationship between auditors and management. This thesis also suggests a statutory ban on the provision of consulting, which can damage auditors' actual and perceived independence. The rationale behind these changes is to restore auditors' independence, which is the sole reason for the existence of external audit.⁵⁸⁶ Apart from the independence problem, the auditing profession is frequently criticised for its lack of accountability.⁵⁸⁷ The market for external audit is created and guaranteed by the state, but the supply is created by the private sector. In the absence of effective accountability mechanisms, it rarely encourages reflections on poor practice. The focus of the following section is on the issue of auditors' accountability deficits inherent in the present audit architecture.

4.2. ACCOUNTABILITY DEFICITS

The following subsections examine the issues of auditors' accountability in the current audit model. Firstly, the origins and definitions of accountability are reviewed. The discussion then proceeds to analyse accountability in the legal, professional and social spheres. It shows that auditors suffer from significant accountability deficits in these areas, which can negatively impact the quality of audits. This thesis argues that accountability deficits remain one of the most egregious problems inherent in the current audit system. The analysis of this chapter provides a basis for chapter six, which suggests

⁵⁸⁶ Without objectivity and independence, the opinion on the financial audit statements could be expressed by the internal audit function of the companies.

⁵⁸⁷ Prem Sikka, Hugh Willmott, and Tony Lowe, 'Guardians of Knowledge and Public Interest: Evidence and Issues of Accountability in the UK Accountancy Profession,' (1989) 2(2) *Accounting, Auditing and Accountability* 47, p. 47.

reforms to strengthen accountability, and to enable the accounting profession to escape the cycle of institutionalised failures.

4.2.1. THE CONCEPT OF ACCOUNTABILITY

Historically, the origins of accountability can be traced to the reign of William I, who required that all property holders in his realm render an account of what they possessed.⁵⁸⁸ These possessions were then valued and listed in the 'Domesday Books', which became the foundation of the royal governance. In the twelfth century this evolved into 'a highly centralized administrative kingship that was ruled through centralized auditing and semi-annual account giving'.⁵⁸⁹

Nowadays, accountability has progressed beyond its bookkeeping and accounting origins and has become a symbol of good governance. The origins of the concept of accountability are different in the US and the UK. In the US, its origins can be found in the discourse between Carl Friedrich and Herman Finer over the extent to which public servants should either rely on their professionalism and morality or simply follow the instructions from their superiors. Friedrich used the term 'accountability' in order to describe the internal responsibility, the inward sense of obligation of public servants to their professional standards and values. Finer, on the other hand, defined accountability as the 'responsibility toward external political direction'.⁵⁹⁰

As far as the UK is concerned, the issue of accountability has been analysed in terms of ministers' answerability to Parliament for the actions of their departments. It was often

⁵⁸⁸ Melvin J. Dubnick, 'Seeking Salvation for Accountability; (2002) Paper presented at the 2002 Annual Meeting of the American Political Science Association (2002), pp. 7-9

⁵⁸⁹ Mark Bovens, 'Public Accountability', in Ewan Ferlie, Laurence E. Lynn Jr, Christopher Pollitt (eds), *The Oxford Handbook of Public Management* (Oxford University Press, Oxford 2007), p. 183.

⁵⁹⁰ Richard Mulgan, 'Accountability: An Ever-Expanding Concept' (2000) 78(3) *Public Administration* 555, p. 557.

referred to as ‘ministerial responsibility’ and had a broad meaning of holding the ministers responsible for all departmental behaviour.⁵⁹¹ Today, however, ‘ministerial responsibility’ constitutes a technical, constitutional term and ‘accountability’ extends to include the whole range of activities and processes covered by responsibility.⁵⁹²

Sometimes ‘accountability’ and ‘responsibility’ are used as synonyms, but adopting a half-way position with separate meanings of the above terms seems to be more reasonable. Responsibility, then, would deal with the internal functions of ‘personal culpability, morality and professional ethics’, whilst accountability would refer to the ‘external sphere of scrutiny, such as calling to account, justifications and imposing sanctions.’⁵⁹³ This division enables ‘accountability’ to exist independently from ‘responsibility’, sticking to its original, most intuitive sense.

‘Account-ability’ denotes an ‘ability’ to be called ‘to account’ to some authority for one’s actions.⁵⁹⁴ It denotes the exchange of reasons for conduct. To give an account means to provide reasons, explanation and justification for one’s behaviour.⁵⁹⁵ According to Mulgan, it has the following characteristics: it is *external*, meaning a person or body being held accountable gives account to some other person or body; it consists of *interaction and exchange*, in that one side seeks answers and rectification and the other responds and accepts sanctions; it involves *rights of authority*, in that one side has the superior authority and control to demand answers and impose sanctions.⁵⁹⁶ Some academics also emphasise the importance of *information*, as an essential feature of the definition of accountability.

⁵⁹¹ Mulgan (n 590) p.557.

⁵⁹² Geoffrey Marshall, ‘The Evolving Practice of Parliamentary Accountability; Writing Down the Rules’ (1991) 44(4) Parliamentary Affairs 460, p. 462.

⁵⁹³ Mulgan (n 590) p.558.

⁵⁹⁴ G.W. Jones, ‘The Search for Local Accountability’ in S. Leach (ed), *Strengthening Local Government in the 1990s* (Longman, London 1992), p. 73.

⁵⁹⁵ Martin Messner, ‘The Limits of Accountability’ (2009) 34(8) Accounting, Organizations and Society 918, p. 920.

⁵⁹⁶ Mulgan (n 590) p.555.

According to Jackson, for example, accountability constitutes ‘explaining or justifying what has been done, what is currently being done and what is planned ... (and) ... involves therefore, the giving of information’.⁵⁹⁷ Gray defines the concept of accountability as ‘the onus, requirement or responsibility to provide an account (by no means necessarily a financial account) or reckoning of the actions for which one is held responsible’.⁵⁹⁸

The concept of accountability has been recently inappropriately extended to include various concepts not necessarily in line with the classic understanding of this term. For example, accountability is often wrongly associated with institutional checks and balances by which democratic institutions, such as courts, competitive markets, interest groups, or the mass media, seek to control the actions of the governments.⁵⁹⁹ Some of these controlling institutions are not able to impose sanctions, and hence they will not be able to fulfil the traditional accountability function.⁶⁰⁰ The meaning of accountability should not then be extended to include control.

Another undue extension of the term ‘accountability’ includes equating it with ‘responsiveness’, meaning pursuing by governments the wishes or needs of their citizens. Whereas ‘control’ would emphasise the ‘coercive role of external pressure’, ‘responsiveness’ relates to the public servants’ general compliance with popular

⁵⁹⁷ P.M. Jackson, *The Political Economy of Bureaucracy* (Philip Allan, 1982), p. 5.

⁵⁹⁸ Robert Grey, 'Accounting and Environmentalism: An Exploration of the Challenge of Gently Accounting for Accountability, Transparency and Sustainability' (July 1991) University of Dundee Discussion Paper, p. 2.

⁵⁹⁹ B.G. Peters, *The Politics of Bureaucracy*, (4th edn, Longman, White Plains 1995), p. 300.

⁶⁰⁰ The traditional mechanism of accountability involves explanation, applying judgement and imposing sanctions.

demands, e.g. public agencies are expected to be responsive to elected politicians aiming to control their activities.⁶⁰¹

Finally, accountability as 'dialogue' is yet another example of an inappropriate use of this term. 'Dialogue', denoting public discussion between citizens, involves answering, explanations, justifications on behalf of officials and questioning, assessing and criticising on behalf of those holding them to account. The basic flaw of this approach is that 'accountability,' in its core sense, assumes an unequal relationship between the superior and subordinate.⁶⁰² The subordinate gives account for his actions and accepts sanctions if his performance is not satisfactory. Equating accountability with a 'dialogue' assumes that parties in the relationship are equal, and so the issue of imposing and accepting sanctions does not exist.⁶⁰³ That is why equating accountability with the democratic dialogue of citizens constitutes an inappropriate extension of the concept of accountability beyond its traditional context of authority and control.⁶⁰⁴ The classic understanding of accountability, which emphasises holding the powerful to account through various means of scrutiny and sanctions, will be used throughout this thesis. In the suggested model stakeholders will be superior to the subordinate auditors.

The traditional accounting model of accountability is rooted in the idea that shareholders, as a separate class to managers, expect managers to be accountable to them. This model of accountability is based on the agency model discussed in chapter two, which suggests that principals will not trust their agents and will try to find a mechanism that will align their interests with the interests of the agents. One of these mechanisms that aim for reducing information asymmetry and opportunistic behaviour is the auditing of financial

⁶⁰¹ Mulgan (n 590) p.556.

⁶⁰² Mulgan (n 590) p.570.

⁶⁰³ P. Day and Klein R., *Accountabilities: Five Public Services* (Tavistock, London 1987), pp. 247 - 8.

⁶⁰⁴ Mulgan (n 590) p.570.

statements conducted by professional, expert auditors.⁶⁰⁵ As discussed in chapter two, however, this model brings up another problem of auditors being agents of principals with similar concerns of trust and objectivity as in the directors-shareholders relationship.⁶⁰⁶ The agency relationship between auditors and shareholders also raises questions about who is auditing the auditor and to whom the auditor should be accountable. In the current model, auditors remain largely unaccountable to anybody apart from the shareholders.⁶⁰⁷ This is what stems from company law. In reality, however, auditors are frequently influenced by managers and acquiesce to managers' demands. This thesis argues that auditing should be reorganised in order to sever the close relationship between auditors and management. It is also suggested that audits should be conducted for the benefit of other stakeholders. Chapter six provides details of suggested reforms.

Having examined a theoretical concept of accountability, the following subsections will move on to discuss the legal, professional and social accountability of auditors in the current audit system. Theoretical research defines many other types of accountability such as political, administrative, or personal.⁶⁰⁸ This section aims for a typology reflective of the current private sector Anglo-American audit model, though inevitably also, the author's perspective and interests. The following analysis is important for this thesis, as the findings indicate that auditors in the current regulatory set-up suffer from legal, professional, and social accountability deficits.⁶⁰⁹ This will provide the basis for the

⁶⁰⁵ Jensen (n 24) pp. 305-315.

⁶⁰⁶ ICAEW (n 36) p.10.

⁶⁰⁷ Rebecca Toppe Shortridge and Pamela Smith, 'Understanding the Changes in Accounting Thought' (2009) 21(1) *Research in Accounting Regulation* 11, p. 11.

⁶⁰⁸ Bovens distinguishes five spheres of accountability: political, administrative, legal, professional and social, in Mark Bovens, 'Public Accountability. A Framework for the Analysis and Assessment of Accountability Arrangements in the Public Domain; Draft made for Connex, Research Group 2: Democracy and Accountability in the EU, p. 14. Sinclair discusses political, managerial, public, professional and personal accountability, in Amanda Sinclair, 'The Chameleon of Accountability: Forms and Discourses' (1995) 20(2-3) *Accounting, Organisations and Society* 219.

⁶⁰⁹ This thesis uses the term legal liability, rather than accountability, when sanctions imposed for the breach are solely legal.

discussion in chapter six, which proposes a new audit model, addressing the issue of accountability deficits in the current audit arrangements.

4.2.2. LEGAL LIABILITY

Decades of numerous audit failures and associated lawsuits against audit firms highlight the magnitude and significance of litigation risk to the audit profession. Some research shows that liability costs for international audit firms have increased over the last two decades due to the increase in the size of damage awards.⁶¹⁰ In response to this, the accounting profession has been fighting for the introduction of various regulatory changes in order to limit its liability. This subsection argues that in terms of protection the balance is tilted towards the auditing sector rather than potential injured parties.⁶¹¹ This in turn leaves auditors largely unaccountable, which is undesirable due to the unique role that an auditor plays in protecting public interest and providing confidence in capital markets.

Auditors may potentially be subject to numerous liability rules (i.e. ‘multi-layered’ liability of auditors).⁶¹² They can be liable for both criminal and civil offences. The discussion in the following sections will consider civil liability rules.⁶¹³ The following section focuses on the auditors’ contractual liability to their clients, tortious liability to non-clients, proportionate liability and liability limitations agreements, as well as Limited Liability Partnership status.

⁶¹⁰ Yangyang Fan, Chan Li, Nandu Nagarajan, Jared Smith, ‘Auditor Litigation, Audit Office Pricing and Client Acceptance’, March 2015, available at <https://www.american.edu/kogod/research/upload/Auditor-Litigation-Audit-Office-Pricing-and-Client-Acceptance.pdf> accessed 20 June 2015.

⁶¹¹ Lise Kolding Foget-Ladefoged and Eric Werlauff, ‘Limitation of Auditors Liability’ (2014), 11(6) European Company Law 271, p.274.

⁶¹² Paulo Guidici, ‘Auditors’ Multi-Layered Liability Regime’ (2012) 13(4) European Business Organization Law Review 501, pp.501-502

⁶¹³ Criminal liability of auditors is much more straightforward. According to s. 507 of the Companies Act 2006 ‘an auditor who knowingly or recklessly makes a statement in the audit report that is misleading, false, or deceptive is subject to criminal liability’. In other words, auditors can be prosecuted for either knowingly or recklessly issuing an inappropriate audit opinion. This thesis focuses on the controversy surrounding the civil liability.

Auditor liability to the Company in the UK

The relationship between the auditor and the audit client is one of service providing.⁶¹⁴

The auditor is appointed in order to provide an objective opinion on the truth and fairness of the financial statements of a client in return for audit fees.⁶¹⁵ The contract of the auditor with shareholders is evident only upon his appointment and when he provides shareholders with an audit report. Otherwise, auditor stays closely connected to the company's management. His primary aim, however, is to look after the interests of the shareholders.⁶¹⁶ Shareholders, on the other hand expect a diligently prepared audit that would shield them from any loss resulting from the audit service, such as payment of unlawful dividends or absence of assets in the balance sheet.⁶¹⁷ Consequently, if they receive a negligently prepared audit they will seek to recover their losses by claiming damages from auditors.

In order to ascertain the liability of the auditor to his client, the primary issue that needs to be established is whether the auditor had been negligent, and if yes, how much loss was caused to the claimant. The standard expected by the auditor is that of reasonable care and skill. It is established that the auditor is not a guarantor of the accuracy of financial statements, so as to be liable irrespectively of exercising reasonable care and skill.⁶¹⁸ In *Re London and General Bank* [1895], Lindley LJ stated that:

⁶¹⁴ Supply of Goods and Services Act 1982, s.12.

⁶¹⁵ Dan A. Simunic, 'The Pricing of Audit Services: Theory and Evidence' (1980) 18(1) *Journal of Accounting Research* 161, pp. 161-162.

⁶¹⁶ Porter (n 17), p. 192.

⁶¹⁷ John Powell, *Jackson & Powell on Professional Liability*, (7th edn, Sweet & Maxwell 2012), pp. 1220-1221.

⁶¹⁸ *Equitable Life Assurance Society v Ernst & Young* [2003] EWCA Civ 1114; *Sasea Finance Ltd v KPMG* (No.2) [2000] 1 B.C.L.C 236.

An auditor... is not an issuer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company...' but auditors must exercise 'reasonable care and skill' and '... he must not certify what he does not believe to be true'.⁶¹⁹

The auditor should not act with suspicion, but with a reasonable caution or with an enquiring mind. If something raises his concern, he should examine it thoroughly, making sure there is no error.⁶²⁰ He has a broad discretion to rely on information provided by the board of directors. In *Re Kingston Mill Company* [1896], Lopes LJ described the duty of auditors by stating that 'an auditor is not bound to be detective. He is a watchdog, but not a bloodhound'.⁶²¹ Accordingly, an auditor may rely on the certifications of the company director in the absence of suspicious circumstances. It is a professional requirement, however, for an auditor to have a questioning mind in terms of 'professional scepticism'.⁶²² An auditor must therefore be critical of the accounts and reports provided by the company management in order to discharge his duty of care.

The courts, in determining the standard of care, are also guided by accounting and auditing standards. The reasons behind this are twofold: firstly, the standards reflect good practice among auditors, as they are concluded with the consensus of all of the professional associations of accountants, and secondly, it is the requirement of every auditor to be registered with one of the professional bodies which adopt auditing standards.⁶²³ Despite the fact that standards do not have a binding force, if an auditor

⁶¹⁹ Lindley LJ in *Re London and General Bank* (No.2) [1895] 2 Ch. 673.

⁶²⁰ *Fomento (Sterling Area) Ltd v Seldson Fountain Pen Co* [1958] 1 W.L.R. 45 (HL), [1958] 1 ALL E.R. 11, 51

⁶²¹ *Re Kingston Cotton Mill*, [1896] 2 Ch. 279, Court of Appeal, where auditors were allowed to rely on the enormously overstated by the managing director certificates as to the levels of stock.

⁶²² According to ISA 315, in order to fulfil the requirement of professional scepticism, an auditor should develop a good understanding of the audited entity's business and its environment.

⁶²³ Powell (n 617) p. 1250.

abides by them, it proves that he acted in a reasonable manner. Consequently, as long as an auditor follows the standards, he is acting in a reasonable way and hence he does not breach the duty of care towards the client.

As far as the quantum of liability is concerned, the auditor's liability extends to the losses that the company suffered, due to the decisions in these areas which the directors would have taken differently if they had known the full facts. This applies even if the decision actually taken was lawful. Moreover, if there was a course of action the directors could have taken, which was wholly within their own control, liability would depend on it being shown that the step would have been taken. This might be difficult, particularly in the case of fraud or mismanagement, when those at fault are directors.⁶²⁴ Even if the claimant could establish liability and substantial loss, an auditor could reduce his liability using the defences of contributory negligence or limitation of liability by contract.⁶²⁵

Overall, it is difficult for a client to sue their auditor in the UK. Litigation would be likely to focus on the question of whether the auditor had in fact been negligent and if so whether, and how much, loss was caused to the claimant. The standard required here is that of reasonable care and skill. Provided the extensive developments by the Accounting Standards Board and the Auditing Practices Board of the accounting and auditing standards (and their international equivalents), it would be surprising if the courts were not guided by those standards in determining the standard of care in common law for auditors. Therefore, there is much greater certainty about what the duty of care requires of auditors than is the case for some other professionals.⁶²⁶ As long as auditors follow the

⁶²⁴ Davies (n 102) p.799.

⁶²⁵ Davies (n 102) pp. 799-801.

⁶²⁶ Davies (n 102) p. 798.

standards, it is unlikely they will ever be in breach of their duty of care to their clients.⁶²⁷

The following section looks at auditor liability to the company in the US.

Auditor Liability to the Company in the US

The auditor's duty under US law is to act in accordance with applicable professional standards and with agreement between parties.⁶²⁸ However, even if an auditor is negligent in performing his duty, the US law vests in the auditor a powerful defence – in pari delicto, which enables an auditor to be shielded from liability. This usually takes place in the following scenario. Managers of a corporation fraudulently misstate the corporation's financial statements in order to make the company more attractive to investors. The financial statements are then certified by an auditor who fails to follow professional standards in performing the audit. When the fraud is uncovered, the stock price decreases in value and the corporation becomes insolvent. Creditors and shareholders want to recover their losses from the auditor, alleging that the negligent audit allowed the fraud to continue for longer than it would have if the auditor had fulfilled his duty.⁶²⁹ This is a typical scenario where a defence in pari delicto is used by a negligent auditor.⁶³⁰

According to the Restatement (Third) of Agency, the knowledge of a corporate officer is imputed to the corporation and the corporation is deemed to have this knowledge.⁶³¹

Accordingly, imputation makes the corporation liable for an officer's fraud. This officer's fraud becomes, in law, the corporation's fraud, which makes the corporation a

⁶²⁷ *Lloyd Cheyham & Co Ltd v Littlejohn & Co* [1987] B.C.L.C. 303.

⁶²⁸ *Official Comm. of Unsecured Creditors of Allegheny Health, Educ. & Research Found. v. PricewaterhouseCoopers, LLP (AHERF)*, 989 A.2d 313, 332 (Pa. 2010)

⁶²⁹ Christine M. Shepard, 'Corporate Wrongdoing and the In Pari Delicto Defense in Auditor Malpractice Cases: A New Approach' (2012) 69(1) Washington and Lee Law Review 275, p. 277.

⁶³⁰ The application of the in pari delicto is subject to significant jurisdictional variability.

⁶³¹ Restatement (Third) of Agency § 5.03 (2006) ('Notice of a fact that an agent knows or has reason to know is imputed to the principal if knowledge of the fact is material to the agent's duties to the principal...').

wrongdoer.⁶³² The defence of in pari delicto prevents one wrongdoer from seeking redress from another potential wrongdoer. As the corporation's creditors bring their claim on behalf of the corporation, they 'step into the shoes' of the corporation and any defence that can be raised against the corporation can be raised against them.⁶³³ These doctrines operate in tandem to immunise auditors from liability.⁶³⁴

The evidence shows that auditors can be immune from liability for negligent work simply because they performed their work for a corporation whose directors committed fraud. It seems particularly curious, when one considers that an auditor, who was hired for the very purpose of monitoring corporate activity, can use the in pari delicto defence to get immunity from answering for his own potential wrongdoing. This is important for the thesis, which argues that holding an auditor accountable for his work is advisable, because his role is unique and has implications beyond its performance under the contract with his client. Auditors 'have duties not just to management, but to the public at large'.⁶³⁵ They are hired to minimise the risk of managers misusing their powers and committing fraud. Limiting auditors' accountability for the very thing they were hired to do eliminates a significant incentive to deliver good quality audits. At the start of an engagement, an auditor is aware that the chances of being held accountable for his work are minimal. The following section looks at the auditors' liability to third parties.

Auditor Liability to Third Parties in UK law

As far as auditors' liability to non-clients is concerned, a significant problem arises out of the fact that the accounts and auditors' reports become public documents. A lot of people rely on them while carrying out a wide range of transactions. Unrestricted liability

⁶³² *Kirschner v KPMG LP*, 938 N.E.2d 941, 951 (N.Y.2010).

⁶³³ 11 United States Code (U.S.C.) § 541(a) (2006).

⁶³⁴ Shepard (n 629) p.278.

⁶³⁵ AIG I, 965 A.2d 763, 828 n.246 (Del. Ch. 2009)

on behalf of auditors toward the third parties could theoretically lead to ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’.⁶³⁶ This thesis argues that over the years, the auditors’ liability to third-party claims has gone through many stages and has become excessively restricted.

Candler v Crane, Christmas & Co [1951] was one of the first cases on tortious liability of the accountants in the UK.⁶³⁷ Here, the Court of Appeal decided that liability for a careless statement could only materialize if ‘the maker of the statement had a contractual or fiduciary relationship with the plaintiff’.⁶³⁸ Denning L.J. dissented and his view then paved the way to the change of law that occurred in *Hedley Byrne & Co v Heller & Partners* [1963]⁶³⁹, where the imposition of tortious liability, where no contractual relationship existed, was established for the first time.

Here, the House of Lords ruled that a third party relying on negligently prepared financial statements could sue the auditor, as long as there was a ‘special relationship’ between them. A special relationship was described as more than just a fiduciary contractual relationship. Here the voluntary assumption of responsibility on behalf of the defendant and reasonable reliance by the plaintiff was necessary. The court described the ‘special relationship’ as:

All those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care as the circumstances required, where it was reasonable for him to do that, and where the other gave the

⁶³⁶ *Ultramares Corp. v Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931).

⁶³⁷ *Candler v Crane, Christmas & Co.*, 2 K.B. 164(1951). In this case, the defendants, the accounting firm, negligently prepared the accounts of a company knowing that the accounts would be relied on by the plaintiff in deciding whether to invest in the business. As a result of accountants’ negligence the plaintiff suffered financial loss.

⁶³⁸ Paula Giliker and Silas Beckwith, *Tort* (3rd edn, Sweet & Maxwell, London 2008), p. 86.

⁶³⁹ *Hedley Byrne & Co v Heller & Partners* 2 All ER 575(1963).

information or advice when he knew or ought to have known that the inquirer was relying on him.⁶⁴⁰

In 1978 Lord Wilberforce's decision in *Anns v Merton Borough Council* [1978] introduced a general foreseeability principle for determining, whether a particular person was owed a duty of care.⁶⁴¹ The foreseeability principle became a substantial litigation deterrent to acquiescent auditing as it 'held out the possibility of further extensions of duties of care to other parties, including existing shareholders or investors, who foreseeably rely on audited financial statements'.⁶⁴² A duty of care, hence, could have been owed, even if the auditor was not aware that a given third party had been provided with the financial statements.

This approach was then restricted in *Caparo Industries v Dickman* [1990], where the court examined the existing authorities and reformulated the requirements to establish negligent misstatement in a way that was much more favourable to auditors than to third parties. The House of Lords stated that auditors owe a duty of care to their clients and as a general rule this duty does not extend to potential investors. The House also stated that the purpose of audited statements is to fulfil the statutory obligation to shareholders as a body, not to individual shareholders or stockholders to enable them to monitor managers.⁶⁴³ It was made clear that statements are not provided to give potential and existing investors information, based on which they could make an investment decision.⁶⁴⁴ As a rule, auditors owe a duty of care to the company.

⁶⁴⁰ See (n 639).

⁶⁴¹ *Anns v Merton Borough Council*, A.C. 728 (1978).

⁶⁴² Kershaw (n 163) p.403.

⁶⁴³ Ingrid De Poorter, 'Auditor's Liability Towards Third Parties within the EU: A Comparative Study between the United Kingdom, the Netherlands, Germany and Belgium' (2008) 3(1) *Journal of International Commercial Law and Technology* 68, p. 70.

⁶⁴⁴ Mark Lunney and Ken Oliphant, *Tort Law: Text and Materials* (3rd edn, Oxford University Press, Oxford 2007), pp. 420-425.

The House, however, acknowledged that only in exceptional circumstances will auditors owe a duty of care to third parties. In order to establish this duty, a third party has to prove the existence of a ‘special relationship’ between himself and an auditor. This, in turn, requires a claimant to show that the following factors are present. First of all, the audited accounts are required for a purpose, which is made known to the auditor. Furthermore, the auditor has knowledge that audited accounts will be communicated to the third party either specifically or as part of an ascertainable class. Next, the auditor has knowledge that the claimant is likely to act upon the audited accounts. Finally, the claimant acts on the audited accounts to his detriment.⁶⁴⁵ Consequently, the mere foreseeability is insufficient to establish the duty of care. There is a need to establish sufficient proximity between the claimant and the auditor. In the absence of at least one of the four requirements, the relationship between the two will not be sufficiently proximate. The House also stated that in every case, it must be must be fair, just, and reasonable to impose this duty on one party for the benefit of the other.⁶⁴⁶

Even if the claimant manages to establish that the auditor owes him a duty of care, he then has to establish that the auditor breached the standard of care. If the auditor acted in accordance with the standards issued by his professional association, he will be unlikely to have breached his duty. Apart from establishing the breach, the claimant also has to prove the factual and legal cause of the loss. The detailed rules of causation further increase an already burdensome process of seeking damages for negligently conducted audit.

Such a burdensome process is highly unusual in the area of other products. According to Cousins, ‘No one can sell a car, breakfast cereal, packet of potato crisps without owing a

⁶⁴⁵ Roach (n 110) p. 139.

⁶⁴⁶ *Caparo Industries v Dickman and others* [1990] 1 All ER 568, AC 605

duty of care to current or potential customers. Yet the auditing industry is not subjected to the same requirements'.⁶⁴⁷ The evidence shows that law is rather protective towards auditors.⁶⁴⁸ This may weaken the position and credibility of the audit function in society and provide low economic incentives to deliver good quality audits.⁶⁴⁹ On the other hand, however, the law needs to protect auditors from frivolous suits, which can lead to another Arthur Andersen style collapse and even further concentration of the audit market. The balance is intrinsically difficult to achieve. Perhaps the solution could be found in ensuring that auditors retain certain regulatory concessions, but at the same time increase their focus on the quality of audits. This could bring down the number of lawsuits for negligent audits in a more natural manner. This is further developed in chapter six.

Auditor Liability to Third Parties in US law

As far as the US is concerned, the scope of an auditor's duty to non-clients for negligent misstatements is a question of state rather than federal or national law. Each state has an authority to decide the legal standard determining which third party has a right to sue for negligent misrepresentation. Among the states, four standards have evolved establishing which non-clients are owed a duty by auditors: privity, near privity, restatement approach, and the reasonable foreseeability standard.

Strict privity approach was first established as a legal standard in *Landell v Lybrand* [1919].⁶⁵⁰ It requires a direct, contractual relationship between an auditor and a third party in order for the latter to sue for negligence. This standard has been applied in a small

⁶⁴⁷ Jim Cousins, Austin Mitchell, Prem Sikka, Hugh Willmott, 'Auditors: Holding the Public to Ransom' (1998) Association for Accountancy & Business Affairs, available at <http://visar.csustan.edu/aaba/ransom.PDF> p. 2, accessed 6 September 2015.

⁶⁴⁸ Cousins (n 647) p. 2.

⁶⁴⁹ R. W. Perks, *Accounting and Society* (Chapman & Hall, London 1993), p. 55.

⁶⁵⁰ *Landell v Lybrand* 107 A. 783 (Pa. 1919).

number of the US cases. It is only followed by two states – Virginia and Pennsylvania.

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The near privity standard was applied for the first time in the *Ultramares Corp. v Touche, Niven & Co* [1931].⁶⁵² When deciding the case, Judge Cardozo argued against allowing injured third parties to recover from harm suffered as a result of reliance on a negligent audit.⁶⁵³ He feared that it could ‘expose accountants to a liability in an indeterminate amount, for an indeterminate time, to an indeterminate class’, placing an extreme burden of liability on the accounting profession.⁶⁵⁴ The court denied the plaintiff’s negligence claim, but established an exception to the strict privity rule, known as the ‘primary benefit rule’. In order to make use of the exception, the plaintiff had to be an intended third party beneficiary of the contract between the auditor and the client. The *Credit Alliance v Arthur Anderson* [1985]⁶⁵⁵ case clarified this approach by setting a three element legal test which had to be satisfied by a third party to be within the scope of the auditor’s duty for negligent misrepresentation. Firstly, the accountant must have known that financial reports were to be used for a particular purpose. Secondly, the known parties were intended to rely on these reports. Thirdly, there must have been some conduct linking the auditor to the relying party.⁶⁵⁶ This approach is followed by twelve states.⁶⁵⁷

⁶⁵¹ Carl Paccini, William Hillison, and David Sinason, 'Auditor Liability to Third Parties: An International Focus' (2000) 15(8) *Managerial Auditing Journal* 394, p. 401.

⁶⁵² *Ultramares Corp. v Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931). Here, Fred Stern and Co. hired Touche to conduct audit of its accounts. Stern was already insolvent at the time of the audit, but it used fictitious assets in its statements to conceal its poor financial situation. The careless audit conducted by Touche failed to discover the company’s condition. In the meantime, Ultramares Corporation provided Stern with a number of loans. When Stern ultimately declared bankruptcy, Ultramares sued Touche for the unpaid balance, claiming that Touche’s negligent audit on which it relied caused losses to third parties such as Ultramares.

⁶⁵³ Siciliano (n 87) p. 342.

⁶⁵⁴ *Ultramares Corp. v Touche, Niven & Co* (n 652).

⁶⁵⁵ *Credit Alliance v Arthur Andersen*, 483 N.E.2d 100 N.Y. (1985).

⁶⁵⁶ Paccini (n 651) p. 402.

⁶⁵⁷ Arkansas, Idaho, Illinois, Kansas, Louisiana, Michigan, Montana, Nebraska, New Jersey, New York, Utah, Wyoming.

By the mid-1970s and 1980s the accounting profession faced a litigation crisis. US Courts had increasingly adopted expansive liability rules. A broadened notion of responsibility was invoked by third parties, who had relied on the negligently prepared statements of public accountants. Audit was no longer perceived as a contractual agreement, but rather as a product, which if defectively produced, could harm third parties. The most famous case involving the audit-as-product analogy was the decision in *Rosenblum, Inc. v. Adler* [1983], which established the reasonable foreseeability approach.⁶⁵⁸ The facts of this case are typical of most cases, where injured third parties relying on negligently produced audits sue auditors. Here, the public accounting firm had negligently failed to detect serious errors in the financial statement of the Giant Stores Corporation. When Giant went bankrupt, the third party sued the auditor for losses incurred as a result of reliance on the negligent audit. The New Jersey Supreme Court concluded that while providing the audit, the auditor, just like the manufacturer, was ‘impliedly holding out that the product is reasonably fit, suitable and safe.’⁶⁵⁹ It was held that auditors owed their duty to those, whom they should reasonably foresee, as receiving and relying on the audited financial statements. The duty, however, extended only to those users whose decision was influenced by audited statements obtained from the audited entity for a proper business purpose. This approach is currently followed only in two states – Mississippi and Wisconsin.

Expanding the liability rule was meant to increase the quality of audits and serve the public interest by enhancing audit safety. Public accounting firms, in order to avoid financial troubles, could have purchased malpractice insurances passing the cost onto the client, and clients’ consumers.⁶⁶⁰ The predicted effects of the *Rosenblum* court decision,

⁶⁵⁸ *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983).

⁶⁵⁹ *Ibid.*

⁶⁶⁰ Siciliano (n 87) p. 345.

however, failed to materialize. Accountants started withdrawing their services from clients in high-risk industries, or businesses in early growth phase, where audit risks were usually the highest.⁶⁶¹ They also expressly limited in their audit contracts the individuals able to rely on their audits.⁶⁶² As accountants could no longer predict risks in their auditing processes the idea of insuring audits, which depends highly on predictability of risks, collapsed.⁶⁶³ Instead of managing risks by more careful accounting, public accountants avoided risky engagements. Consequently, instead of better quality audits, an ‘overly expansive liability rule had the perverse effect of producing less information.’⁶⁶⁴

This litigation trend was reversed again by the decision of California Supreme Court in *Bily v Arthur Anderson & Co in* [1992].⁶⁶⁵ The court was unwilling to uphold the broad tort liability rule stemming from *Rosenblum* and expressed doubts that exposing accountants to increased liability would actually result in better quality audits. The analogy ‘audit-equals-defective product’ was discredited and the court returned in its judgement to the approach found in the Restatement of Torts (1977).⁶⁶⁶ Under the Restatement rule, third parties are able to sue a negligent auditor, if they belong to the group of foreseen individuals, whom the public accountant would expect to rely on audit.⁶⁶⁷ This test seems to strike the balance between two extreme approaches, the too protective privity doctrine adopted in *Ultramares* and the too open-ended foreseeability of harm established in *Rosenblum* decision. The Restatement approach ‘...balances the

⁶⁶¹ Newton N. Minow, 'Accountants' Liability and the Litigation Explosion' (1984) 158(3) Journal of Accountancy 70, p. 80.

⁶⁶² John A. Siliciano, 'Negligent Accounting and the Limits of Instrumental Tort Reform' (1988) 86(8) Michigan Law Review 1929, p. 1949.

⁶⁶³ Siliciano (n 662) p.1949.

⁶⁶⁴ Siliciano (n 87) p.345.

⁶⁶⁵ *Bily v Arthur Andersen & Co.*, 11 Cal Rptr.2d 51(1991).

⁶⁶⁶ Siliciano (n 87) p.348.

⁶⁶⁷ Restatement (Second) of Torts, par. 552 (1977).

need to hold public accountants to a standard that accounts for their contemporary role in the financial world, with the need to protect them from a liability that unreasonably exceeds the bounds of their real undertaking.’⁶⁶⁸ Most of the states now follow the restatement rule.

Having discussed the auditors’ liability to third parties, this thesis now proceeds to discuss further legal limitations of auditors’ liability such as proportionate liability, limited liability agreements and introduction of the Limited Liability Partnership form. This thesis argues that these regulatory concessions further reduce the auditors’ accountability. At the same time, as was argued at the beginning of this chapter, the incentives to remain independent, (such as professional discipline with its lenient sanctions), do not provide a sufficient deterrent against auditors’ acquiescing to the managers’ demands. This leaves auditors insufficiently incentivised to be objective and to deliver good quality audits.

Auditor Liability Limitation and Further Issues

This thesis argues that an auditors’ legal accountability is further diminished by introducing proportionate liability and the limited liability agreements. The doctrine of joint and several liability led to a significant increase in the tort exposure of auditors. Under this doctrine, the injured party could recover the loss from any of the tortfeasors liable in respect of the same loss. In a case where misstatements in the company’s accounts resulted from the fraud or negligence of someone within the company, and the auditors failed to discover wrongdoing, the claimant was then able to recover the whole loss from the auditor, rather than from the original wrongdoers. Claimants were then encouraged to sue defendants with ‘deep pockets’ for the recovery of the whole loss, even

⁶⁶⁸ First Florida Bank v Max Mitchel & Co, 558 So.2d 9,15 (1990).

though auditors were only partially at fault. This problem was addressed in the US by introducing proportionate liability in the Private Securities Litigation Reform Act in 1995.

In the UK, the Big Four have long argued that proportionate liability should be introduced in order to reform the system of joint and several liability in negligence claims against them as partnerships. At various stages, the Law Commission, the Government, and the Company Law Review Steering Group have all rejected its adoption on the grounds that it simply shifted the risk of insolvency from the auditor to the innocent claimant. Audit firms, however, were successful in liberalising the prohibition of liability limitation agreements, which delimit the audit firm's contractual and tortious liability to its corporate clients.⁶⁶⁹

Liability limitation agreements, which permit the auditor and the company to limit the amount of a liability arising out of negligence, default, breach of duty, or breach of trust in the conduct of audit, were introduced by s.532-538 of the Companies Act 2006. The effect of this was to overturn one of the fundamental principles of company law, enshrined in legislation for almost eighty years, which precluded the company to relieve the auditor from liability for these breaches.⁶⁷⁰

The liability limitation agreements are sufficiently open-textured to allow some forms of proportionate liability into audit firms and their clients' contractual relationships. The agreements are optional and only limit the liability to the company, not to third parties. It is immaterial how Liability Limitation Agreements (LLA) are structured; in particular

⁶⁶⁹ The campaign of the audit firms to introduce proportionate liability was flawed by the absence of convincing empirical evidence on the amount of negligence litigation against the firms. On the contrary, there is some evidence, at least in the UK context, that litigation against audit firms remains extremely rare, in David Gwilliam, 'Auditor Liability: Law or Myth?' (2004) 20(3) *Professional Negligence* 172, 78-79.

⁶⁷⁰ P.E. Morris, 'Contractual Limitations on the Auditors' Liability: An Uneasy Combination of Law and Accounting' (2009) 72(4) *Modern Law Review* 607, p. 607.

they are not confined to fixed sums or formulae.⁶⁷¹ The amount to which the agreements are limited must be fair and reasonable, though there is no guidance as to what is a reasonable amount.⁶⁷² All of the LLA, however, have to be authorized by the shareholders. This constitutes a non-negotiable safeguard, which is supposed to reduce the risk of abuse of this contractual form. The duration of the LLA is fixed at one financial year and requires annual renewal.⁶⁷³ Transparency is achieved through the requirement of attaching the LLA principal terms to the company's annual accounts or the director's report.

On one hand, the LLA are sensitive to parties' contractual autonomy and avoid the arbitrary nature of their principal alternative – a fixed statutory cap, which exists in five EU member states⁶⁷⁴ and two Australian states⁶⁷⁵, as a solution to this increasingly perceived international problem. The LLA provisions place the UK in conformity with the European Commission Recommendation on the civil liability of statutory auditors.⁶⁷⁶ It has been argued that given the insufficient capacity of insurance coverage, liability limitation agreements are necessary to protect the large audit firms from being destroyed by a major claim. The agreements allow audit firms to face lower risk of liability and

⁶⁷¹ Companies Act 2006, s. 535(4).

⁶⁷² It would be difficult for the UK government to set monetary thresholds, as risks of conducting audits vary across the industries, in Michael Paterson, 'Reform of the Law on Auditors' Liability: An Assessment' (2012) 23(2) *International Company and Commercial Law Review* 55, p. 58

⁶⁷³ Companies Act 2006, s. 536 (4)(b).

⁶⁷⁴ These are: Austria, Belgium, Germany, Greece, Slovenia. Germany has operated a system of fixed statutory caps since 1931, in M. B. Gietzmann and R. Quick, 'Capping Auditor Liability: The German Experience' (1998) 23(1) *Accounting, Organizations and Society* 81.

⁶⁷⁵ Vylan Nguyen and Pelma Rajapakse, 'An Analysis of the Auditors' Liability to Third Parties in Australia' (2008) 37(1) *Common Law World Law Review* 9.

⁶⁷⁶ European Commission, Recommendation of 5th of June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms OJ L162/39 (2008). The recommendation is not binding and due to significant divergences in civil liability systems among the member states harmonisation has been ruled out in favour of national implementation of one of the three options: 1) fixed statutory caps 2) proportionate liability 3) the UK option of LLA combined with the shareholder approval; in Morris (n 670) p.611.

consequently be less affected by ‘deep pocket syndrome’, since other parties of joint and several liability, such as directors, would also become subject of litigation.⁶⁷⁷

On the other hand, proportionate liability and the LLA share the common flaw that in case of a breach of contract or negligence claim they prevent the claimant’s full recovery. According to Morris, it seems unfair, doctrinally in the context of mandatory professional service, but also it raises question, as to why precisely the auditing profession, performing important corporate regulatory function on behalf of the State, should be the beneficiary of such immunities.⁶⁷⁸ The auditing profession continues its lobbying on liability reform, despite the fact that their claims regarding litigation risks are exaggerated. Also since in most cases the duty of care is owed to the company, with its scope shaped by contractual definitions of assumed risks, recovery of losses could be effectively prescribed by careful drafting of the audit contract. If this can delimit the risks for which audit firms are responsible, and the losses are purely economic, it is difficult to see the necessity for the LLA.⁶⁷⁹

There is also a danger that, if the business relationship between the audit firm and the company is too cosy, the LLA could become abusive in the sense of granting audit firms excessive liability contracts in return for smaller audit fees or lower quality audits. Even though the Big Four have a diversified practice portfolio, statutory audit still generates a significant profit.⁶⁸⁰ Despite various regulatory measures and official commitments to quality, the commercial dimension, with its preservation of profits remains particularly influential. Reduced audit fees in return for tight LLAs will most definitely decrease audit

⁶⁷⁷ Roach (n 110) p. 140.

⁶⁷⁸ Roach (n 110) p. 140.

⁶⁷⁹ Roach (n 110) p. 141.

⁶⁸⁰ Roach (n 110) p. 142.

quality and its value as a form of assurance to key stakeholders and the capital markets.⁶⁸¹ This in turn can lead to the damage of economic and reputational interests of the profession. This thesis argues that auditing is not a casual contractual relationship between the audit firm and its client. It is an essential ingredient of effective corporate governance and performs a public policy function by enhancing investor confidence and effective functioning of capital markets.

Good audits and auditors' legal accountability is considered to have been further endangered through the adoption of the Limited Liability Partnership legal form by the biggest accounting firms. This legal structure introduced limited liability for professionals, excluded their vicarious liability, and enabled firms to enjoy tax concessions associated with partnerships.⁶⁸² This, in turn, could have contributed to a decline in the monitoring function, and maintenance of robust systems of corporate governance, alongside the fall in perceived litigation risk.

As far as the US is concerned, the LLP form was introduced as a result of a lobby on behalf of lawyers and accountants, who, during the saving and loan crisis in the 1980s, saw for the first time, significant personal risks associated with their business practices.⁶⁸³ The first LLP legislation was introduced in Texas. By 1995 all other states had enacted similar legislation.⁶⁸⁴ In the UK, the Limited Liability Partnership Act was passed in 2000 and came into force in 2001. It was enacted as a response to particularly intensive

⁶⁸¹ Tim Bush, Stella Fearnley, and Shyam Sunder, 'Auditor Liability Reform in the UK and US: A Comparative Review' (2007) Yale School of Management Working Paper, available at <http://depot.som.yale.edu/icf/papers/fileuploads/2575/original/07-33.pdf> p. 22, accessed 6 January 2016.

⁶⁸² Sikka (n 103) p. 414.

⁶⁸³ Macey (n 106) p. 1171.

⁶⁸⁴ Robert Hamilton, 'Registered Limited Liability Partnerships: Present at the Birth (Nearly)' (1995) 66(4) *University of Colorado Law Review* 1065, p. 1069.

lobbying by Ernst & Young and Price Waterhouse, who were working on similar LLP legislation for Channel Islands.⁶⁸⁵

Even though, in traditional partnerships, there was no explicit duty to monitor one's peers, the fact that partners were vicariously liable for each other's professional conduct created incentives to monitor one another and actively participate in the firm's affairs and management.⁶⁸⁶ Partners with unlimited liability were eager to sacrifice their time and resources to monitoring and risk management, reducing at the same time their potential personal liability exposure.⁶⁸⁷

The introduction of the LLP eliminated vicarious liability. Accordingly, professionals in traditional partnerships providing advice and supervision could resist doing it in an LLP in order to avoid potential liability. According to Macey, the conversion from general partnership to the LLP created disincentives to monitor.⁶⁸⁸ Most LLP Acts impose personal liability on partners involved in the supervision of others and this eliminates the incentive to supervise one's peers. Why would LLP partner get involved in the firm's affairs and supervision if those actions could expose his personal assets? Is the willingness to protect the firm's reputation and assets sufficient to risk personal liability exposure? As the LLP status eliminates vicarious liability and focuses liability on individual tortfeasors and supervisors, it seems more likely that senior auditors would be more inclined to shirk supervisory responsibilities.⁶⁸⁹ Vicarious liability is costly for professionals as it transfers risks to them and away from clients and investors. In an

⁶⁸⁵ Freedman (n 104) p. 905; Sikka (n 103) p.414.

⁶⁸⁶ Macey (n 106) p. 1169.

⁶⁸⁷ Susan Saab Fortney, 'High Drama and Hindsight: The LLP Shield, Post-Andersen,' American Bar Association, available at <http://www.americanbar.org/content/dam/aba/publications/blt/2003/01/high-drama-hindsight-200301.authcheckdam.pdf>, accessed 20 January 2016.

⁶⁸⁸ Macey (n 106) p. 1171.

⁶⁸⁹ Fortney (n 687).

attempt to minimize these risks, professionals may be inclined to give very careful and conservative advice, or even completely refuse it for clients in highly regulated or risky industries. This, in turn, can deny access to capital markets to those with new, potentially good, but untested ideas.⁶⁹⁰

The LLP form can also create other problems such as asset insufficiency. This occurs when the assets of a firm and tortfeasors are not sufficient to cover the amount necessary to satisfy creditors' claims. Following a large judgement, like in the case of Arthur Andersen, partners who are not personally liable can actually seek to dissolve the firm and relocate.⁶⁹¹ This can also cause a significant injustice to tort victims. If the firm goes bankrupt, secured creditors are given priority over tort victims. This leaves tort victims with a case against the bankrupt firm and individual tortfeasors, making it virtually impossible for them to receive any compensation.⁶⁹²

Conclusion

This thesis argues that the combination of legal and organisational changes has led to significant legal accountability deficits and the decline of audit quality.⁶⁹³ As a result of numerous reforms, it is now very difficult for clients and non-clients to sue auditors for negligent audits. Moreover, due to the introduction of proportionate liability in the US and limitation liability agreements in the UK, auditors can now decrease the amount of compensation that can be owed to those harmed by negligent audits. The introduction of

⁶⁹⁰ Larry E. Ribstein, 'Limited Liability of Professional Firms after Enron' (2004) 29(2) *The Journal of Corporation Law* 427, pp. 435-437.

⁶⁹¹ Fortney (n 687).

⁶⁹² Ribstein, on the other hand, argues that vicarious liability is an ineffective way to make professionals perform their duties. He argues that vicarious liability is based on 'an attenuated notion of responsibility and unrealistic assumptions about firm members' ability to monitor', in Ribstein (n 690) p. 429.

⁶⁹³ Marleen Willekens and Dan Simunic, 'Precision in Auditing Standards: Effects on Auditor and Director Liability and the Supply and Demand for Audit Services' (2007) 37(3) *Accounting Business Research* 217, p. 230

the Limited Liability Partnership,⁶⁹⁴ and the elimination of vicarious liability reduced partners' personal liability and created disincentives to monitor the conduct of other partners. This thesis maintains that this apparent success in legislative and political spheres has made auditors undeterred and unaccountable and could contribute to poor quality audits and irreparable damage to the core economic interests of the accountancy profession.

The following sections argue that lack of professional discipline and disregard for the public function that audit plays in society cause further accountability deficits. The thesis argues that audits should fulfil a public interest role by ensuring integrity and public confidence in the market, and by protecting stakeholders from corporate fraud.

4.2.3. PROFESSIONAL ACCOUNTABILITY

The effective functioning of capital markets is heavily dependent upon the integrity and competence of professional accountants. In theory, professional discipline could act as a substitute for private or public enforcement in order to maintain high professional standards.⁶⁹⁵ Its aim is to ensure that auditors are appropriately supervised and qualified, and that they fulfil their duties properly. In practice, however, auditors in the current audit model are considered to suffer from professional accountability deficits. This issue has already been considered earlier in this chapter in the context of deterrents against auditors' acquiescence to managers' demands, where the procedure and competent bodies responsible for disciplining auditors were examined.

⁶⁹⁴ Alan Dignam, *Hicks and Goo's Cases and Materials on Company Law* (7th edn, OUP 2011), p. 534

⁶⁹⁵ Coffee (n 51) p. 156.

4.2.4. SOCIAL ACCOUNTABILITY

This section focuses on auditors' social accountability, which evolves along two issues, namely the subject and the audience of audit reports. As far as the subject of accountability is concerned, auditors believe their only responsibility is to provide an opinion on whether the financial statements provide a true and fair view of the companies' financial status. Studies on the perception of financial report users on auditors' responsibilities in fraud prevention and detection, however, have found that many financial users believe that fraud detection should be the primary audit objective and that auditors have a responsibility to detect all irregularities.⁶⁹⁶ This is frequently described as the expectation gap.⁶⁹⁷ It is a problematic issue in the current auditing model, as it can lower auditors' credibility, earning potential, and reputation. It is also an important issue for the public, investors and politicians, as it blurs the issue of auditors' accountability.⁶⁹⁸

As far as the intended audience for auditors' report is concerned, the Companies Act in the UK and securities regulation in the US require that auditors owe their duties to their clients – the companies they audit. Auditors, however, are frequently perceived as guardians of public interest⁶⁹⁹ and agents of social change.⁷⁰⁰ Moreover, society expects auditors to protect public interest by providing diligent, good quality audits that will help preserve the stability of financial markets and prevent future scandals.⁷⁰¹ This raises a

⁶⁹⁶ Gary Monroe and David Woodliff, 'An Empirical Investigation of the Audit Expectation Gap: Australian Evidence' (1994) 34(1) *Accounting and Finance* 47; Marc Epstein and Marshall Geiger, 'Investors Views of Audit Assurance: Recent Evidence of the Expectation Gap' (1994) 177(1) *Journal of Accountancy* 60; Christopher Humphrey, Peter Moizer, and Stuart Turley, 'The Audit Expectation Gap in Britain: An Empirical Investigation' (1993) 23 (91A) *Accounting and Business Research* 395.

⁶⁹⁷ Marianne Ojo, 'Eliminating the Audit Expectations Gap: Myth or Reality?' (2006), available at http://mpr.ub.uni-muenchen.de/232/1/MPRA_paper_232.pdf, accessed 10 January 2016.

⁶⁹⁸ Sikka (n 8) pp. 299-300.

⁶⁹⁹ John L. Carey, 'Professional Ethics and the Public Interest' (1956) November, *Journal of Accountancy* 38, p. 38.

⁷⁰⁰ A. J. Berry, T Capps, D. Cooper, P. Fergusson, T. Hopper and E.A. Lowe, 'Management Control in an Area of the NCB: Rationales of Accounting Practices in a Public Enterprise' (1985) 10(1) *Accounting, Organizations and Society* 3.

⁷⁰¹ Limperg (n 250).

question as to whether the auditors' sole responsibility should be to their clients, or whether they should be accountable to other persons, stakeholders, or even to society at large.

As far as the subject of audit reports is concerned, corporate auditing, in its origins, was concerned with investigating improper conduct such as error and fraud in accounting. More recently the focus has been on verifying the information contained in annual accounts.⁷⁰² The need for further investigation of the issue of an expectation gap is clear from the growing evidence of uncertainty and dissatisfaction about the purpose and objective of current auditing practice.

In the US, concern about the expectation gap is well documented by both professional and government enquiries. The Cohen Commission established the existence of the expectation gap.⁷⁰³ The Metcalf Committee (1978) concluded that 'the pattern of conduct followed by independent auditors and the scope of services they offer must be re-examined to determine whether they are compatible with public expectations'.⁷⁰⁴ In 1986 the Anderson Committee established, in a section entitled 'Public Expectation Gap', that 'although significant changes have been made in auditing standards since the issuance of the report [the Cohen Commission] to state the auditor's responsibility in this area more positively, public expectations are not fully satisfied by the level of responsibility assumed'.⁷⁰⁵ The passage of Sarbanes-Oxley Act is an even stronger indication that the social usefulness of auditing, as interpreted by practicing auditors, was being called into serious question by society. The Act removed from auditors the ability to exclusively

⁷⁰² Roy Chandler, John Richard Edwards, and Malcolm Anderson, 'Changing Perceptions of the Role of the Company Auditor, 1840-1940' (1993) 23(93) *Accounting and Business Research* 443, p. 446.

⁷⁰³ Cohen Commission (n 46) p. xii.

⁷⁰⁴ Metcalf Committee (n 533) p. 90.

⁷⁰⁵ AICPA, 'Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment' Report of the Special Committee on Standards of Professional Conduct for Certified Public Accountants (American Institute of Certified Public Accountants, New York 1986), p. 15.

interpret their role in society. This task is currently in the hands of the PCAOB. The Board requires the profession to be responsive to the public perception of the assurance that society needs and requires from auditing. It remains to be seen whether the Board will be effective in this role.⁷⁰⁶ It is suggested that, so far, the PCAOB has not put sufficient emphasis on this task.

In the UK, the expectation gap problem found expression in press comments and the reports of the DTI. In reporting on the investigation into the affairs of Peachey Property Corporation Ltd in 1979, the DTI stated, in relation to the functions of auditors: ‘it seems to us that many of the criticisms which we have encountered stem from an imperfect understanding of the functions of auditors both as laid down by statute and as understood by the auditing profession’.⁷⁰⁷ As a result of the collapse of the Johnson Matthey Bank, a working party of the Institute of Chartered Accountants of England and Wales (ICAEW) was brought into being in 1985, in order to address the issue of auditors’ responsibilities regarding fraud. It resisted, however, any extension of the auditors’ duties, mainly on the grounds of cost and practicality. Five years later the profession’s self-regulatory body issued guidance on the auditors’ responsibility to detect fraud and other irregularities. It stressed managerial responsibility to establish adequate systems of internal control, and that auditors should plan the audit to provide a ‘reasonable expectation’ of detecting material misstatements. The term ‘reasonable expectation’, however, has not been defined. Consequently, the detection of management fraud is neither excluded from the audit process (as this would lower expectations to the point that audit would lose its value), nor explicitly included, as this would put extra cost for conducting audits.⁷⁰⁸

⁷⁰⁶ Carmichael (n 269) p.131.

⁷⁰⁷ Department of Trade Inspectors, Report of Investigation under Section 165(B) of the Companies Act 1948 into the Affairs of Peachey Property Corporation Ltd, (HMSO, London 1979), p. 24.

⁷⁰⁸ Power (n 15) p. 25.

One of the greatest difficulties with the issue of the expectations gap is the problem with the very definition of audit. What exactly is it that audits produce?⁷⁰⁹ According to Power, audit is an opinion, which adds credibility and assurance to the financial statements and it is usually expressed in statutory terms of a 'fair and true' view.⁷¹⁰ But this is only an opinion and two different auditors presented with the same data could actually produce different results. Power claims that the problem with the 'expectation gap' lies in the obscurity of audit.⁷¹¹ If one was able to give an objective and precise definition of what audit is rather than referring to his judgement, the problem of the expectations gap would probably not exist. Due to the lack of definition, the whole auditing process requires lots of procedural rules, professional codes of ethics, rules on independence, and trust that practitioners really do their best.⁷¹² According to Power, the existence of the expectation gap is advantageous to auditors and significantly contributes to their economic success. If there was no expectation gap, the market for audit services would be 'scrutable', both in terms of its objectives and the production of assurance relating to these objectives.⁷¹³ Elimination of the expectation gap is difficult to achieve, not only because of the fact that auditors refuse to adopt fraud detection as the primary aim of their practice. It is also problematic and opaque as it is difficult to define what audit really is. It is neither an assurance nor certification. It remains just an opinion and society has no other option but to rely on the judgments of individual auditors. This leaves auditors largely unaccountable to the public.

⁷⁰⁹ Power (n 15) p. 15.

⁷¹⁰ Power (n 15) p. 15.

⁷¹¹ Power (n 15) p. 30.

⁷¹² Alistair M. Preston, David J. Cooper, D.Paul Scarbrough and Robert C. Chilton, 'Changes in the Code of Ethics of the US Accounting Profession, 1917 and 1988: The Continual Quest for Legitimation' (1995) 20(6) *Accounting, Organizations and Society* 507, p. 510.

⁷¹³ Power (n 15) p. 31.

Describing the auditor's function as expressing an opinion on, or lending credibility to financial statements, does not, however, identify the social function of auditors or the underlying purpose of an audit. Following Flint, the preoccupation of auditors with lending credibility to financial statements, and the current emphasis on this function in professional statements, is only part of the scope of auditing. It is the 'conceptual quality of the social function which must be understood if the social expectation is to be interpreted effectively by audit policy-makers and auditors. The general concept of audit and interpretation of its social function do not limit the scope of auditing to accounting data and accountability for financial affairs'.⁷¹⁴

This thesis argues that the accounting frauds of the past, such as Enron, and the financial crisis of 2008, call for the greater accountability of auditors, and a greater effort in preventing accounting failures that have already been put forward by the Sarbanes-Oxley and EU legislation. Audit plays an important function in the capital markets and in society and it is desirable for auditors to take into account the interests of a wider group of stakeholders, such as employees, investors, creditors, or even society at large. A large number of people invest in the capital markets through pension funds, hence the role of socially responsible investment of corporations is of paramount importance. Auditors should operate as an effective monitor of companies' financial statements because the public is entitled to expect diligent audits and effectively operating financial markets, where its money is invested.

The following section focuses on another major problem inherent in the current audit arrangement, namely excessive concentration of the audit market. It discusses the impact of a highly concentrated audit market on the competition, audit quality, and price. The

⁷¹⁴ Flint (n 3) p. 6.

findings indicate that a high concentration of the audit market can significantly limit the number of auditor choices for the large public companies, and can have even more severe consequences if one of the Big Four audit firms withdraws from the market.

4.3. CONCENTRATION OF THE AUDIT MARKET

The effect of market structure on the conduct and performance of audit firms has been debated for many years.⁷¹⁵ Multiple mergers among the leading accounting firms in the 1990s have led to the Big Five audit firms dominating the large client audit market. Concerns have been raised that concentration could reduce competition, leading to an increase in the price of audits, and facilitate the possibility of successful collusion between the top firms which could then have a negative effect on the companies' auditor choices. Another shock to the financial reporting system arose when Enron failed in 2001. This, alongside other scandals, such as WorldCom, led to the enactment of the Sarbanes-Oxley Act in 2002, which aimed at restoring confidence in corporate governance. Due to the global nature of the capital markets, and similar scandals in Europe⁷¹⁶, there have been attempts to introduce similar reforms in Europe and elsewhere.⁷¹⁷

As a result of the Enron scandal, Andersen, one of the top five audit firms lost its auditing license in the US and ceased business, reducing the number of large audit firms from five to four. Most of its former clients switched to other accounting firms. In the UK, Andersen

⁷¹⁵ Kevin McMeeking, *Competition, Choice, and Governance in the UK Audit Market: Interview Evidence* (The Institute of Chartered Accountants of Scotland, Edinburgh 2009), p. 12; Shamharir Abidin, Vivien Beattie and Alan Goodacre, 'Audit Market Structure, Fees and Choice in a Period of Structural Change: Evidence from the UK - 1998-2003' (2010) 42(3) *The British Accounting Review* 187; Stuart E. Michelson, Carel M. Wolk, Charles W. Wooton, 'Auditor Concentration and Market Share in the US: 1988-1999. A Descriptive Note' (2001) 33 (2) *British Accounting Review* 157; OXERA, *Ownership Rules of Audit Firms and Their Consequences for Audit Market Concentration*, Report prepared for DG Internal Market and Services 2007.

⁷¹⁶ For example Parmalat scandal.

⁷¹⁷ Reiner Quick, Stuart Turley, and Marleen Willekens, *Auditing, Trust and Governance: Developing Regulation in Europe* (Routledge, Oxford 2007); Michael G. Oxley, 'The Sarbanes-Oxley Act of 2002 - Restoring Investor Confidence' (2007) 1(1) *Current Issues in Auditing* C1-C2.

was acquired by Deloitte & Touche. This event further sparked the ongoing debate regarding competition, concentration, audit quality, and barriers to entry, which will be analysed below.⁷¹⁸ This section is important for this thesis, as it argues that excessive concentration of the audit market and significant barriers to market entry for mid-tier audit firms are one of the most dominant problems intrinsic in the existing auditing arrangements.⁷¹⁹ The thesis argues that in order to encourage competition and improve the quality of audits in the biggest companies, a public regulatory body should be responsible for the appointment of auditors. Such a body could assign audits, not only to the auditors of its in-house practice, but also to the existing first-tier and mid-tier audit firms, which would increase the choice of auditors for public companies.

The purpose of measuring the concentration level of the market is to determine whether a merged company has an excessive market power, and to predict the extent of the departure of price from the competitive level.⁷²⁰ Excessive concentration, not only is undesirable on competitive grounds, it could also allow a merged firm to exercise an excessive degree of influence over the standards and practices of the entire accounting profession.⁷²¹

⁷¹⁸ Abidin (n 715) p.188; European Commission, Consultation on Control Structures in Audit Firms and Their Consequences on the Audit Firm. Working Paper, Directorate General for Internal Market and Services 2008; Office of Fair Trading (OFT), Competition in Audit and Accountancy Services - a Statement by the OFT, London 2002; Government Accountability Office (GAO), Public Accounting Firms: Mandated Study on Consolidation and Competition, 2003; OXERA (n 715); Financial Reporting Council, 'Choice in the UK Audit Market: 4th Progress Report, London 2009; The Department of Treasury, Advisory Committee on the Auditing Profession. Final Report, 2008, available via <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> accessed 18 February 2016.

⁷¹⁹ Government Accountability Office (GAO), Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action, 2008.

⁷²⁰ Jim Romeo, 'Looking at Mergers the Way Federal Regulators Do' (1999) 188(6) *Journal of Accountancy* December 59, p. 62; George Stigler, *The Organization of Industry* (The University of Chicago Press, Chicago, IL 1968), p. 30.

⁷²¹ Financial Times, 'Consolidating Accounts', 19th September 1997, p.13.

Notwithstanding numerous sampling differences, most academic and professional studies on the concentration of the audit market show that the general trend over time is one of increasing concentration among the largest accounting firms.⁷²² The overall audit market, both in the UK and the US, represents a tight oligopoly⁷²³, which is a concentrated market in which a small number of firms have significant market share and can potentially use their market power, either unilaterally or through collusion, to influence price or business practices to their advantage.⁷²⁴ For example, firms with significant market power can potentially reduce the quality of their products or decrease the amount of services they provide as lack of competitive alternatives could limit their clients to obtain these services elsewhere. Additionally, dominant firms may experience less pressure to introduce innovative products and services. They can also engage in coordinated actions harming their clients, for instance by influencing the development of standards that would raise costs for the clients. The presence of a high concentration, however, does not necessarily mean that the anticompetitive behaviour will take place. Oligopoly might well be

⁷²² Peter Moizer and Stuart Turley, 'Surrogates for Audit Fees in Concentration Studies - a Research Note' (1987) 7(1) *Auditing: A Journal of Practice and Theory* 118; Peter Moizer and Stuart Turley, 'Changes in the UK Market for Audit Services: 1972-1982' (1989) 16(1) *Journal of Business Finance & Accounting* 41; Ramesh Narasimhan and Shifei Chung, 'Auditor Concentration of Listed Public Companies on International Stock Exchanges' (1998) 9(3) *Journal of International Financial Management and Accounting* 201; Kevin P. McMeeking, 'Competition in the UK Accounting Services Market' (2007) 22(2) *Managerial Auditing Journal* 197; C.K.M Pong and S. Burnett, 'The Implications of Merger for Market Share, Audit Pricing and Non-Audit Fee Income: The Case of Pricewaterhousecoopers' (2006) 21(1) *Managerial Auditing Journal* 7; Carel M. Wolk, 'Auditor Concentration and Market Share in the US: 1988-1999. A Descriptive Note' (2001) 33(2) *The British Accounting Review* 157; GAO (n 719); Huw Jones, 'Competition Commission Rows Back on Audit Reforms, Reuters, 15 October 2013, available at <http://uk.reuters.com/article/2013/10/15/uk-britain-accounting-idUKBRE99E03K20131015> accessed 18 February 2016.

⁷²³ Tight oligopoly is generally defined as a market where the concentration ratio exceeds 60 percent, i.e. where the top firms hold over 60 percent of the market and other firms face significant barriers to entry into the market.

⁷²⁴ The usual indicator of the market structure is the number of audit firms active in the market. The two concentration measures reported in various studies are the k-firm concentration ratio (CR) and the Hirschman-Herfindahl index (HI). These measures are based on either audit fees or audit numbers; in GAO (n 719) p.21.

characterized by intense competition, competitive prices, good quality and innovative products.⁷²⁵

Concentrated markets can at times be beneficial, and can form for natural reasons. There were many factors which contributed to the increasing concentration of the audit market in the 1980s and 1990s. The global expansion of the US corporations necessitated the increased global reach of accounting firms. As public companies developed more complex operations and financial transactions, such as the use of derivatives and other financial instruments, accounting firms were compelled to extend industry specific and technical expertise. They also modernised their operations, increased staff numbers, and spread risks over a bigger capital base.⁷²⁶ This enabled them to work globally, and to meet the demands of their multinational clients.⁷²⁷

Increased market concentration also does not necessarily decrease competition.⁷²⁸ The US GAO recent studies found no empirical evidence to support the statement that competition in the US audit market has been impaired⁷²⁹, similar to the earlier studies of Dopuch and Simunic⁷³⁰ and Eichenseher and Danos⁷³¹. According to these studies, current levels of concentration are not significantly affecting audit prices and audit

⁷²⁵ GAO (n 719) p.22.

⁷²⁶ Certain fixed costs, such as staff training, were spread over a larger client base.

⁷²⁷ Although the audit market overall is concentrated, the degree of concentration declines with the size of public companies. According to the GAO Report, in the US the proportion of large companies being audited by the Big Four has not changed since 2002. However, the proportion of the smallest public companies that used the largest auditors fell by 50 percent from 2002 and 2006. The main reasons for this change are the resource constraints of the accounting firms in the aftermath of the Andersen dissolution and the enactment of the Sarbanes-Oxley Act or raised audit fees which smaller companies were unwilling to pay, in GAO (n 719) p. 17.

⁷²⁸ David Flint, 'The Role of the Auditor in Modern Society: An Exploratory Essay' (1971) 1(4) *Accounting and Business Research* 287; Wolk (n 715) p. 170; Abidin (n 715) p. 204.

⁷²⁹ GAO (n 719) p. 6.

⁷³⁰ Nicholas Dopuch and Dan Simunic, 'The Nature and the Competition of the Auditing Profession: A Descriptive and Normative View' in J.W. Buckley and J.F. Weston (eds), *Regulation and the Accounting Profession* (Lifetime Learning Publications 1980).

⁷³¹ John W. Eichenseher and Paul Danos, 'The Analysis of Industry-Specific Auditor Concentration: Towards an Explanatory Model', (July 1981) 56(3) *The Accounting Review* 479, p. 479.

quality. Although audit fees have generally increased over the years, other factors such as changes in regulation and accounting rules, appear to explain recent fee increases. Also, the UK Competition Commission report found that both the average and median total audit fees increased over the period 2001 to 2010, by 23 and 52 per cent respectively.⁷³² The Commission, however, was not able to reach conclusions as to whether prices of audits were above the competitive level. The Report was also inconclusive with regards to the impact of concentration on audit quality, due to the difficulty in identifying an objective metric which would allow meaningful comparisons between audits.⁷³³

Despite the fact that continuing concentration in the market for large public companies does not appear to have significantly affected audit fees, it does limit these companies' auditor choices.⁷³⁴ Most of the large public companies are not likely to use a midsize or small audit firm. In explaining their position, they usually cite the Big Four's ability to handle big and complex client operations, their technical capability with accounting principles and auditing standards and industry specialisation and expertise.⁷³⁵ The need to comply with auditor independence standards, and other factors, can further limit the auditor choices available to large public companies. As required by the Sarbanes-Oxley Act public companies are prohibited from obtaining audits from firms that simultaneously provide them with certain non-audit services, such as bookkeeping, valuation services, or internal audit outsourcing services.⁷³⁶ If a large public company uses one of the Big Four audit firms for non-audit services, this can potentially further reduce the number of its

⁷³² Competition Commission, 'Statutory Audit Services for Large Companies Market Investigation. A Report on the Provision of Statutory Audit Services to Large Companies in the UK', 15 October 2013, p.52.

⁷³³ Competition Commission (n 732) p.2.

⁷³⁴ GAO (n 719) p. 21; OXERA, Competition and Choice in the UK Audit Market. Prepared for the Department of Trade and Industry and Financial Reporting Council, April 2006, p. 3.

⁷³⁵ GAO (n 719) p. 21.

⁷³⁶ Sarbanes-Oxley Act 2002, Section 201 and 2(a)(8).

auditor choices.⁷³⁷ Also, companies are sometimes not willing to use their competitor's auditor, which restricts their auditor choice as well. Finally, in certain sectors such as banking and insurance, concentration is even higher, and choice even more limited. In the UK, only three out of the Big Four firms have any significant presence in these FTSE 350 sectors.⁷³⁸ The dominance of one or two Big Four auditors in a significant number of sectors may be troublesome for companies requiring an industry-specialist auditor. It is suggested that these companies' choice would be significantly restricted, especially if they did not want to engage the auditor of a competitor.⁷³⁹

Even though larger companies have more technical and complex requirements for auditing, it does not necessarily mean that mid-tier firms would not be able to satisfy these demands. According to the OXERA survey, numerous public companies considered that a mid-tier firm would be technically capable of providing their company's audits. Also mid-tier firms responded that they should be considered as capable of auditing many FTSE 250 and FTSE 100 companies.⁷⁴⁰ Accordingly, the high and stable market share of the Big Four is not derived mainly from their ability to provide the technical audit product, but from the existence of barriers to entry to the large company audit market.

Many mid-tier and smaller firms have introduced certain changes in order to expand their share in the audit market. Some of them extended their practices into niches that enabled them to use their expertise rather than branch out into new industries. This, in turn, enabled them to build their reputations in specialised areas and to grow incrementally. Others expanded, through a series of mergers and acquisitions, building on new industry

⁷³⁷ Although the Sarbanes-Oxley Act is US law, the Act has had a significant impact on auditing practices worldwide. This is due mainly to two reasons: many multinational companies have a US listing and hence they have to comply with the Act, and companies in many other jurisdictions have adopted similar rules and practices, in OXERA (n 734) p.ii.

⁷³⁸ EY accounting firm does not audit banks in the UK.

⁷³⁹ Abidin (n 715) p. 200.

⁷⁴⁰ OXERA (n 734) p. 65.

expertise and extending their geographic reach. While these practices have helped smaller firms to extend and improve their operations, some of the barriers are likely to remain, especially in the market for large companies' audits, as small and mid-tier firms are still much smaller and have less expertise than their larger competitors.

Several proposals have been offered to reduce the risk of further concentration, and address the expansion challenges faced by mid-tier and smaller accounting firms. The proposals included, among others, mandatory audit firm rotation, audit firm financial statement disclosure, and dividing up the largest accounting firms.

As far as mandatory audit firm rotation is concerned, some sources have suggested that by periodically bringing in a new auditor, it would enhance auditors' independence, and reduce concentration, as it would provide more opportunities for mid-tier and small accounting firms to compete to provide audit to public companies.⁷⁴¹ This option was criticised on the basis that it would not increase the number of viable competitors and large companies would likely just rotate to another one of the largest audit firms. It was also considered to be a costly option, due to the higher marketing and support costs for assisting a new accountancy firm in understanding a company's operations, auditing practices, and systems.⁷⁴²

Another option that has been suggested would require auditors to provide financial information, such as their revenues and profits that, could be used to assess the competitiveness of audit fee levels. The idea behind this is to increase transparency and help regulators ascertain whether firms are charging prices above the competitive level.

⁷⁴¹ GAO (n 719) p.52.

⁷⁴² Some commentators argue that it is necessary to allow new audit firms additional time to become fully familiar with the client's operations, in order to prevent the risk of an auditor not being able to detect financial issues, which could materially affect the company's financial situation, in GAO (n 719) p.52.

It is unclear, however, whether this approach would bring desired effects. In some jurisdictions, e.g. the UK, audit firms are required to file information on fees charged for audits, and other services, in a consolidated form. This is of limited usefulness in assessing the economics of the firm's audit services. Furthermore, regulators already have the authority to request appropriate financial information from accounting firms, if necessary. Therefore, this proposal is unlikely to have any direct effect on market competition.⁷⁴³

Finally, another suggestion to decrease concentration is based on the idea of dividing up the largest firms into smaller ones. If one or more of the Big Four accounting firms could spin off a large portion of their operations and create additional firms, this could at least temporarily decrease concentration and mitigate the potential negative consequences of one of the big firms' failure. Numerous market participants, however, expressed concerns about this option. Some of them pointed out that division of firms could be very costly and could diminish the economies of scale, and depth of expertise of the large accounting firms. This, in turn, could lead to higher costs and lower quality of audits performed.⁷⁴⁴

It is surprising that despite the fact that the audit market is highly concentrated, and there are significant barriers to entry for small and mid-size companies, the US authorities found no compelling need to take any action. According to the GAO report, there is limited evidence that the current concentration of the audit market has created any adverse

⁷⁴³ GAO (n 719) p. 54.

⁷⁴⁴ Other proposals have been offered to prevent further concentration and allow small and mid-tier firms to expand their market share. These proposals include: introducing liability caps as a means of reducing the risk of litigation that could lead to another loss of the large audit firm; targeting enforcement actions against the individuals rather than entire organizations reducing at the same time the risk of failure of another audit firm; creating a group of accounting and auditing experts to provide expertise to smaller firms; constituting an accreditation program to help these firms overcome some of the name recognition and reputation challenges they face; allowing outside ownership of these firms in order to provide capital for expansion of their operations, in GAO (n 719) pp.51-63.

impact. Also, the proposals addressing concentration risk and challenges facing smaller firms were considered of limited effectiveness, feasibility, and benefit.⁷⁴⁵

In the UK, the 2013 report by the Competition Commission has confirmed that competition in the audit market is restricted due to factors that inhibit companies from switching auditors, and by the incentives that auditors have to focus on satisfying management rather than shareholder needs.⁷⁴⁶ Unfortunately, the suggested solutions that the Competition Commission set out in response to these findings do not go far enough to fix the audit market. The main measure, proposed by the Competition Commission, is the requirement that FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years.⁷⁴⁷ This is in line with the recent EU legislation regarding the reform of the audit market, which requires all EU public interest entities to rotate their statutory auditors after a maximum period of tenure. The maximum period was set at twenty years in the UK, with a mandatory tender at the ten year midpoint.⁷⁴⁸ This differs from the guidance introduced in 2012 by the Financial Reporting Council, which encouraged companies to go to tender on a ‘comply or explain’ basis. It is also different from the earlier draft recommendation of the Commission that would have forced companies to re-tender their audits every five years. Furthermore, the Commission recommended that the FRC’s Audit Quality Review should review every FTSE 350 audit engagement every five years. The Competition Commission also prohibited the use of the ‘Big Four only’ clause agreements, though it allowed parties to require that any auditor should satisfy objective criteria. It also suggested that an advisory vote should be

⁷⁴⁵ GAO (n 719) p.6.

⁷⁴⁶ Competition Commission (n 235) p.3.

⁷⁴⁷ There has been no such requirement before and many FTSE 350 companies had the same auditor for many decades e.g. PwC had been Barclay’s auditor for 120 years, Deloitte has audited Vodafone for 26 years, in Competition Commission (n 732).

⁷⁴⁸ Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audit of annual accounts and consolidated accounts.

introduced on the audit committee report, which should further encourage shareholder involvement.

Admittedly, whilst there are costs of going out to tender more frequently, they do not outweigh the benefits of the more competitive market in which shareholders can have increased trust. It is also difficult to see how the ten year tendering periods will ensure that companies make regular and well informed assessments of whether their auditor is competitive, or how it will open up more opportunities for other firms to compete. The proposal to empower shareholders to control audits also leaves much to be desired. At major banks, such as Barclays, shareholders provide less than 5 per cent of the capital and hence they are not the main owners or risk-bearers. The average duration of their shareholding is approximately three months. It is therefore impossible to talk about their long-term interest in supervising auditors and exerting pressures for improving audit quality.⁷⁴⁹ The actions taken by the Competition Commission are disappointing and constitute a missed opportunity to give the largest listed companies in the audit market the shake-up they badly need.⁷⁵⁰

In the UK and the US, the largest companies are required by law to have their financial statement audited by independent auditors. The demand for audit assurance services is therefore inelastic, but the supply of audit firms is restricted due to significant barriers to entry.⁷⁵¹ In market economies, competition, consumer pressure and threats of liability are the usual drivers for improvement of standards, but they are very weak in the audit market. The high concentration ratio in the audit of large companies can have severe implications

⁷⁴⁹ Prem Sikka, 'Break the Stranglehold of Shareholders', 11 December 2014, The Guardian, available at <https://www.theguardian.com/commentisfree/2014/dec/11/break-stranglehold-shareholders-company-funding-key-decisions> accessed 20 November 2016.

⁷⁵⁰ Jones (n 722).

⁷⁵¹ McMeeking (n 715) p.9.

if one of the Big Four firms withdraws from the market. The authorities in the UK and the US, however, decided that very little action was needed to deal with the concentration issue. This thesis recommends that the public regulatory body should be directly involved in the appointment of auditors, which would help alleviate the concentration problem. The proposal is discussed further in chapter six.

4.4. CONCLUSIONS

The previous chapter provided an analysis of a regulatory framework for auditing. It answered the following questions of why, how and by whom audit is regulated. This chapter built on the discussion and provided a further analysis of the regulatory status quo by focusing on some of the most egregious issues that the auditing profession is faced with, such as independence and accountability deficits, and excessive concentration of the audit market. It argued that despite numerous regulatory reforms in the sphere of audit, enacted particularly in response to the Enron scandal, the auditing model remains fundamentally flawed and unfit for purpose.

As far as auditors' independence is concerned, the evidence shows that auditors have very strong incentives to acquiesce to management demands and compromise their independence. Auditors have conflict of interest at the heart of their business – they are hired and paid by the companies they are supposed to assess objectively. This ties them to these companies and pushes them away from protecting investors, and the public. Auditors are also allowed to have business relationships with their clients, which can further diminish their independence.⁷⁵² In order to address investors' concerns, the Sarbanes-Oxley Act created the PCAOB to regulate and oversee audit firms. It also

⁷⁵² Debbie Freier, 'Compromised Work in the Public Accounting Profession: The Issue of Independence', Goodwork Project Report Series, Number 35, available at http://thegoodproject.org/pdf/35-Compromised-Work-7_04.pdf accessed 18 February 2016.

introduced a restriction on the scope of non-audit services an auditor can provide to his client, the mandatory rotation of audit partners, and a one year cooling-off period between acting as an auditor and being hired as an audit client. In the UK the provision of non-audit services still remains the auditor's self-assessment.⁷⁵³ This thesis argues that regulatory responses to independence issues are insufficient. They do not go far enough to secure the dual conception of independence - the independence in fact, and independence in appearance.

This thesis argued that auditors' lack of accountability in the current model should be examined from the legal, professional, and social perspective. Lack of legal accountability is the result of numerous regulatory arrangements that make the oversight of the audit profession and their work ineffective. The first line of defence against bad audits – litigation, which could theoretically act as a deterrent to acquiescent auditing, is of little use as clients and non-clients are hardly ever successful in suing auditors for negligent audits. From the mid-1980s, a trend emerged towards a more narrow scope of duty to non-clients. This signalled a change in state public policy decisions which transferred risk away from accountants and onto financial statement users. The evidence shows that law enhances an already comfortable situation for auditors and by not taking into account the interests of stakeholders, it endangers the public interest.

The proportionate liability and Liability Limitation Agreements effectively minimised the potential litigation risk and reputation losses, creating at the same time another layer of protection for auditors. This, in turn, unveiled the imbalance between the parties' interests, with the strong and secure position of the auditor and a potentially insufficiently compensated client. This conclusion is particularly striking, since auditors perform their

⁷⁵³ See n 549.

duties in the public interest, and on behalf of the State and there is no reason why they should be the beneficiaries of such immunities.

The accounting firms' rush in the 1990s to reorganise themselves into the LLP forms diminished their accountability even further. This prompts the following questions – would the Andersen collapse have happened if Andersen were a traditional partnership? Would Andersen partners have elected to carry higher levels of insurance if they were exposed to vicarious liability? Would Andersen partners, facing vicarious liability, have questioned Enron accounting techniques instead of taking \$52 million in revenue from Enron? The evidence suggests that limited liability creates a moral hazard as it increases the chances that there will be insufficient assets to pay creditors' claims, this allows partners 'to reap the benefits of risky activities but do not bear all of the costs'.⁷⁵⁴ As audit partners in LLPs are shielded from personal liability, it is less risky for them to engage in the questionable accounting practices of the management. The introduction of the LLP form also caused disincentive among audit partners to monitor their peers. All of that should spur firms to evaluate carefully the advisability of operating as LLPs.

As legal incentives are eroding, and market incentives are inadequate to motivate gatekeepers, other options, such as a stronger system of self-regulation and disciplinary enforcement should work as a supplementary form of deterrence. The evidence shows, however, that sanctions administered as a result of disciplinary proceedings to audit firms and specific individuals are lenient. Also reputational penalties fail to motivate and

⁷⁵⁴ Frank Easterbrook and Daniel Fishel, 'Limited Liability and the Corporation' (1985) 52 Chicago Law Review 89, p.104.

discipline auditors.⁷⁵⁵ With these problems inherent in the audit model, earnings management continue to be a pervasive phenomenon.⁷⁵⁶

Despite playing an important role in securing integrity and public confidence in the market, the accounting profession remains largely unaccountable to society. Over the years auditors successfully resisted making the responsibility to detect fraud one of its main goals. Even though fraud has increased considerably over recent decades and is likely to continue, the auditing profession claims that the responsibility of fraud detection rests with management, stressing the need for implementation of internal control systems.

This chapter also argued that excessive concentration of the audit market is another problem intrinsic in the current model. Even though the evidence shows that the competition in the auditing markets in the UK and US is not impaired, the findings of the chapter point out that excessive concentration limits the choice of auditors for public companies. The thesis puts forward several proposals that could reduce the risk of further concentration, such as mandatory audit firm rotation, enhanced disclosure of auditors' financial statements, and dividing up the largest accounting firms. None of them, however, is guaranteed to address the expansion challenges faced by mid-tier and smaller accounting firms. The thesis will argue in chapter six that establishing a state-backed autonomous agency responsible for the appointment of auditors could help alleviate the problem of excessive concentration and spark competition among the big and mid-tier audit firms.

In conclusion, this chapter argued that the post-Enron and the financial crisis of 2008, reforms of the regulatory frameworks of auditing failed to deal effectively with the

⁷⁵⁵ Coffee (n 555) p. 59.

⁷⁵⁶ Coffee (n 555) p. 60.

problems inherent in the current audit arrangement. It seems that a more significant overhaul of the auditing system is necessary in order to rectify the flaws present in the current model. The next chapter will look at alternative theoretical, practical, and international audit models. It will contribute to the debate on possible solutions to the contentious issues discussed above, such as lack of auditors' independence, accountability deficits, and excessive concentration of the audit market. This in turn will enrich the analysis contained in chapter six, which suggests a structural reform of the audit system.

CHAPTER 5. AUDIT MODELS

So far this thesis has analysed the regulatory and structural changes that affected the auditing profession from the 1950s onwards. This was followed by an analysis of the theoretical underpinnings of audit in chapter two, where it was argued that the auditing practice developed without a comprehensive theoretical grounding. This contributed to the fact that the regulation of audit is reactionary and usually takes place in the aftermath of a crisis. The thesis then examined the regulatory framework of auditing in chapters three and four. There it was argued that there are many flaws associated with the current auditing model. The thesis remained focused on the three most egregious problems, such as lack of auditors' independence, accountability deficits, and excessive concentration of the audit market. The evidence revealed that despite numerous regulatory changes enacted in the aftermath of the Enron scandal and the financial crisis 2008, which attempted to fix these problems, the auditing model remains flawed and unfit for purpose. The aim of this chapter is to review models for the regulation of audit that have already been proposed in auditing literature, and to consider the appropriateness of these models to improve the regulation of financial audit in the UK and the US. This chapter is important for the thesis as it initiates a discussion on the potential solutions to flaws intrinsic in the current audit model. It also provides a grounding for chapter six, which presents a proposal for a new audit model.

This chapter starts with the analysis of the models that favour pro-regulatory approaches, which are in turn divided into micro and macro options.⁷⁵⁷ Micro models presuppose that a greater level of monitoring and control of the audit process can be ensured at the level of the individual company, hence they assume active involvement of the existing

⁷⁵⁷ The terms 'micro' and 'macro' models were used by Hatherly; in David Hatherly, 'The Case for the Shareholder Panel in the UK' (1995) 4(3) *The European Accounting Review* 535, p. 540.

company's organs. They attempt to create new legal and institutional relationships that would decrease management power and restore it to the shareholders using organs within the company. Macro models, on the other hand, assume that the accountability of management cannot be effectively restored to the shareholders, and therefore the state must be charged with this task.⁷⁵⁸ These models place audit control in the hands of the state through the establishment of the state agency or through broadly based private-sector models with statutory backing.⁷⁵⁹ This chapter then turns to analyse the Financial Statement Insurance (FSI) model, which leaves the operation of audit in the hands of the market.⁷⁶⁰ This is followed by a discussion of practical, country-specific models of Germany, Italy, Japan, and France. The final section discusses the implications of the proposed models for current audit arrangements in the UK and the US.

5.1. MICRO OPTIONS

The aim of micro models is to ensure better monitoring and control of the audit process within individual companies. Therefore, the central role is played by one of the existing organs within a company. The purpose of this arrangement is to decrease excessive managerial power. In micro models, each panel is entrusted with the responsibility to appoint auditors to a company. The following part of the thesis describes the examples of micro models, such as the audit committee, the shareholder panel, and the stakeholder panel models. An audit committee model is centred on the role and responsibilities of the audit committee, which decides on the appointment and remuneration of auditors. The shareholder panel has been suggested as a more direct way to enhance the accountability of auditors to shareholders. The panel would be controlled by shareholders, and apart

⁷⁵⁸ Ian P. Dewing and Peter O. Russell, 'Models for the Regulation of UK Company Audit' (1997) 12(6) *Managerial Auditing Journal* 271, p. 277.

⁷⁵⁹ Dewing (n 758) p. 277.

⁷⁶⁰ Joshua Ronen, 'A Proposed Corporate Governance Reform: Financial Statements Insurance' (2006) 23(1) *Journal of Engineering and Technology Management* 130.

from deciding on appointment and remuneration of auditors, it could also determine issues such as the scope of audit and the provision of consulting services. A stakeholder panel is an expansion of a shareholder model, whereby auditors owe a duty of care not only to shareholders, but also to stakeholders with a direct economic interest, such as creditors and employees and even potential investors and their advisors. This thesis will now to discuss an audit committee panel.⁷⁶¹

5.1.1. AUDIT COMMITTEE PANEL

Despite their long history, audit committees only recently became an important constituency in the governance of companies. Birkett suggests that the SEC recommended the establishment of audit committees in 1940, but they only became mandatory in 1977 as a result of the New York Stock Exchange's decision that all listed companies were required to institute audit committees.⁷⁶² In the UK, institutions such as Pro Ned were advancing a more important role for non-executive directors in the 1980s. According to Spira, Pro Ned's role was to 'to sell the virtues of having more and better non-executive directors ... [and its] second task was to provide an additional source of names'.⁷⁶³ It was the 1992 Cadbury Report that encouraged companies to establish audit committees.

The audit committee is one of the committees of the board and is composed of non-executive directors. It is charged, among other things, with making recommendations to the board on the appointment and remuneration of auditors. As a committee of the board, it is accountable to the board. It is also responsible for ensuring that the board properly

⁷⁶¹ Dewing (n 758) p. 272.

⁷⁶² W. P. Birkett and Elaine Evans, 'Theorising Professionalisation: A Model for Organising and Understanding Histories of the Professionalising Activities of Occupational Associations of Accountants' (2005) 10(1) Accounting History 99, pp.112-115.

⁷⁶³ Laura F. Spira and Judy Slinn, *The Cadbury Committee. A History* (1st edn, OUP, Oxford 2013) p. 28.

discharges its reporting responsibilities.⁷⁶⁴ It has been suggested in the literature that audit committee's constitutional position and composition makes it 'an appropriate body to influence the appointment and remuneration of auditors, if the role of the auditor is to report to directors.'⁷⁶⁵ This is, however, not the current statutory role of the external auditor. Since the auditor is statutorily accountable to the shareholders, the audit committee as a solution to secure auditors' independence and their accountability to the members is 'both conceptually unsound and practically difficult'.⁷⁶⁶

There are several reasons why audit committees are not a good solution to corporate governance problems and why they might be ineffective. First of all, the existence of the audit committee as a sub-committee of the board does not solve the underlying conflict of interest caused by the fact that auditors are hired and paid by the companies for whom they are supposed to provide an independent and objective financial assessment of their financial statements. The only effective way of solving this problem is to place the appointment and remuneration of auditors in the hands of an external body, unrelated to the company.

Secondly, according to Hatherly the concept of an audit committee evolved around the idea that non-executives participate in corporate governance by scrutinizing the actions of executives. As governance is considered to be a 'hierarchical' concept, executive directors should be in a more formal accountability relationship with non-executives.⁷⁶⁷ Sheridan and Kendall suggest that this works effectively in countries with dual board, where the management board is accountable to the supervisory board.⁷⁶⁸ In the UK and

⁷⁶⁴ Hatherly (n 757) p.540.

⁷⁶⁵ Hatherly (n 757) p.541.

⁷⁶⁶ Hatherly (n 757) p.541.

⁷⁶⁷ Hatherly (n 757) p.541.

⁷⁶⁸ Thomas Sheridan and Nigel Kendall, *Corporate Governance: An Action Plan for Profitability and Business Success* (Pitman Publishing, London 1992), pp. 59-65.

the US, however, executives and non-executives are not in a hierarchical relationship due to the unitary board arrangements.

A further consequence of this is the fact that in the UK and the US non-executives are involved in strategic decision-making of the company. Consequently, as far as strategic decisions are implicated in financial statements, non-executives cannot be impartial towards accounting outcomes. It is possible that an audit committee will not aid the independence of auditors from shareholders, even if non-executives act in an effective and diligent way.

Furthermore, numerous non-executive directors fulfil executive functions in other major companies. This can equip them with the 'executive mind set', and as non-executives they should remain independent. Consequently, auditors may become careful not to upset a non-executive director holding an executive role elsewhere, as this can diminish an auditor's chances of gaining audit engagements in these companies. This, in turn, can deter the auditor from going against the wishes of the audit committee, and therefore impact upon his independence.⁷⁶⁹ These practical problems prove that audit committees are not the best means of auditors' independence and accountability to shareholders.

It has been argued that non-executive directors contributed to the financial crisis 2008 by failing to challenge the management of numerous top banks.⁷⁷⁰ They failed to raise questions on perverse compensation incentive systems of executives commonly associated with the failure of the banks. The reward system in place induced senior executives to pursue highly lucrative but equally highly risky financial strategies, which

⁷⁶⁹ Hatherly (n 757) p.541.

⁷⁷⁰ Brooke Masters, UK Minister Claims Non-execs Contributed to the Financial Crisis, Financial Times, 14 November 2008, available at http://www.ft.com/cms/s/0/09b4cc38-b1ed-11dd-b97a-0000779fd18c.html?ft_site=falcon&desktop=true#axzz4CXB9FOxD accessed 25 June 2016.

contributed to systemic risks. According to the UK Treasury Committee, the excessive use of huge debts frequently disguised as ‘off-balance sheet financing’ was hardly ever challenged by external directors.⁷⁷¹ Many non-executives also had limited time dedicated to their roles and many lacked sufficient knowledge, skills and expertise to challenge the use of complex and opaque financial products, which were used by many of the failed banks.⁷⁷² For these reasons an audit committee composed of non-executive directors may not be best suited to improve the functioning of audits. The following section looks at the shareholder model.

5.1.2. SHAREHOLDER PANEL

The shareholder panel has been suggested as a more direct way in which to increase auditors’ accountability to shareholders.⁷⁷³ The panel is an alternative to the audit committee and would be fully controlled by shareholders, not directors. The panel’s main task would be the appointment and remuneration of auditors. It might also consider matters such as the scope of audit, and provision of consulting services. In order to maintain independence, panellists could not be directors of the company nor have any connections with the auditors. At least one panellist should have audit experience. The panel would not adjudicate in board-auditor disputes. It would be the panel’s responsibility to ensure that the auditor was in a position to provide an independent audit opinion to shareholders. The opinion itself would be the auditors’ opinion, not the panellists’, thus its role would be only facilitative.⁷⁷⁴

⁷⁷¹ UK Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City*. 9th Report of Session 2008-2009, 12 May.

⁷⁷² Peter Yeoh, ‘Causes of the Global Financial Crisis: Learning from the Competing Insights’ (2010) 7(1) *International Journal of Disclosure and Governance* 42, p. 58.

⁷⁷³ Dewing (n 758) p. 274.

⁷⁷⁴ Dewing (n 758) p. 275.

The advantage of the shareholder panel is that it involves shareholders in the auditing framework, increasing representative democracy.⁷⁷⁵ It would represent shareholders in a similar way as the board of directors, but only for the specific purpose of appointing and deciding on auditors' remuneration. This arrangement, however, has several flaws. To begin with, it would be difficult to decide how to choose the panellist in order to provide equal representation of various shareholders. Considering the dispersed ownership in the UK and the US, this could become very problematic in practice. Furthermore, questions should be raised as to the right set of skills that shareholders would bring. As the previous section argued, it would be desirable for the panellists to have sufficient financial expertise and industry-specific experience, especially if they are to decide not only on the appointment and remuneration of auditors, but also on the scope of audit. It might be difficult to find a number of shareholders who could fulfil these requirements.

This model also fails to deal with a conflict of interest similar to the one that exists in the current auditing arrangements. A shareholder panel would not alleviate the 'mother of all conflicts', which arises when an audited company chooses its own auditor and pays audit fees. This could only be achieved by having an independent and external body responsible for the appointment and remuneration of auditors, which thesis suggests in chapter six. Moreover, a shareholder panel would operate through shareholders, and for the benefit of shareholders. It does not envisage any involvement of stakeholders, which also contradicts the main argument of this thesis that audits should be conducted for the benefit of multiple stakeholders. The following section examines the idea of a stakeholder panel.

⁷⁷⁵ Hatherly (n 757) p.543.

5.1.3. STAKEHOLDER PANEL

The stakeholder panel model is an extension of the concept of a shareholder panel, providing an opportunity for a wider stakeholder involvement. Under this regime, the auditors have a duty not only to shareholders, but also to multiple stakeholders. Here, the concept of stakeholders covers those with a direct economic interest in the company such as creditors or employees, and the tertiary stakeholders such as potential investors and their advisors: brokers, underwriters, lawyers, members of the public.⁷⁷⁶ The importance of including company stakeholders in corporate activities has been extensively discussed. Some authors give the examples of Germany and Japan, where close relationships between a company and its stakeholders has been the key to corporate success.⁷⁷⁷

If corporate governance was to shift towards the stakeholder oriented model, it could have significant implications for the audit framework. It would no longer be sufficient to check for compliance with the codes of conduct. Audit could potentially involve the assessment of the quality of relationships between particular stakeholders and the suitability of these relationships to the company's objectives.

One of the problems associated with this model lies in the identification of the stakeholders, as multiple business participants have different importance in different business cultures. Following the Japanese example, the most important stakeholders can be found among the customers and suppliers who provide the most valuable services to the company. In Germany, on the other hand, the core stakeholders are employees. The issue of identifying stakeholders raises many questions. For instance, should overseas plants, suppliers and outsourced workers who are non-strategic and non-core be treated

⁷⁷⁶ Dewing (n 758) p. 275.

⁷⁷⁷ Sheridan (n 768) pp.72-90.

as stakeholders as well? It would be controversial to establish a definite range of stakeholders who could participate on the panel without creating an underprivileged class.⁷⁷⁸

A stakeholder panel model can also be characterised by the same problems as a potential lack of skills and expertise among the members of the panel. It also does not solve the conflict of interest arising from the fact that a company chooses and pays an auditor whose duty is to provide an independent opinion on a company's financial health. This conflict of interest would not be solved without placing the duty of appointing and remunerating auditors in the hands of an external agency. This is suggested in some of the macro models, which are discussed in the following section. In macro models, an external institution – or regulatory agency, is created in order to provide greater monitoring and control of the audit function.

5.2. MACRO MODELS

One of the key assumptions behind the macro models is that the regulation of auditing and auditors should be taken away from the accounting profession and placed in the hands of the state, either through the establishment of a state-backed agency or through broadly-based private-sector regulation with statutory backing. The main examples of the macro models are the Audit Commission model, Stock Exchange Panel, and Listed Companies Audit Board.

5.2.1. AUDIT COMMISSION

Audit Commission, as one of the examples of macro models of audit regulation, is based on the former government-appointed Audit Commission for England and Wales, which

⁷⁷⁸ Hatherly (n 757) p.545.

had an overall responsibility for the audit of local authorities. It has been discussed in the literature that a similar body could be established in order to control the appointment and remuneration of auditors of listed companies.⁷⁷⁹ The most significant characteristic of this model is that it stresses the need to place corporate audits under public control, as audits should be conducted either in the public interest or in the interests of companies' wide group of stakeholders.

The structure of the Audit Commission for England and Wales was that of a government body, funded by a national government.⁷⁸⁰ Ideally, if this structure was to be adopted for a new audit model, the Commission would have to be independent from government and not funded by it. The principal functions of the Audit Commission, as stated in the 1982 Act, consist of:

- the appointment of auditors, who may be employed by the Commission or in private practice,
- the preparation and review of a Code of Audit Practice,
- the undertaking of studies designed to improve the economy, efficiency and effectiveness of local authority services,
- reporting on the impact on the economy, efficiency, and effectiveness of the statutory provisions and ministerial directions and guidance.⁷⁸¹

Additionally in the proposed model, the Commission could also be in charge of setting auditing standards and the regulation of audit, which could potentially include quality

⁷⁷⁹ Richard Murphy, 'Time to Rebuild the Audit Foundations?' (1991) 107(1173) *Accountancy* 23; Brian Singleton-Green, 'Audit Independence-Dodging Mr Davies' (1990) 106 (1168) *Accountancy* 22.

⁷⁸⁰ Dewing (n 758) p. 273.

⁷⁸¹ Mike Radford, 'Auditing for Change: Local Government and the Audit Commission' (1991) 54(6) *Modern Law Review* 912, p. 914.

monitoring and disciplinary actions.⁷⁸² Importantly, auditors working for the Audit Commission for England and Wales were independent of the Commission, which had no authority to intervene into how audits were performed. Nevertheless the Commission had certain influence over the audit process, through, for example, monitoring of compliance with the Code of Audit Practice or reappointment of auditors.

Hatherly argues that it is uncontroversial that the public sector audit model is suitable for the audit of public sector institutions under public ownership operating in the public interest. The element of public interest in the activities of listed companies, however, is different. Applying the public sector audit model to listed companies could imply that an auditor should nevertheless report on the company's activities in the public interest. According to Hatherly:

Such a public interest is incongruous and most probably ineffective if there is no necessity for directors to be accountable other than to shareholders, and hence there is no mechanism for the public interest to influence the directors, other than perhaps through the auditors themselves. If an auditor were successful in pressing directors on behalf of the public interest the auditor might be implicated in corporate decision taking and audit independence compromised.⁷⁸³

This thesis suggests that audits should be performed with a view of having public interest in mind. Audits play a vital role in serving public interest by reinforcing trust and confidence in financial reporting. Audited financial information is widely available and it generates public interest. Even though auditors carrying out audits are accountable only to the company, there are other stakeholders who believe that an independent audit provides some means of ensuring that the company's responsibilities to them are being

⁷⁸² Dewing (n 758) p. 273.

⁷⁸³ Hatherly (n 757) pp.546-547.

met and that in effect it serves their interests as well.⁷⁸⁴ These stakeholders such as employees and creditors expect that auditors should be independent of shareholders. The varying expectations of multiple stakeholders impact on varying demands for improvements in audit quality. This thesis argues in chapter six that the needs of these stakeholders should be met, and that audits should be extended to include core financial information important for key stakeholders, such as employees and creditors. This is because audit is seen as public goods and stakeholders should be able to make use of it. The following section examines a stock exchange panel as another example of a macro-model.

5.2.2. A STOCK EXCHANGE PANEL

A Stock Exchange Panel might be an alternative to the individual shareholder panels for each listed company. This model suggests creating a single panel by the Stock Exchange to initiate the appointment and remuneration of auditors for listed companies.⁷⁸⁵ According to Hatherly, all listed companies could be regulated by a single panel of the Exchange, through incorporation of audit regulation requirements into the listing requirements. The panel would consist of those institutional investors, who do not have any strong commitments in any particular company. The whole purpose of the panel would be to facilitate independent company reporting by auditors on behalf of the market as a whole.⁷⁸⁶

The Stock Exchange panel model, however, is not free from controversies. First of all, it creates an imbalance in the auditing market place, as a single panel would become a monopoly purchaser for listed companies' audits.⁷⁸⁷ Furthermore, it assumes that auditors

⁷⁸⁴ ICAEW (n 36) p. 11.

⁷⁸⁵ Dewing (n 758) p. 274.

⁷⁸⁶ Hatherly (n 757) pp.543-544.

⁷⁸⁷ Hatherly (n 757) pp.543-544.

should be accountable to the market as a whole. At present auditors are accountable only to the company they audit. Making auditors accountable to the market would require a significant change in their duties and the scope of audit.

5.2.3. LISTED COMPANIES' AUDIT BOARD

The idea of the Listed Companies Audit Board (LCAB) was suggested by Dewing and Russell, who argue that there is a strong case for the establishment of an independent regulatory body for the audits of listed companies.⁷⁸⁸ They argue that an independent body should be established in order to match the main components of the audit expectations gap, namely independence, monitoring, and discipline. The LCAB should, therefore, be structured into three panels of responsibility: an Auditor Independence Panel, an Audit Quality Panel, and a Disciplinary Panel. The exact constitution of the Board, and whether it should be a public or a private body is open to debate.

The main task of the Independence Panel would be to establish and monitor independence standards and guidelines, for instance, by restricting the provision of non-audit services in whole or in part. The role of the Audit Quality Panel would be to set up a register of auditors recognised by the Panel as capable of conducting audits of listed companies. It would also be in charge of monitoring the quality of audit work by investigating all cases of listed company failures, and firms involved in litigation connected with the audit of listed companies. A Disciplinary Panel would be charged with investigating all the cases referred to it by the other two panels.⁷⁸⁹

⁷⁸⁸ Ian Dewing and Peter Russell, *Stakeholder Perceptions on an Independent Regulatory Body for Listed Company Audit in the UK* (ICAEW, Centre for Business Performance, London 2001), pp. 95-99.

⁷⁸⁹ Ian Dewing and Peter Russell, 'The New Accountancy Foundation: A Credible Form of Regulation for UK Listed Company Audit?' (2002) 6(3) *International Journal of Auditing* 231, p. 239.

The LCAB model is an interesting proposal, as it aims at eliminating the expectations gap, which is one of the biggest problems inherent in the current audit arrangements. It does not, however, provide any solutions to the conflict of interest arising from the fact that auditors are paid by the companies they are supposed to assess objectively. It seems that unless that changes, there will be no substitute for investors doing their own due diligence.

Having discussed multiple micro and macro models, the following section examines a Financial Statements Insurance model, which is an example of a market driven reform of the auditing model.

5.3. FINANCIAL STATEMENT INSURANCE MODEL

Financial Statement Insurance (FSI), (as opposed to micro and macro models), is a proposition of a market based mechanism that does not involve introduction of any regulation. It is a theoretical model, proposed by Joshua Ronen, as a response to the Enron scandal. Ronen believes that in the present social arrangement, auditors have to operate under a major conflict of interest – they are hired and paid by the companies they audit. As it is usually CEOs and CFOs who ultimately decide on their hiring, (with shareholders rubber-stamping their decision), auditors become dependent on management for their compensation instead of being agents of the shareholders. The fear of losing future audit fees, even without the consulting services, secures the auditors' compliance with the management's wishes. According to Ronen's proposition, regulation, enforcement, or litigation are incapable of dealing with this inherent conflict of interest. In his model, he

suggests severing the agency relations between auditors and managers by creating principal-insurance carriers, whose interests would be aligned with those of investors.⁷⁹⁰

The financial statements insurance proposal would work in the following way. To begin with, companies would approach insurance carriers in order to receive offers of insurance coverage against losses caused by omissions and misrepresentations in financial statements. The insurance carriers would then turn to an underwriting reviewer who would assess the risk of omissions and misrepresentations through the examinations of a company's internal controls, management incentive scheme, riskiness of business, its competition, and other relevant factors. Based on the underwriters' reports, insurance carriers would decide on issuing coverage offers and their conditions. Once the managers decide to accept the coverage offer, the coverage and premiums would be made public.⁷⁹¹ Companies would choose an external auditor from a list of approved auditors provided by the insurance carrier. The chosen auditor would then be hired and paid by the insurance carrier. Audit fees would then be reimbursed by the insured, and publicised. Audit firms would be subject to being rated by an independent organisation financed from the fees collected from the audit profession.⁷⁹²

The auditor would owe his duty and loyalty to the FSI carrier for at least two reasons. First, the FSI carrier would be a paymaster of the auditor. Second, auditors would be providing their audit services to more than just one company, hence a single audit failure

⁷⁹⁰ Joshua Ronen, 'Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited' (2002) 8(1) *Stanford Journal of Law, Business & Finance* 39, p. 48.

⁷⁹¹ Ronen (n 18) p. 205.

⁷⁹² Ronen (n 18) p. 205.

could potentially jeopardise their relationship with the insurance carrier and could lead to a loss of other audit engagements.⁷⁹³

The FSI coverage would come into effect only if the auditor issued an unqualified opinion on a financial statement. Otherwise, there would be no coverage, or the policy terms would have to be renegotiated and made public. Investors' claims for the recovery of losses caused by omissions and misrepresentations from the companies with effective coverage would be settled through a judicial process involving a sui generis institution established for this purpose, or some previously confirmed arbitrators.⁷⁹⁴

It is important to note why the insurance coverage has to be publicised. Companies announcing higher limits of coverage and smaller premiums would appear to have higher quality of financial statements and hence would be more valuable to investors. On the other hand, those with smaller and no coverage, or higher premiums would be treated by investors as the ones with lower quality financial statements. Consequently, every company would aim at getting higher coverage and paying smaller premiums in order to be perceived as a valuable company with good quality financial statements. A kind of reverse Gresham's Law would come into operation, resulting in a drive to higher quality.⁷⁹⁵

As far as consulting services are concerned, the FSI model does not prohibit auditors from providing them. Ronen claims that providing audit and consulting services simultaneously increases the auditors' knowledge about the systems and operations of the

⁷⁹³ Joshua Ronen and Arnold Berman, 'Musings on Post-Enron Reforms' (2004) 19(3) *Journal of Accounting, Auditing and Finance* 331, p. 340.

⁷⁹⁴ Ronen (n 18) p. 205.

⁷⁹⁵ Ronen (n 793) p. 340.

company and hence enables the auditor to carry out better audits and reduce the FSI carrier's risk.⁷⁹⁶

FSI emerged as an interesting proposal to tackle problems with the current audit arrangement. It has a number of structural advantages. To begin with, the FSI model is a market mechanism that offers changes in the structure and incentives of the auditing profession in such a way that their interests are aligned with those of the managers and investors. Once an insurer underwrites a financial statement insurance policy, its objective is to minimize the cost of claims against this policy, meaning that the insurer's incentives are aligned with those of investors. The insurer will then pay the auditor, so that he can produce a high quality audit. The insurer will have to strike a balance between charging too high a premium in order to be competitive and too low a premium to avoid going bankrupt.⁷⁹⁷ Auditors hired by insurers would want to build their reputations for conducting high quality audits. Their independence, both real and perceived, would be enhanced by the fact that they will no longer be hired and paid by companies in return for providing audit.⁷⁹⁸

To follow, traditional audit reports comprise of three paragraphs that provide no comparative or statistical information about financial statement reliability. With FSI a particular company would be charged for a particular level of coverage. That creates a transparent financial statement reliability index that gives investors specific, public information about a company's financial reporting.⁷⁹⁹

⁷⁹⁶ Ronen (n 793) p. 340.

⁷⁹⁷ Ronen (n 18) p. 206.

⁷⁹⁸ Ronen (n 18) p. 206.

⁷⁹⁹ Lawrence Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels' (2006) Boston College Law School Research Paper 108, available at SSRN: <http://ssrn.com/abstract=928482>, p. 61, accessed 15 February 2016.

Furthermore, the FSI risk model is based on specific information, not abstract generalities. Instead of using pooled-risk and diversification models, FSI's risk model is based on thorough, specific investigation. The assessment of risk is not based on general actuarial tools, but is tailored to an individual audit engagement taking into account risk, premium, coverage, and other tailored policy terms. Hence, in the suggested Financial Statement Insurance model, certain financial statements can be uninsurable, 'but not the entire auditing industry'.⁸⁰⁰

Moreover, FSI may encourage greater competition in the audit market. Due to the fact that FSI is tailored to specific audit risk, it should facilitate smaller firms in entering existing insurance markets. The 'Big Four' could continue with the existing large audit assignments, while FSI insurers could hire smaller audit firms to audit smaller public companies. That should increase the number of alternative audit firms available for FSI insurers.⁸⁰¹

FSI, however, has a few important imperfections. In this model auditors and insurers have incentives to detect and correct discovered irregularities in a particular year's audit. They may be tempted to suppress discoveries made in later years covered by a previously issued insurance policy. Another danger is a risk of a race to the bottom by the insurers aiming at increasing premium volume by offering lenient audits. The model also allows for the simultaneous provision of consulting services, which are considered to damage an auditors' independence.

The following sections provide examples of the international audit models of Germany, Italy, Japan, and France. These countries can be characterised by different corporate

⁸⁰⁰ Cunnigham (n 799) p. 64

⁸⁰¹ Ronen (n 18) p. 207.

governance systems, shaped by various socio-economic, political and historical factors. They provide an interesting study of different practical, regulatory approaches to the regulation of the auditing function. The analysis of their pros and cons might be useful in considering the appropriateness of the elements of these models that could improve the regulation of external audits in the UK and the US.

5.4. INTERNATIONAL OPTIONS

Despite the globalisation forces, and a certain degree of harmonisation at the EU level, national audit markets still operate separately. One of the arguments explaining a lack of harmonisation is the difference in corporate governance systems of various countries. Auditing performs a different function in the market-based (outsider) system than in the banking-governance (insider) one. In outsider systems, such as the UK and the US, external auditing operates as a monitoring mechanism of management and reduces the agency cost by mitigating information asymmetry.⁸⁰² In insider systems, where the equity markets are less developed and the banks are the primary source of capital, auditing is considered less as a monitoring device and more as a source of information to the minority shareholders. This is because the controlling shareholders, whose wealth largely depends on firm performance and who usually have a long-term interest in a firm, are more eager to monitor management to ensure that it does not exploit the corporate resources.⁸⁰³ In these systems, however, minority investors have limited or no access to financial information and are likely to be subject to expropriation by the dominant controlling shareholders. The audit is one of the mechanisms that mitigate the costs of this kind of agency problem by providing minority shareholders with an objective, external opinion

⁸⁰² Jensen (n 24) p. 305.

⁸⁰³ Jensen (n 24) pp. 312-313.

on the financial situation of a company.⁸⁰⁴ The audit is also used to assess whether financial statements comply with national regulations.

Given that national corporate governance systems, regulatory culture, and history may affect the auditor's role, it is worth investigating the main contrasts in audit regulation of different jurisdictions. The following part of the chapter looks at country-specific, national audit models in Germany, Italy, Japan and France, which provide an interesting study of different regulatory approaches to the external audit function.

5.4.1. GERMANY

The auditing arrangements depend on the national corporate financing and governance systems.⁸⁰⁵ The German corporate governance system relies on internal monitoring mechanisms. Most of the corporate capital is provided by a small number of banks and institutional investors.⁸⁰⁶ Internal monitoring takes place through the power of banks and insurance companies, the formal separation between the management and supervisory board and the employees' involvement in governance structures. Banks have been controlling the majority of votes at the annual general meetings by cumulating shareholders and debt-holders positions in listed companies. All stock corporations must have a separate supervisory board.⁸⁰⁷ This dual structure preserves the monitoring

⁸⁰⁴ The existence of independent directors on the boards is another means of protecting the minority shareholders.

⁸⁰⁵ Geoffrey Whittington, 'Corporate Governance and the Regulation of Financial Reporting' (1993) 23(91A) *Accounting & Business Research* 311, p. 311.

⁸⁰⁶ Theodor Baums, 'Takeovers vs Institutions in Corporate Governance in Germany' Arbeitspapier 1/92, available via <https://www.jura.uni-frankfurt.de/43028984/paper1.pdf>, accessed 19 February 2016, pp.1-3.

⁸⁰⁷ Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Schleifer, 'Corporate Ownership around the World' (1999) 54(2) *Journal of Finance* 471, p.496

function of the supervisory board. Additionally, the Codetermination Act 1976 requires that employees' representatives to fill some of the supervisory seats.⁸⁰⁸

The supervisory board examines the annual financial statements, and this examination is usually based on the findings of the external auditor. As auditors are engaged by supervisory boards, they become primarily the agents of supervisory boards and only indirectly of shareholders and other stakeholders. This makes the German model different from the theoretical stakeholder model discussed earlier in this chapter, which presupposes that auditors should owe their duties to stakeholders. In the German model, the auditor merely enhances the monitoring function of the supervisory board and hence shareholders are less concerned with the auditors' independence. Shareholders rely more on the monitoring provided by the supervisory board.⁸⁰⁹ As far as provision of non-audit services is concerned, auditors have been allowed to provide consulting services simultaneously with auditing services without any major restrictions until recently.⁸¹⁰ Advisory services were not generally considered problematic with respect to auditor independence.⁸¹¹

The German auditing model can also be characterised by other features that are a direct result of its specific corporate governance system. Since a small number of large banks and pension funds traditionally provide most business capital, the ownership and voting

⁸⁰⁸ Klaus J. Hopt and Patrick C. Leyens, 'Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy' (2004) Law Working Paper No 18/2004 European Corporate Governance Institute, available at https://www.researchgate.net/profile/Patrick_Leyens/publication/228156601_Board_Models_in_Europe_Recent_Developments_of_Internal_Corporate_Governance_Structures_in_Germany_the_United_Kingdom_France_and_Italy/links/00b49521b03f152943000000.pdf accessed 19 February 2016.

⁸⁰⁹ Reiner Quick and Bent Warming-Rasmussen, 'Auditor Independence and the Provision of Non-Audit Services: Perceptions by German Investors' (2009) 13(2) International Journal of Auditing 141, p. 144.

⁸¹⁰ In 2004 certain restrictions on the provision of consulting services by the German auditors were added to the corporate law. Among them one can find prohibition on the provision of legal and tax advisory services, involvement in the performance of the internal audit function, provision of actuarial or valuation services that have material bearing on the annual financial statements to be audited etc., in Quick (n 809) p. 145.

⁸¹¹ Quick (n 809) p. 144.

rights in Germany are generally concentrated. As a result of that, there is less demand for independent audits and for an advanced, investor-friendly financial reporting system. Moreover, the German accounting profession has much less influence on setting the accounting standards than in the UK and the US. The standards are generally established by commercial laws.⁸¹²

In Germany, lenders and institutional investors have direct access to company information, which reduces the need for sophisticated financial reports and auditing standards designed predominantly to protect widely dispersed shareholders. Thus the sole audit objective for many years was to judge whether the accounting records and financial statements complied with regulations. It was only in 1987 that a true and fair view concept became part of German accounting requirements.⁸¹³

Due to the close relationship between managers and external auditors in Germany, some of the audit practices differ from those in the UK and the US. One of the most prominent ones is the fact that German managers may consider it inappropriate for auditors to question management's oral statements. They are also more unlikely to accept responsibility for detecting irregularities than their UK and US counterparts.⁸¹⁴

The structure of the German audit model is a result of national corporate governance characteristics. The principal-agent problem is of relatively small concern in the insider dominant environment. Bankers often enjoy shareholders' powers, privileged relations

⁸¹² Christian Leuz and Jens Wustemann, 'The Role of Accounting in the German Accounting System' (2003) No. 2003/16 Center for Financial Studies, available at https://www.ifk-cfs.de/fileadmin/downloads/publications/wp/03_16.pdf pp. 11,13, accessed 18 February 2016.

⁸¹³ A true and fair view concept became part of the law as a result of the incorporation of the European Union's fourth directive on individual company accounts into company law. The directive's requirement is that financial statements must give a fair and true view of a company's financial situation, making both compliance with company law and adherence to the fair and true view audit objectives in Germany; available at Carol A. Frost and Kurt P. Ramin, 'International Auditing Differences' (1996) 181(4) *Journal of Accountancy* 62, p.63.

⁸¹⁴ Frost (n 813) p. 64.

with managers and the auditor, and thus exert an effective control over key strategic decisions and financial reporting. As a result of the concentrated ownership and close relations between management and auditors, the demand for independent, external audits by outside stakeholders is much smaller than in the UK and the US.⁸¹⁵

5.4.2. ITALY

For many decades, only listed companies in Italy were required to be audited by external auditors, while non-listed companies were audited by the Board of Statutory Auditors regulated by the Italian Civil Code. In 1998, the so-called ‘Draghi law’ introduced a unified set of rules related to financial intermediaries. With explicit reference to listed companies, the financial audit was assigned to auditing firms, leaving the statutory committee uninvolved. As a result of that, a separation was instituted between the financial and the administrative audit.⁸¹⁶

The financial audit involves all the activities centred on the correctness of bookkeeping entries and documents concerning the reporting of management operations. Within the framework of the financial audit, auditors are required to verify whether accounts are kept correctly and whether financial statements fairly represent the true economic position of a company. The administrative audit, on the other hand, involves scrutinising existing laws, corporate by-laws, and principles of correct management. It also involves verifying organisational, administrative and accounting structures adopted by a company, as well as checking on the internal control system.⁸¹⁷

⁸¹⁵ Frost (n 813) p. 64.

⁸¹⁶ Laura Mariani, Patrizia Tettamanzi, and Fabio Corno, 'External Auditing vs Statutory Committee Auditing: The Italian Evidence' (2010) 14(1) *International Journal of Auditing* 25, p. 26.

⁸¹⁷ Mariani (n 816) p. 26.

The ‘Draghi law’ has required the statutory committee members to be selected from an official registrar of auditors kept by the Ministry of Justice. The registrar consists of professionals who have passed a specific test, managers of complex enterprises with at least three years’ experience, and professors of law and economics. They are entitled to an annual fee, which is based on the relevant professional tariffs and varies accordingly to the company’s net asset value. The ‘Draghi law’ has also granted the statutory committee the power to report to the court any serious irregularities performed by the management in breach of their duties.⁸¹⁸

The recent reform of the Italian civil code conducted in 2004 has shifted all financial auditing activities to an external auditor for both listed and unlisted companies. A separate body has been created in charge of administrative auditing. Its composition and features depend on the type of corporate governance model that is adopted by a company. According to the Italian civil code, there are three alternative governance models. Firstly, the most traditional and most frequently employed by the Italian corporations model includes two bodies, both elected by the shareholders: the board of directors (responsible for day-to-day management of the company), and a statutory committee, in charge of administrative auditing. Secondly, the ‘dualistic’ model, which transfers administrative auditing to a supervisory board elected by shareholders.⁸¹⁹ The management powers remain with the board of directors elected by the supervisory board. Thirdly, the ‘monistic’ system, which attributes management and administrative powers to a board of directors and to an audit committee respectively. The auditing committee members are chosen from within the board of directors and must be professional and independent.⁸²⁰

⁸¹⁸ Mariani (n 816) p. 26.

⁸¹⁹ The structure of a dualistic model is influenced by the German corporate governance structure.

⁸²⁰ This model is based on the Anglo-Saxon governance model, in Mariani (n 816) p. 27.

As far as the most common and traditional model is concerned, the main features of the statutory committee depend on the status of a company. In the case of listed companies, by-laws must establish that at least one member of the statutory committee must be elected by the minority, and at least one must be chosen from among external auditors. In non-listed companies the statutory committee must consist of three to five actual members and an additional two standby members. While performing their duties, members of the statutory committees must exercise due care and take into consideration the real financial situation of a company, its size, and structure.

The supervisory board in the dualistic model is charged with the same auditing duties as the statutory committee. In addition to that, it also possesses powers to influence shareholders' meetings. It can, for example, nominate or revoke the board of directors or approve the financial statements. It consists of at least three members, who can at the same time be shareholders. In the monistic model, the 'committee for management control' is chosen by the board of directors. The number of its members is established by the board of management except when the company is listed. At least one of the members must be listed on the national auditors register.⁸²¹

The only instance where the general separation between financial and administrative models does not have to be upheld relates to the companies which not only have traditional corporate governance model, but also do not have diffused shares and which do not have to prepare consolidated accounts. In such cases, statutory provisions can delegate all financial auditing to the statutory committee, as long as its members are on the list of auditors prepared by the Ministry of Justice.

⁸²¹ Mariani (n 816) p. 29.

Despite the fact that the duties of statutory and external auditors are actually separated, the overall control of audit activities should be conducted in a complementary way, with the common aim of protecting stakeholders. To this extent, the Italian model resembles the theoretical stakeholder panel discussed earlier in this chapter, which presupposes that auditors should have a duty to act in the best interests of stakeholders. In the Italian model, this creates a need for statutory and external auditors to work closely with each other looking for potential synergies and trying to avoid any duplication.⁸²² This is explicitly required by article 2409 of the Italian civil code, which stresses the need for co-operation, through a timely exchange of information, while performing their duties. The exchange of information should not be limited to the extraordinary or critical situations, but should be the base of constant communication between the two bodies.⁸²³

5.4.3. JAPAN

The extent and type of audit under the Japanese Commercial Code depends upon the type and size of the company. The Commercial code classifies companies into three different size groups: small, medium and large. There is no requirement for audit of small and medium companies. Large companies, however, are required to be audited by both: a corporate (statutory) auditor (*Kansa yaku*) – a member of the corporation, and by an independent external auditor (*Kaikei kansa nin*) – appointed at the annual general meeting.⁸²⁴

⁸²² Alessandro Cortesi, Patrizia Tettamanzi, and Fabio Corno, 'Empirical Evidence on Internal Control Systems' (2009) 13(1-2) *Journal of Management and Governance* 75, p. 79.

⁸²³ Mariani (n 816) p. 29

⁸²⁴ Terence Cooke and Masato Kikuya, *Financial Reporting in Japan: Regulation, Practice, and Environment* (Basil Blackwell, 1992), p. 115.

The corporate auditor in Japan is comparable to audit committees in UK companies.⁸²⁵

The corporate auditor is an employee of a company, and does not have to be a qualified accountant. Frequently, large companies establish a board of corporate auditors.⁸²⁶ The role of a corporate auditor is to ensure that fraud does not take place, that directors have fulfilled their responsibilities, and complied with regulatory requirements and articles of association.⁸²⁷ The corporate auditor must examine financial statements prepared by directors and if directors violate regulations or articles of association, the auditor must state this at the ordinary general meeting of shareholders. A negligent performance on the auditor's behalf may render him jointly liable with the company for damages incurred by third parties.⁸²⁸

In contrast to the corporate audit, the external audit is conducted by a highly qualified accountant, whose role is to express an opinion on financial statements. In Japan, all individual certified public accountants and audit firms must be members of the Japan Institute of Certified Public Accountants, which is incorporated under Article 43 of the Certified Public Accountants Law.⁸²⁹ External auditors must at all times be free and independent. They have to exercise due professional care and proper judgement in rendering their services.⁸³⁰ If the external auditor does not qualify the financial statement and the statutory auditor concurs with his opinion, then the accounts do not require an approval at the annual general meeting. However, if the statutory auditor does not concur with the view of the external auditor, then the financial statements must be presented at

⁸²⁵ Peter Collier, 'Corporate Governance and Audit Committees' in Michael Sherer and Stuart Turley (eds) *Current Issues in Auditing* (3 edn, Paul Chapman, London 1997), pp. 70 - 84.

⁸²⁶ Christopher K.M. Pong and Tsutomu Kita, 'Influence of Banks on Company Auditor Choice: The Case of Japan' (2006) 10 *International Journal of Auditing* 87, p. 88.

⁸²⁷ Cooke (n 824) p. 115.

⁸²⁸ Ian P. Dewing and Peter O. Russell, 'Models for the Regulation of UK Company Audit' (1997) 12(6) *Managerial Auditing Journal* 271, p. 275.

⁸²⁹ Akio Okuyama, The Japanese Institute of Certified Public Accountants, available at <https://www.sec.gov/rules/pcaob/pcaob200303/jicpa062703.htm> accessed 19 February 2016.

⁸³⁰ Okuyama (n 829).

the annual general meeting for a decision to be made. Also if the external auditor discovers some material misconduct the statutory auditor must be informed. This is due to the fact that the statutory auditor must express an opinion on the external auditor's report. This seems somewhat curious, as the statutory auditor does not need to have any accounting qualifications.⁸³¹

5.4.4. FRANCE

One can find the origins of the French auditor in the Industrial Revolution when a *commissaire de sociétés* was established in 1867. According to Mikol, auditors at that time were variously described as *commissaires de surveillance*, *commissaires des comptes*, or *censeurs*.⁸³² The role of auditor and the scope of his duties were developed through a series of court decisions from this period up to 1935, when the Decree Act legislated for an independent and competent commissaire. Mikol, quoting from Solus's 1938 study of the reform of company law, states:

The fundamental idea which must have informed the legislator when it was necessary to determine the attributes and powers of the auditors is that they are only organs of control, and that, in exercising this function, they should in no way involve themselves in the management of the company.⁸³³

The French legislature defined the restricted role of the statutory auditor as a reviewer of financial statements. This, in turn, laid down the fundamental principles, which shaped professional guidance on independence.

⁸³¹ Okuyama (n 829).

⁸³² Alain Mikol, 'The Evolution of Auditing and the Independent Auditor in France' (1993) 1(1) *The European Accounting Review* 1, p. 3.

⁸³³ Mikol (n 832) p. 8.

The French Company Law 1966 recognises solely *le Commissaire aux Comptes* as being eligible to conduct statutory audits. The Ministry of Justice has supervised statutory auditing through the professional body that issues standards and guidelines since 1969. The fact that auditing is the responsibility of the Ministry of Justice implies that in France the statutory auditor is regarded as being part of the judicial system, which makes it unique in comparison to other theoretical and international models discussed earlier. According to corporate law, the auditor's mission in France is of public order.⁸³⁴ This implies that the audit report is not specifically addressed to shareholders, but to any interested stakeholder. Civil liability of the auditors cannot be restricted even contractually.⁸³⁵ This makes the French audit model similar to the stakeholder panel model discussed earlier in this chapter, which assumes that auditors should exercise their duties for the benefit of stakeholders.

The statutory auditor in France is also required to disclose to the public prosecutor any audit clients' criminal acts, of which the auditor becomes aware (Article 233 of the French Company Law).⁸³⁶ This requirement has been described as the 'most stringent' reporting requirement in Europe.⁸³⁷ Sheid and Watson, with regards to the fact that the commissaire, additionally, must inform the courts if he comes across any going concern problems, describe the auditor as '... more than a statutory auditor, he has become the judicial scrutineer of the well-being of the business.'⁸³⁸

Statutory appointment as auditor in France is for a six-years term (Article 224 of the 1966 Company Law), thereby creating a structure giving the auditor in France greater

⁸³⁴ Alain Mikol and Peter Standish, 'Audit Independence and Nonaudit Services: A Comparative Study in Differing British and French Perspectives' (1998) 7(3) *European Accounting Review* 541, p. 566.

⁸³⁵ Mikol (n 834) p.549.

⁸³⁶ Mikol (n 834) p.546

⁸³⁷ J.C. Sheid and Peter Walton, *European Financial Reporting - France* (Routledge and ICAEW, London 1992), p. 101.

⁸³⁸ Sheid (n 837) p.101.

protection from short-term client pressures than in the UK, for example. In the case of French companies, which are under duty to publish consolidated accounts, there is a requirement of appointment of joint auditors, at least two in number (Article 223 Company Law) from different audit firms.⁸³⁹

The French model appears to be different to the German or the UK ones as far as the regulation of auditors' independence and provisions of non-audit services are concerned. There is a total ban on the provision of non-audit services to audit clients. The prohibition of consulting services, however, is widely contested by large audit firms, which manage to conform artificially with the regulation by creating separate legal structures responsible for providing only non-audit services. Simultaneously, French regulatory authorities have refused to impose strong constraints on major firms, with the result that the practical operation of the French audit market may actually be quite similar to the audit market in the UK.⁸⁴⁰

5.5. CONCLUSIONS

This thesis established in chapters three and four that the present audit model can be characterised by significant flaws, such as deficiencies in the auditors' independence and accountability, and excessive concentration of the audit market. This chapter analysed a variety of different theoretical and practical audit models, which suggested some solutions to the above mentioned problems inherent in the current auditing arrangements in the UK and the US. The analysis of this chapter was centred on the theoretical micro and macro models, as well as country-specific international options.

⁸³⁹ Mikol (n 834) p. 546.

⁸⁴⁰ Mikol (n 834) p. 547.

Micro models assume that the monitoring of the auditing process can be established at the level of a company, by using some of the existing company organs. There are certain practical difficulties associated with micro models. In the context of shareholder panels, questions can be raised as to how to choose members of the panel. This could be done, for example through selecting representatives of the largest shareholders in a company or by means of election within bodies of shareholders. It is, however, unlikely that there would be enough people of sufficient standing, skills, and expertise to serve on the panels. Another implication is the fact that insider information would be made available only to a privileged group of shareholders.⁸⁴¹ With regards to a stakeholder panel, it would also be difficult to identify the stakeholders with a reasonable right to information. Extending the auditor's duty of care would require significant changes to corporate laws and reconsideration of auditors' liability. It is also unlikely that any of the micro options could solve the conflict of interest arising from the fact that auditors are hired and paid by the very companies they are supposed to provide with an independent audit. The only way of solving this problem is to delegate appointment and remuneration of auditors to an external and autonomous body. This is the focus of the macro options.

The macro model solutions make provisions for external, independent bodies charged with the appointment and remuneration of auditors. Despite certain disadvantages of macro models, such as the unclear constitutional nature of a state regulatory body, the strong dependence of state bodies on national regulatory frameworks, and the dangers of considering macro models out of context, there is a public interest in the efficient and effective audit of listed companies, which warrants auditors working under the aegis of a state-controlled auditing body.⁸⁴² This avenue is further explored in the next chapter,

⁸⁴¹ Dewing (n 828) p. 276.

⁸⁴² Hatherly (n 757) p. 547.

which suggests a new regulatory audit model based on the macro model option. It proposes a regulatory overhaul of the current auditing arrangements by suggesting the establishment of an autonomous agency responsible for the appointment and remuneration of auditors of public interest entities. Following the French model, the new model introduces a total ban on the provision of consulting services by auditors. The rationale behind the appointment of auditors by a public body, and the prohibition of delivering consulting services is to restore truly independent and autonomous auditors.

CHAPTER 6. NEW AUDIT MODEL

Up to this point the thesis provided, in chapter one, a literature review of the structural and regulatory changes that have occurred in the auditing profession over time. It was argued that the excessive reliance on fees for consulting services transformed the auditing firms into money-driven businesses and had a negative impact on the profession's perceived independence. Numerous regulatory concessions decreased the deterrent function of litigation, leading to the decrease in auditors' accountability; and the frequent use of mergers left the profession dangerously consolidated.⁸⁴³ The thesis also argued that the regulation of audit developed without any prior theoretical grounding. The corollary of this is that regulatory changes in the sphere of audit are usually enacted *ad hoc* in the aftermath of major accounting scandals and fail to provide material changes to the auditing model. Despite the importance of audit for the capital markets there is still no definite answer as to what the purpose of audit is. Following Limpberg and Flint's theories, chapter two argued that since audit fulfils an important social function, it should be conducted not only for the benefit of shareholders, but also various stakeholders that rely on audited financial statements. Chapters three and four provided a detailed overview of the regulation of audit in the UK and the US and some of the most egregious problems that characterise the existing arrangements, such as independence, accountability deficits, and excessive concentration of the audit market. There it was argued that most of the reforms, enacted as a reaction to corporate scandals, were unsuccessful in fixing the underlying issues. This prompted a discussion in chapter five, which looked at how diverse theoretical audit models and other jurisdictions deal with similar problems of audit practice. This chapter is important for the thesis, as drawing from the evidence

⁸⁴³ See chapter one.

presented in previous chapters; it proposes a free-standing legal reconceptualisation of the external audit function in the Anglo-American system.

A key function in the new model is played by an external public body – the Public Auditing Board (PAB), in charge of the appointment and remuneration of auditors, as well as the setting of auditing standards. The PAB operates as an autonomous institution, independent from executive government, and funded by the fees paid by companies requiring audits. In the suggested model, the PAB operates as a guarantor of auditors' independence, as it appoints and compensates auditors. The PAB is able to appoint independent auditors either from its in-house practice, or to outsource them from private practice. Under this regime, a contractual relationship is created between the PAB and a company requiring audit, and hence client claims for negligently prepared audits would be brought against the auditors and the PAB. Moreover, auditors are no longer directly hired and paid by the very companies they audit, which breaks up the close relationship between the auditors and management. Auditors' independence is further strengthened by a total ban on the provision of consulting services simultaneously with audits.

The model draws on several aspects of the Limperg's and Flint's theories of auditing and proposes extending the scope of audit, so that it includes financial information relevant to the core stakeholders, such as employees and creditors. The model, however, does not suggest these stakeholders should have a *locus standi* in negligent audits claims. As the evidence shows the auditing profession faces an ever increasing litigation pressure, which may culminate in the bankruptcy of one of the biggest audit firms. This in turn can lead to further problems associated with increased concentration of the audit market and limited choice of auditors. For this reason, the thesis suggests that laws governing negligent audit claims should be restrictive, perhaps similar to the Caparo ruling, in order

to protect auditors from frivolous suits. At the same time the model envisages that auditors' exposure to claims for negligence should decrease naturally as a result of increased audit quality. This is due to the proposed structural reforms eliminating conflicts of interest, pervasive incentives inherent in the current audit arrangements, and creating truly autonomous and independent auditors.

6.1. THE CONCEPTUAL FRAMEWORK OF A NEW AUDIT MODEL

The contemporary statutory financial audit has a clear legal purpose of providing an independent opinion on the truth and fairness of financial accounts. The auditors' ultimate client is the audited company. This simple agency model of the statutory audit, however, does not take into account the interests of other stakeholders that have a keen interest in the companies. For example, creditors, such as lenders or suppliers, may see audit as providing assurance that companies will continue to pay for the goods, services, or finance. Employees may want the audit to provide some comfort about job security and future direction of the organisation. This chapter argues that the scope of companies' disclosure and audits should be extended in order to include financial information relevant to these core stakeholders. This would meet the information needs of employees and creditors, and reconcile their expectations of audit. This is explored in more detail later in this chapter.

In the proposed model audit of private corporations is transferred to a state-backed institution. There are numerous benefits of having autonomous, public auditors. Most importantly, corporations would not hire their own auditors; it would be the task of the Public Auditing Board. This arrangement, discussed in detail below, would enable the auditors to be truly independent of their clients. Furthermore, the Public Auditing Board,

responsible for setting auditing standards, would be able to apply the standards more consistently, mitigating problems caused by ambiguous rules. Last but not least, the public auditing body would be better placed to further public interest. According to Shapiro, ‘even though capitalist societies leave investment decisions in private hands, the allocation of productive economic resources to entities that can best use them is a matter of extreme importance to literally everyone, including future generations and those too poor to ever participate in the market directly’.⁸⁴⁴

The idea of moving audit of the corporations into the public domain had already been suggested in the US before the Securities Act of 1933 was passed. The early draft of the legislation assigned this duty to a corps of national auditors in the Government Accounting Office (GAO), an oversight branch of the US Congress.⁸⁴⁵ As Swanson noted, the final decision to leave the auditing of financial statements to private sector auditors was due to the fact that neither government nor industry wanted to collectivise auditing.⁸⁴⁶ According to Swanson, ‘...People didn’t want to accelerate the centralization of power, because what happens with the centralization of power is you get corruption and stagnation. Nobody wanted that.’⁸⁴⁷ Also most of the senators had little or no knowledge regarding the accounting profession and hence were easily influenced by the American Institute of Accountants (the predecessor of the AICPA), which lobbied to give the audit franchise to its members – the CPAs.⁸⁴⁸ It must be acknowledged that corruption and complacency can affect public institutions, on balance; however, this is relatively less of a problem in developed economies than poor quality audits. Potential corruption could also be counterbalanced, as the new model eliminates any conflicts of interest originating

⁸⁴⁴ Amy Shapiro, ‘Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients’ Incentives’ (2005) 35 Seton Hall Law Review 1029, p. 1072.

⁸⁴⁵ Sunder (n 412) p. 12.

⁸⁴⁶ Tennessee Tech accounting professor G.A. Swanson quoted in Brewster (n 94) p. 80.

⁸⁴⁷ Brewster (n 94) p. 80.

⁸⁴⁸ Ibid p.80.

from the fact that auditors are hired and paid by their clients. It also provides greater transparency of the audit process, which is governed and supervised by an independent agency with a statutory backing.

The idea of having financial statements audited by a public institution was then revisited in the 1950s. The US Congress considered the possibility of auditors being employed by the Federal Government.⁸⁴⁹ As suggested by Gaa, this could have enabled a closer monitoring and control of the auditing profession, which would have benefited society as a whole by means of improved financial reporting and more stable capital markets.⁸⁵⁰ Despite this early debate, mandatory auditing by self-regulated private sector auditors has remained largely the regular practice. The previous decades, however, showed the increasing role of the state in the regulation of financial reporting.

As chapter three argued, the increasing role of the state has been noticeable in the areas of standard setting, by establishing strong policing institutions such as the SEC and FRRS or audit governance institutions such as the PCAOB and FRC. Also the new model, with the establishment of the Public Auditing Board, envisages a greater role of the state in audit regulation. This seems to be in line with the findings of Baggott, who demonstrates that a typical progression in the regulatory system's development is a move away from voluntary, to a statutory-based system, involving increased participation by outsiders.⁸⁵¹

⁸⁴⁹ Andrew Barr, 'The Independent Accountant and the SEC' (Address of Andrew Barr before the Twenty-First Annual Ohio State University Institute on Accounting, Columbus, Ohio 1959) available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1950/1959_0521_BarrIndependentT.pdf p. 6, accessed 16 February 2016.

⁸⁵⁰ James Gaa, 'Critical Commentaries: The Expectations Game: Regulation of Auditors by Government and the Profession' (1991) 2 (1) *Critical Perspectives on Accounting* 83, p. 86.

⁸⁵¹ This trend is not uniform and in some cases the reverse move can be observed; in Rob Baggott, 'Regulatory Reform in Britain: The Changing Face of Self-Regulation' (1989) 67(4) *Public Administration* 435, p. 437.

Baggott's general analysis of regulation is comparable to Whittington's analysis of the regulation of financial reporting. Whittington identifies three general systems of regulation: self or private regulation, which is usually carried out by professional bodies; broadly based private regulation, which involves representation of a broader range of interests; and public regulation, where formal authority of law backs a regulatory body.⁸⁵² He finds that the regulation of accounting and audit has moved from self or private regulation to broadly-based private regulation (with elements of public regulation).⁸⁵³ As chapter two argued, this is due to the numerous scandals affecting the auditing profession, lack of consistent theoretical underpinning of the audit function, and the strong need to protect capital markets by means of audit. The proposal of a new model in this thesis, with the Public Auditing Board at the centre, remains in line with the observed trends that public regulation plays an increasing role in the area of financial reporting.

The structure of the proposed Public Auditing Board is similar in the structure and functioning of the Audit Commission responsible for conducting audits for local authorities in England and Wales between 1983 and 2015.⁸⁵⁴ Ironically, the Audit Commission was closed in 2015, in order to replace the centralised arrangements for the

⁸⁵² Whittington (n 805) pp. 316-318.

⁸⁵³ Whittington (n 805) p. 317.

⁸⁵⁴ The Audit Commission's closed in April 2015 as a result of the Local Audit and Accountability Act 2014. The competencies of the Audit Commission were split among the Public Sector Audit Appointments Ltd., National Audit Office, Financial Reporting Council and Cabinet Office. The new transitional body - the Public Sector Audit Appointments Ltd. is responsible for overseeing the Commission's current external audit contracts with audit firms from April 2015 up to 2020. It manages the contracts and exercises statutory powers to appoint auditors, and sets the fees. According to the new framework, local bodies will have to appoint their own independent external auditors at least once every five years. They will need to consult and take into account the advice of an independent auditor panel. Accountancy professional bodies will register audit firms and auditors. They will be required to have rules and practices in place that cover the eligibility of firms to be appointed as local auditors and also the qualifications, experience and criteria that individuals will need to have to sign an audit report. They will also monitor and enforce audit standards. This will be supervised by the Financial Reporting Council's Audit Quality Review. The scope of the audit will remain very similar to the current audit, and auditors will continue to be required to comply with a code of practice produced by the National Audit Office and have regard to its guidance. The Cabinet Office will be responsible for the National Fraud Initiative; available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/418151/The_future_of_the_Audit_Commission.pdf accessed 30 December 2015.

audit of local bodies, with a more ‘localist approach’, enabling the local bodies to appoint their own auditors from an open and competitive market.⁸⁵⁵ The Audit Commission changed the traditional public sector model of auditing by introducing genuinely autonomous auditors.⁸⁵⁶ Auditors were appointed by the Audit Commission and answerable only to the public and the ‘courts’ instead of their ‘clients’ in the field.⁸⁵⁷ The Commission operated independently from government, and its formal governing body was made up of several commissioners and a chairman. The day-to-day operations of the organisation were managed by a team of managing directors led by the Chief Executive.⁸⁵⁸

The Audit Commission Act conferred statutory powers and duties on the auditor in person. The way in which the auditor performed his duties, including decisions relating to possible illegality, was free from any external influence. All of an auditor’s professional responsibilities were to be discharged independently of the Audit Commission, which could not influence the way in which audit was performed. In law, the auditor remained accountable to the courts for the way in which he exercised his statutory duties.⁸⁵⁹ As far as financing was concerned, the Audit Commission purchased audits from the pool of audit firms and district auditors and ‘resold’ them to the audited

⁸⁵⁵ Department for Communities and Local Government, Local Audit and Accountability Bill, May 2013, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198057/Local_Audit_and_Accountability_Bill_-_plain_English_guide.pdf accessed 30 December 2015.

⁸⁵⁶ Michael Heseltine, *Where There's a Will* (Hutchinson, London 1987), pp. 37 - 40.

⁸⁵⁷ It was a novel idea, as there was no emphasis on independence of auditors of public institutions before 1983. For many years auditors worked so closely with the local authorities that they were often considered part of the municipal family; in Duncan Cambell-Smith, *Follow the Money. The Audit Commission, Public Money and the Management of Public Services, 1983-2008* (Penguin Group, London 2008), p. 2.

⁸⁵⁸ Under Part II of the Act the Audit Commission had four statutory functions in relation to audit. It appointed auditors to local government and NHS bodies. It prepared and kept under review the Codes of Audit Practice, which prescribed how auditors should discharge their statutory duties. It also prescribed scales of fees for audits and made arrangements for the certification of grant claims and returns. See The Audit Commission, available at <http://www.audit-commission.gov.uk/aboutus/howwearerun/pages/default.aspx>, accessed 23 May 2012.

⁸⁵⁹ Radford (n 781) p. 914.

bodies – building a mark-up into the process and generating extra cash to pay for its national report work and publications.⁸⁶⁰ While towards the end of its functioning it had begun to receive some funding from government, it remained substantially self-funded.⁸⁶¹

As far as the appointment of auditors is concerned, the Audit Commission was able to appoint auditors both from private firms and from among the District Audit Service (DAS), its in-house practice. From the very beginning of the Commission's work, it was clear that the DAS would not cope on its own and that some of the audit work had to be delegated to private firms. The usual practice for over twenty years was to outsource about thirty per cent of the audit work to private sector audit firms, with the remaining seventy per cent being done by DAS auditors.⁸⁶²

Whilst agency theory is useful in explaining the rationale of the external audit function in the present Anglo-American arrangements, it does not explain the way the auditors are appointed. Even though agency theory suggests that auditors should be hired by and be accountable to shareholders, in reality individual shareholders are too diverse and rarely have time to be directly involved in the hiring process.⁸⁶³ In practice this task is usually delegated to the company directors who choose auditors and their selection is usually rubber-stamped by shareholders at the annual general meetings.⁸⁶⁴ It is worth noticing,

⁸⁶⁰ Cambell-Smith (n 857) p. 8.

⁸⁶¹ Cambell-Smith (n 857) p. 12.

⁸⁶² Cambell-Smith (n 857) p. 12.

⁸⁶³ Prem Sikka, Steven Filling, and Pik Liew, 'The Audit Crunch: Reforming Auditing' (2009) 24(2) *Managerial Auditing Journal* 135, p. 138.

⁸⁶⁴ This way of appointing auditors is typical for the UK and US system, which are characterized by dispersed ownership. The role and appointment of auditors can be performed differently in countries with other corporate governance settings. For example, in the Nordic context, the auditor is appointed by the general meeting. Even though it is usually the board or audit committee that propose an auditor, the general meeting is never bound by their suggestion and has the unrestricted power to make a different decision. Furthermore, minority shareholders holding at least 10% of the shares can demand an appointment of a

that initially in the UK in the nineteenth century, the law required auditors to be selected by a shareholder vote in order to guarantee that the agent stayed faithful to its principal.⁸⁶⁵ This practice, however, had gradually become much less feasible. As shareholders had become increasingly dispersed, holding small stakes in various entities, they could not, as a matter of practice, negotiate subjects of audit engagements with multiple auditors performing audits at thousands of corporations.⁸⁶⁶

The current auditing model makes auditors dependent upon clients for their fees, as a result of which their advice and opinions may be favourable towards them. According to Coffee, ‘watchdogs hired by those they are to watch typically turn into pets, not guardians.’⁸⁶⁷ Drawing on the elements of the structure and functioning of the Audit Commission, the main functions of the proposed model institution - the PAB include the appointment and remuneration of auditors.⁸⁶⁸

As far as the current appointment of auditors is concerned, according to s.475 of the Companies Act 2006 the only companies that are exempt from audit requirements are the ones that are small, dormant, or non-profit-making and subject to public sector audit. In the US, under the Securities and Exchange Act of 1934, audit is required for an ‘issuer’.⁸⁶⁹ It would be practically impossible for the PAB to conduct audits for all the companies

special ‘minority auditor’; in Per Lekvall, *The Nordic Corporate Governance Model* (SNS Forlag, 2014), p. 82.

⁸⁶⁵ Coffee (n 51) p. 113.

⁸⁶⁶ Coffee (n 51) p. 340.

⁸⁶⁷ Coffee (n 51) p. 335.

⁸⁶⁸ Analogous to ss. 12, 13 and 14 of the Part III of the Local Government Finance Act 1982, creating Audit Commission for Local Authorities in England and Wales.

⁸⁶⁹ Definition of an issuer is contained in Sec.3 of the Securities Exchange Act 1934 – ‘an issuer – any person who issues or proposes to issue any security...’. This thesis will refer to audits of public companies that are subject to securities laws.

covered by these requirements.⁸⁷⁰ Appointments of auditors would have to be restricted only to listed companies, as there is a considerable public interest in the provision of good quality audits to listed companies. This is due to the amount of public savings located in these companies and their importance to the economy. Public listed companies produce benefits for many individuals, including shareholders receiving dividends, bondholders earning interests, or employees getting salaries, health and retirement benefits. These corporations also pay taxes, produce new technologies and make scientific discoveries.⁸⁷¹ For practical reasons, the PAB's ability to appoint auditors should therefore be restricted to listed companies, which are usually the biggest and most sensitive to the economy.

Moreover, conducting audits for large companies operating in various markets would require sufficient knowledge and expertise from the auditors. Independent appointments would have to take account of different strategies and operational approaches of audit clients.⁸⁷² The PAB could consider appointing auditors from among its in-house practice, as well as private firms which already possess the knowledge of the client's industry and infrastructure, to deal with the major clients. There is also no reason why the PAB could not receive expert advice with regards to the requirements of specific industries. The Audit Commission was able to appoint auditors both from private practice and from among its in-house practice, which was the sixth largest audit practice in the UK.⁸⁷³ Approximately thirty per cent of Audit Commission audits were conducted by private sector audit firms such as Deloitte, KPMG, PKF, PricewaterhouseCoopers, and Grant Thornton. These firms proved to have the necessary skills, expertise and resources to meet

⁸⁷⁰ There are over 2600 listed companies in the UK and over 3200 listed only on NYSE in the US.

⁸⁷¹ Lynn Stout, *The Shareholder Value Myth, How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berrett-Koehler Publishers Inc., San Francisco 2012) p. 104

⁸⁷² The Accountancy Foundation Review Board, 'The Regulatory Solution in the UK' available via http://cclsr.law.unimelb.edu.au/files/Regulatory_Solutions_in_the_UK_0303_final_web.pdf accessed 6th January 2012.

⁸⁷³ The Audit Commission, available at <http://www.audit-commission.gov.uk/audit-regime/pages/default.aspx> accessed 25th May 2012.

the Audit Commission's exacting standards.⁸⁷⁴ Moreover, if the PAB allowed firms from the private sector to be appointed to conduct some audits, subject to fulfilling quality requirements, and established indicative fee rates, the practice of 'low balling', with its detrimental effects on audit quality could be diminished.⁸⁷⁵

As far as funding is concerned, in order to establish and maintain true institutional independence, the PAB should not have to rely on government for its finance. Its funding should come from companies requiring audits. The PAB could purchase audits from the auditors, such as private audit firms or its in-house practice, and resell it to the audited bodies, building a mark-up along the way, which would support paying for the maintenance and expenditure of the Board.

As far as the legal form of the PAB is concerned, there are a number of possibilities, ranging from a quasi-autonomous non-governmental organisation (quango), also known as a non-departmental public body,⁸⁷⁶ a public interest company (PIC),⁸⁷⁷ a company

⁸⁷⁴ See (n 873).

⁸⁷⁵ See (n 872).

⁸⁷⁶ Quangos remain independent from government; but they are directly financed by it. Quangos, however, have lost popularity due to their lack of accountability to the public and service users. It is often considered that they lack accountability even to these public bodies that finance them. Another disadvantage of this legal form is the fact that members of the board are usually employed on a part time basis and lack sufficient expertise, in Resource Centre, *Not for Profit Organisations: A Brief Guide to Legal Structures for Community and Voluntary Organisations and Social Enterprises* (Brighton: Brighton & Hove, 2012), available at <http://www.resourcecentre.org.uk/information/legal-structures-for-not-for-profit-organisations/> accessed 19 February 2016.

⁸⁷⁷ PIC is a not-for-profit company, accountable to its stakeholders and providing public services. It is structured as a company limited by guarantee without shareholders and its activities are financed by debt or subsidy. The lack of shareholders in the public interest companies means that their corporate governance must be organised differently than in the public limited companies. Appointed members fulfil the same role as shareholders in the public limited companies. They do not have a financial stake in the company though and if the company goes bust, they must pay out a fixed sum (often a payment of £1). They can also be directors on the board. Members can be selected from the general public, from among the stakeholders and can include staff, industry experts, public utility users or even government officials. Beyond this, the PICs are flexible with regards to their organisation. There would be some difficulties, though, to structure the board, so that it brings it the interests of all the stakeholders. Also, stakeholders are often criticised for being too unfocused and unable to undertake tough decisions, but the fact that they do not have any financial interest in the company increases the accountability of public services and prevents the potentially harmful profit-maximising attitude of shareholders, in (n 876).

limited by guarantee, or a social enterprise, which trades in order to fulfil social aims.⁸⁷⁸

Most importantly, however, the Board must be free from any links to government in order to ensure independence and accountability of its decision-making process.

In the suggested model, the PAB could operate as the auditing standards setter. The standards would have to change in order to accommodate wider stakeholders and their audit needs.⁸⁷⁹ Similarly to the Audit Commission, the PAB would also prepare and review the code of audit practice constituting the best professional practice regarding standards, techniques and procedures adopted by auditors. Auditors' reappointment would depend on the PAB's judgement of how well an auditor discharged his duties under the law and met the requirements of the code. The PAB could also provide auditors with a significant amount of guidance, advice, and training, and ensure that auditors achieve the same standards and were subject to the same quality reviews.⁸⁸⁰

It has to be acknowledged that the suggested model can give rise to several problems.

One of the main criticisms of establishing a public body which appoints and remunerates

⁸⁷⁸ Social enterprise can adopt any of the following legal forms: partnership or limited liability partnership, limited company, community interest company, industrial and provident society; in Resource Centre (n 876). The differences between the PICS and social enterprises are more theoretical and philosophical than legal. If the public service involved is a monopoly, then it will more likely be structured as a PIC. If it competes with other institutions in the provision of services, it will be a social enterprise, in Paul Gosling, *Accountability in Public Services* (ACCA, London), p. 38.

⁸⁷⁹ This could potentially be a problematic area, as the UK auditing standards are based on International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC), which makes them compatible with regulatory frameworks, including the EC's Statutory Audit Directive. Any regulatory changes would cause practical difficulties, because of the international context of standard setting. In *Institute of Chartered Accountants in England and Wales*, available via <https://www.icaew.com/library/subject-gateways/auditing/knowledge-guide-to-uk-auditing-standards> accessed 15 February 2018.

⁸⁸⁰ Radford (n 781) p. 915.

auditors is that it would require substantive changes in the current governance framework and company law. To begin with, according to the UK Corporate Governance Code, the audit committee makes recommendations to the board in relation to the appointment and removal of the auditor. The audit committee also approves the remuneration and terms of engagement of the external auditor, reviews and monitors the auditor's independence, develops and implements policy on the engagement of the auditor to supply non-audit services. Under the new model these competencies of the audit committee would be transferred to the public agency, and hence the role of the audit committee in the current shape would be made redundant.⁸⁸¹ Moreover, at present according to the Companies Act 2006 it is the shareholders that approve auditors in the general meeting. Under the new model this task would be delegated to the public agency, taking away the current control right of the shareholders.

One can also argue that such a drastic overhaul is not necessary in view of the recent changes put forward by the new EU Audit Framework.⁸⁸² The legislation introduced, among others, mandatory firm rotation, restrictions on the provision of certain non-audit services and fee capping, and new monitoring and reporting requirements imposed on audit committees of PIEs. The rationale behind this reform was to eliminate misaligned incentives, conflict of interests and lack of competition.⁸⁸³ Whilst it is still too early to

⁸⁸¹ On the other hand, the use of independent audit committees, whilst potentially mitigating the problems of auditor independence, clearly does not eliminate the conflict of interest dilemma. After all, audit committee members are paid by the company and can be dependent on top management for different benefits, such as referrals to boards of other companies.

⁸⁸² See n 530.

⁸⁸³ Department for Business, Innovation and Skills, 'UK implementation of the EU Directive on statutory audits of annual accounts and consolidated accounts, and of the EU Regulation on specific requirements

assess the full impact of the reform, the key assumptions of the thesis are that without a major regulatory overhaul of the current auditing arrangements suggested in this chapter, any further attempts of reform would be futile.

The model can also raise concerns about the independence of the members of the public agency. It can be argued that their true independence may be unattainable, as it is very difficult for people with expertise and significant experience not to have any connection with the relevant industry. Moreover, irrespective of the motive for the initial regulation and the establishment of the regulatory agency, it is probable that the agency might eventually be captured by the special interests of the accounting industry. In order to counteract the regulatory capture, it is advisable to increase transparency of the agency's internal processes, but this can lead to further increases in operational costs.

Some commentators claim that moving audits into the public sphere could create the same incentives as is the case of other civil servants, with its corollary low efficiency and poor customer service.⁸⁸⁴ Admittedly, it is also likely that the cost of audits would rise. It is inevitable, however, that good quality audits would require more time and resources. If the PAB were to increase the quality of audits and enhance confidence in financial reports, it might well be that the cost of establishing the Board would be a small price to pay.

Having discussed the general structure of the Public Auditing Board and its potential criticism, the following section explains how the suggested model proposes to solve the problems inherent in the current audit arrangements. It addresses key issues discussed in

regarding statutory audit of public interest entities 2014', available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470195/BIS-15-606-impact-assessment-audit-and-reporting-requirements.pdf accessed 11 February 2018.

⁸⁸⁴ Shapiro (n 844) p. 1073.

the previous chapters, such as lack of auditors' independence, accountability deficits, and concentration of the audit market.

6.2. NEW MODEL AS A SOLUTION TO OLD PROBLEMS

Having discussed the structure and functioning of the Public Auditing Board, this section continues developing the proposed model by attempting to provide resolutions to the problems inherent in the current audit arrangement, which were discussed extensively in chapter four. The problem of insufficient auditors' independence – a fundamental concept in enhancing public confidence and reliability of auditors' reports is analysed first. The problems of auditors' accountability deficits and the excessive concentration of the audit market follow.

6.2.1. RESTORING AUDITORS' INDEPENDENCE

Audit is an important part of the framework that underlies capital markets.⁸⁸⁵ Audits provide independent verification of the information included in the financial statements presented by the managers to the public.⁸⁸⁶ They are beneficial to numerous stakeholders, not only by providing information to the market that financial statements produced by managers are reliable, but they also reduce the cost of information exchange.⁸⁸⁷ If the auditor does not act independently, then audit loses value to all parties.

According to the American Institute of Certified Public Accountants (AICPA) Council, 'Independence, both historically and philosophically, is the foundation of the public

⁸⁸⁵ Vivien Beattie and Stella Fearnley, 'Auditor Independence and Non-Audit Services: A Literature Review', available at http://www.icaew.com/en/technical/research-and-academics/publications-and-projects/~/_media/Files/Technical/Research-and-academics/publications-and-projects/audit-and-assurance-publications/auditor-independence-and-non-audit-services.ashx accessed 19 February 2016.

⁸⁸⁶ Karla M. Johnstone, Michael H. Sutton, and Terry D. Warfield, 'Antecedents and Consequences on Independence Risk: Framework for Analysis' (2001) 15(1) Accounting Horizons 1, p.2.

⁸⁸⁷ Dopuch and Simunic (n 730)

accounting profession and upon its maintenance depends the profession's strength and its stature'.⁸⁸⁸ Auditors must be independent from their clients' interests. As former judge of the US Supreme Court Warren Burger wrote:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.⁸⁸⁹

The rationale of the suggested audit model, which moves audit into the public sector, is its ability to guarantee the true independence of auditors. The proposed model addresses the agency problem that arises because auditors are hired and paid by their clients. By creating an independent, public agency responsible for the audit of public companies, a direct principal-agent relationship between investors and auditors is restored. Companies would no longer have any influence on the appointment and remuneration of auditors, as this would be the role of the audit agency.

The ICAEW claims that 'as long as audit appointments and fees are determined by the shareholders of the company being audited, the auditor can never be economically independent of the client'.⁸⁹⁰ The basic principle of the proposed model is that the appointment should not be made by persons whose positions may be affected by the outcome of an audit opinion and who have an interest in influencing the auditors in their

⁸⁸⁸ John L. Carey, *The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1969* (American Institute of Certified Public Accountants, New York 1969), p. 182.

⁸⁸⁹ *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

⁸⁹⁰ ICAEW, available at <http://www.icaew.com/en/technical/ethics/auditor-independence/auditor-independence-approach> accessed 19 February 2016.

investigation or report. If auditors are in such a position, then they are potentially exposed to pressure and influence. This in turn can impair their independence.

Directors should not be in a position to recommend auditors who report to shareholders on the performance of the company. This is, however, the prevalent practice in the UK and the US. The mere fact that shareholders retain the power not to endorse the directors' recommendation and occasionally exercise this option does not ensure that the practice invariably operates in the public interest in all other cases. Also the bidding process, whereby directors are presented with offers from a number of auditors in order to make a selection, has the potential for even greater threats to auditor independence. This is because such a procedure gives directors an opportunity to exercise improper influence on the freedom of investigation and pressure on the fee. If directors have a selfish incentive, they are able to influence audit outcomes and simultaneously present themselves as having a proper regard for cost effectiveness. Also according to Flint, an auditor who is willing to work for less than an economic fee for the work and responsibility involved, expecting at the same time to recover any 'discount' by later increased fees on a continuing appointment, has immediately compromised independence. An interest in re-appointment can produce a conscious or unconscious predisposition to avoid confrontation with directors on difficult matters or difference of opinion.⁸⁹¹

For shareholders alone to have the responsibility to appoint and remunerate auditors is hardly practicable, and in any event raises other reservations. First of all, even if shareholders were endowed with real power to make corporate decisions, the temptation to inflate earnings and other accounting measures might persist. Inevitably, some

⁸⁹¹ Flint (n 3) pp. 75-76.

shareholders apply a short-term approach to decisions on buying, holding or selling stock. They are often called ‘day-traders’ or ‘speculators’, whose main business it is to buy cheap, sell with a mark-up, and to exit the company as soon as they make a profit.⁸⁹² It would be difficult for the reformer to distinguish between short-term oriented shareholders and those interested in the long-term value of the company. Hence, empowering shareholders is not a panacea, as it is impossible to know which shareholders to empower.⁸⁹³

Furthermore, following Flint’s theory that audit is a social phenomenon, companies’ auditors who are appointed primarily to report to shareholders, are likely to be perceived by other interest groups as the shareholders’ auditors and to be suspected of having a shareholder bias, unless they are appointed by truly independent, external body, acting in the public interest. Employees and their representatives, creditors and other stakeholders, whose interests may conflict with those of shareholders, are unlikely to accept the shareholders’ auditors also reporting to them, unless they are satisfied that the arrangements for appointment ensure complete impartiality.⁸⁹⁴

The role of the auditors should be appreciated by all parties participating in the operation of capital markets. An auditor should not be an advocate for any particular party. If the parties require a partisan commitment to their interest at the time of a conflict, it is not the auditor that they should turn to. The overriding principle of the suggested model is that the audit should perform a totally independent function, and all parties with an interest should have confidence in the integrity, impartiality and objectivity of auditors, otherwise the social purpose of audit will become frustrated. Once appointed, the

⁸⁹² Ronen (n 760) p.132.

⁸⁹³ Ronen (n 760) p.132.

⁸⁹⁴ Flint (n 3) p.78.

principal measures for the protection of an auditor would include irrevocability during the tenure of the appointment – except for misconduct.

Another important issue which potentially affects auditors' independence is the involvement of auditors in other work, such as consulting services. The basic question which arises here is whether involvement in another capacity, consciously or unconsciously, influences the mental attitude of an auditor, introduces a personal interest in the outcome, or exposes the auditor to influence or pressure which is prejudicial to their independence; or whether such involvement would lead an interested party to believe that the auditor's independence was compromised, or would be damaging to the authority of the auditor in the opinion of any such person.⁸⁹⁵

It has been difficult to assess a definite impact of non-audit services on auditors' independence in the current system. This is due to the fact that independence is in fact unobservable and hence difficult to measure. It is generally agreed, however, that the joint provision of audit and consulting negatively affects the perception of auditor independence. Also, according to research discussed in chapter four, certain consulting services, such as financial system design and implementation, create conflicts of interest that may bias an auditor's opinion on financial statements, because they partially reflect the auditor's own work.⁸⁹⁶ Also consulting revenues may increase the auditor's financial dependence on any given client. An audit firm, which provides both audit and consulting services, deriving significant income from the latter, does not want to lose a client. This, in turn, can lead to a situation, where auditors do not challenge dubious accounting practices, causing lower financial reporting quality.

⁸⁹⁵ Flint (n 3) p.80.

⁸⁹⁶ Ronen (n 760) p. 136.

The proposed model suggests that auditors should be free from any other business relationships, such as consulting, with their clients.⁸⁹⁷ The correct mental attitude, independent thought and action, impartiality and use of freedom of investigation and reporting, are ultimately dependent on the personal qualities of the auditor. This thesis, however, argues that an audit system should be designed in such a way as to eliminate all possible organisational deficiencies, which give auditors an opportunity not to act in an independent way. The possibility of providing non-audit services is an example of such a deficiency. As the Enron debacle showed, consulting can be damaging to the independence of auditors, and destroy the value of audit for the persons for whose benefit it is performed.

6.2.2. INCREASED AUDITORS' ACCOUNTABILITY

Why is there a need to increase one's accountability? First of all, accountability enhances the integrity of governance. It prevents corruption and nepotism. It fulfils the deterrence role for those who might potentially abuse power vested in them.⁸⁹⁸ The process of accountability is also important in order to improve performance. It is considered to foster individual and group learning, as norms are produced, internalised and adjusted through accountability.⁸⁹⁹ Accountability also creates trust and confidence in public institutions and helps to bridge the gap between citizens and their representatives.⁹⁰⁰ The auditing profession's influence, power and lack of accountability in the present audit model have

⁸⁹⁷ The statutory ban on providing consulting services is in place in France, see Hatherly (n 757) p. 548.

⁸⁹⁸ Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences and Reform* (Cambridge University Press, New York 1999) p.7.

⁸⁹⁹ Peter Aucoin and Ralph Heintzman, 'The Dialectics of Accountability for Performance in Public Management Reform' (2000) 66 (1) *International Review of Administrative Sciences* 45 , p 45.

⁹⁰⁰ Aucoin (n 899) p. 50.

been widely criticised.⁹⁰¹ The aim of this section is to examine how the new model, which moves audits of private corporations into public domain, can enhance auditors' accountability in the legal and social spheres.

It was argued in chapter four that the auditing profession suffers from legal accountability deficits caused by excessive regulatory protection gained over the past decades. First of all, the extent and level of the standard of care owed by the auditors is relatively lax.⁹⁰² Claimants, in particular those who lack a contractual relationship with auditors, find it hard to recover damages for loss resulting from negligent audits. These claimants' loss is purely economic and the courts have adopted a restrictive approach with regards to the recoverability of pure economic loss, particularly in tortious cases.⁹⁰³ Furthermore, both in the UK and the US, international auditing firms have adopted the limited liability partnership vehicle that reduces partners' personal liability for business. Last, but not least, auditors are also protected by means of proportionate liability and limited liability agreements.

These protective regulatory arrangements were enacted in order to limit tort exposure and litigation against auditors. It has been argued that in the case of a massive claim resulting in the collapse of one of the Big Four firms, the negative effects on the auditing market would be significant.⁹⁰⁴ Partners and staff at the remaining firms may become excessively

⁹⁰¹ Austin Mitchell and Prem Sikka, 'Accounting for Change: The Institutions of Accountancy' (1993) 4(1) *Critical Perspectives on Accounting* March 29; Prem Sikka, Hugh Willmott and Tony Lowe, 'Guardians of Knowledge and Public Interest: Evidence and Issues of Accountability in the UK Accountancy Profession' (1989) 2(2) *Accounting, Auditing and Accountability Journal* 47; Hugh Willmott, 'Serving the Public Interest? A Critical Analysis of a Professional Claim' in D.J. Cooper and Trevor M. Hopper (eds), *Critical Accounts* (Macmillan, London 1990).

⁹⁰² As far as auditor liability to third parties in US is concerned, the majority of the states now follow the approach found in the Restatements of Torts (1977), according to which third parties are able to sue a negligent auditor, if they belong to the group of foreseen individuals, whom the public accountant would expect to rely on audit. For more detailed analysis see chapter four.

⁹⁰³ Roach (n 110) p. 140.

⁹⁰⁴ London Economics, 'Study on the Economic Impact of Auditor's Liability Regimes – Final report to EC-DG Internal Market and Services' September 2006, p. 115.

risk-averse and unwilling to provide audit services to risky clients, such as start-up businesses or those in the finance sector.⁹⁰⁵ This could create a market whereby companies would struggle to appoint a suitable auditor, which in turn could lead to poor quality audits or an increase in fees charged by those willing to take on risky engagements. All of that might adversely affect investors' confidence in the value and effectiveness of audits, and the reputations of the remaining audit firms. The collapse of one of the Big Four auditing firms would also cause a further concentration of the audit market, as the majority of the clients of the failed firm would most likely be picked up by the three remaining ones.⁹⁰⁶

There are numerous ways in which audit firms can control their exposure to claims of negligence. Perhaps the most obvious is not being negligent in the first place. The aim of the suggested model is to create such an organisational structure that will enable auditors to exercise due care and provide high quality audits. To begin with, auditors would no longer find themselves in a position of a conflict of interest, as the Public Auditing Board would be responsible for their appointment and compensation. Furthermore, the 'low-balling' phenomenon would be eliminated, as under the proposed regime, auditors would not be allowed to provide consulting services to their audit clients. These changes would restore the true independence of auditors and enhance the quality of audits. The establishment of an external public audit body would not be without influence on litigation. If the quality of audit was to be challenged, substantial claims could be made against both the auditor and the appointment body. That is why the model envisages maintaining the current legal status quo with regards to auditors' tortious liability to third parties for negligent audits. It does not advocate extending auditors' liability by granting

⁹⁰⁵ There is already some evidence of auditors dropping high-risk clients, e.g. in 2003 Deloitte dropped Huntington Life Sciences, in 2004 Grant Thornton dropped Parmalat; in Roach (n 110) p. 141.

⁹⁰⁶ Roach (n 110) p. 142.

locus standi to various stakeholders relying on auditors' reports. The Caparo-based system would protect auditors from excessive litigation and major claims against the biggest audit firms. At the same time, it is suggested that the litigation levels against auditors would drop as a matter of course, because of the enhanced quality of audits.

This thesis has also argued that there are social accountability deficits in the current auditing regime. Auditing firms are the police force of capital markets and perform a significant public function. They are also subject to private sector pressures, which compromise their public function. For this reason this thesis suggests delegating audits to a designated state regulator and making auditors accountable not only to shareholders, but also to employees and to creditors. It is also desirable to reconsider the scope of auditing, which has been inhibited by the narrow perception that audit's sole purpose is to lend credibility to the financial statements.

There appears to be little academic literature that specifically addresses stakeholders and their expectations of audit. In the 1990s Sutton and Arnold looked at the US Single Audit Act 1984 and proposed transposing its requirements from the public to the private sector in order to introduce a social dimension of public accountability to corporate stakeholders.⁹⁰⁷ They argued that the information needs of various stakeholders are disregarded by the standard setters and that the quality of corporate social disclosures should be enhanced. They aimed at creating a more inclusive model of corporate reporting. Their model, however, did not consider the diverse needs of stakeholders and the way they should be incorporated into the corporate audit. Roberts has also examined a stakeholder approach to the corporate single audit.⁹⁰⁸ He argued that stakeholder theory

⁹⁰⁷ Steve G. Sutton and Vicky Arnold, 'Towards a Framework For a Corporate Single Audit: Meeting Financial Statements Users' Needs' (1998) 9(2) *Critical Perspectives on Accounting* 177.

⁹⁰⁸ Robin W. Roberts, 'A Stakeholder Approach to the Corporate Single Audit' (1998) 9(3) *Critical Perspectives on Accounting* 227.

provides an adequate grounding for designing a corporate single audit that would accommodate the diverse information needs of multiple corporate stakeholders. He argued that the success of stakeholder-based corporate single audit would be contingent on the ‘development of reporting and attestation requirements that lead to the dissemination of reliable corporate social responsibility information, and a change in the relative power of the corporate stakeholder groups that influence the adoption of regulated, mandatory corporate social reporting’.⁹⁰⁹

The corporate single audit theory, however, fails to address some of the practical issues of trying to meet stakeholders needs through the statutory audit. To begin with, if audit was to be restructured to accommodate multiple stakeholders, it is likely that its purpose would change. It would become less valuable to shareholders as a means of mitigating the agency problem. It would also necessitate a change to the legal purpose of audit. Furthermore, in order to meet all the potential stakeholders’ expectations, it would require corporations and auditors to provide more information, which raises concerns about the completeness of information, its accessibility for all stakeholders, and invariably an increase in cost.⁹¹⁰

This thesis advocates a model, which unlike the single corporate audit, does not purport to deal with issues pertaining to stakeholder governance. It suggests a more focused financial stakeholder model that addresses the financial aspects of core stakeholders, such as creditors and employees. First of all, it advocates extending auditable financial information about the reporting entity that would be useful to present and potential

⁹⁰⁹ Roberts (n 908) p. 227.

⁹¹⁰ ICAEW, Evolution. Stakeholder Expectations of Audit, December 2008, available at <http://www.icaew.com/~media/corporate/files/technical/audit%20and%20assurance/audit%20quality/audit%20quality%20forum%20evolution/evolution%20stakeholder%20expectations%20of%20an%20audit.a.shx> accessed 12 June 2016.

creditors in making decisions in their capacity as capital providers. This could include information about the general level of debt, or timely payment of invoices.⁹¹¹ As far as employees are concerned, the proposed auditable human capital information could include the total cost of the workforce employed (inclusive of contingent labour), recruitment costs, total investment in training, and development and employee engagement survey scores.⁹¹²

The suggested model draws on the work of Flint, who argued that a preoccupation with accounting number-oriented auditing has obscured a realisation of the social purpose of auditing.⁹¹³ Flint argued that it is desirable that auditors take into account the interests of other stakeholders while performing their public function. Flint also provided some arguments for the extended accountability of auditors. To begin with, he insisted that when individuals engage in performing a public function, mainly in the provision of a professional service, they must be accountable for efficiency and effectiveness with which the service is delivered.⁹¹⁴ Furthermore, he argued that where a party produces an account, or information, which is publicly available and which is known to be used or to be relied upon by an identifiable group, a constructive relationship of accountability is created. Despite the fact that such a relationship is not legally constituted, it is real in

⁹¹¹ A welcome change in this direction can be found in the recent Reporting on Payment Practices and Performance Regulations 2017. It introduced a new transparency requirement that is intended to promote a culture of better payment practices. According to the Regulations, all large UK companies and LLPs, which exceed certain size threshold, now have to report on their payment policies and practices and report on performance against their policies twice a year. Specifically, each business is required to publish among others: standard payment terms; average time the business has taken to pay suppliers, from the invoice date; details of the proportion of invoices that have been paid by the business beyond the agreed terms; how much late payment interest has been paid and is due to be paid by the business to the supplier. The rationale for this Regulation is to tackle a widespread problem of late payment of the invoices, which can be particularly burdensome for small suppliers to larger corporations.

⁹¹² Evidence suggests that employee engagement is positively linked to an organisation's financial performance, available at <http://www.valuingyourtalent.com/for-external-stakeholders/external-perspectives/towards-standardised-measures#> accessed 13 June 2016.

⁹¹³ Flint (n 3) p. 24.

⁹¹⁴ Flint (n 3) p. 26.

practical terms and should be respected.⁹¹⁵ Accordingly, it is likely that under the proposed regime auditors' accountability would increase, as auditors would be reporting on information vital not only for shareholders, but also stakeholders, such as employees and creditors, and as such they would be responsible for the quality of the service provided to these parties.⁹¹⁶

As far as the subject and scope of audit reports are concerned, another issue that requires attention is the problem of the expectations gap. A failure on the part of auditors and audit-policy makers to recognise the social dimension of an auditors' work and to respond to legitimate societal pressure, results in frustration of the social purpose of audit and the emergence of the expectation gap. The expectation gap can be damaging, as it produces unrealistic expectations of audit and leads to the overall disappointment with its value. In the following paragraphs this thesis proposes steps that need to be taken to strengthen public confidence in the audit approach and to increase auditors' social accountability.

As chapter four argued, the auditors' role defined by law and standards is to provide an opinion as to whether the financial statements give a true and fair view of the financial health of a company. The auditors' role is not to detect fraud or provide an absolute

⁹¹⁵ Flint (n 3) p. 24.

⁹¹⁶ As an alternative, Burton suggests that increased accountability could be satisfactorily achieved through the development of legal standards and enforcement through the legal process. He points that once social accountability becomes a norm; it would be applied by the courts and would become part of the legal structure of the reporting environment; in John C. Burton, 'Symposium on Ethics in Corporate Financial Reporting' (1972) 133(1) *Journal of Accountancy* 46, p. 49. Mautz, on the other hand, claims that functioning of the independent audit is resolved ultimately by social consent. He argued that '...Society either accepts or rejects the role that a professional group assumes for itself; in time the group either finds a role acceptable to society or the group disappears. As conditions and apparent needs change, society may reject roles formerly considered acceptable so professional groups must continually be alert to the desirability of role modification and revision', in Robert Kuhn Mautz, 'The Role of the Independent Auditor in a Market Economy' (1975) (unpublished background paper for the AICPA Commission on Auditor's Responsibility), p. 2.

assurance or guarantee that the financial statements are correct. According to the ISA 240 applicable in the UK:

An auditor conducting an audit in accordance with ISAs (UK and Ireland) is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISA.⁹¹⁷

Neither of the terms ‘reasonable assurance’ nor ‘material misstatement’ has been precisely defined, and hence the auditor’s responsibility to find fraud depends on particular interpretations of these terms.⁹¹⁸ In the US, the standard on responsibilities and functions of the independent auditor states that:

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.⁹¹⁹

The primary responsibility for fraud policing lies with the board and it is part of the directors’ fiduciary obligation to protect a company’s assets. The auditor’s role is centred on planning and performing his work in such a way as to have a reasonable expectation of detecting material misstatements. Fraud, by its very nature, is very difficult to detect,

⁹¹⁷ IFAC Handbook, International Standard on Auditing (UK and Ireland) 240, The Auditor’s Responsibilities Relating to Fraud in and Audit of Financial Statements, p. 3.

⁹¹⁸ Power (n 15) p. 23.

⁹¹⁹ AS 1001 Responsibilities and Functions of the Independent Auditor

as it requires forgery, collusion, and management overriding the control systems. Placing a duty to detect fraud on the auditor is not a solution, as he will never be able to guarantee that no such fraud has occurred.⁹²⁰ This thesis suggests that a better safeguard against some categories of fraud and poor quality audits would be carrying out more extensive audits.

The financial crisis of 2008 has shown that there are many concerns related to the current standards of financial reporting, particularly to increased inherent volatility of accounting numbers. According to Humphrey, the valuation methods contained both in the US GAAP (FAS 157) and international accounting standards such as IAS39, which were drafted during the times of stable markets, are difficult to apply to volatile and highly illiquid assets currently held by the banks.⁹²¹ Moreover, these methods of valuation require exercising professional judgement. Using judgement in relation to the verification of valuations and the materiality of assessments causes further problems with regards to the transparency of the audit practice, due to its lack of visibility.

It is suggested that audits should not operate on a simple pass or fail basis, where almost all the companies pass every year. Large companies' audit reports should be more extensive and perhaps even contain a more nuanced grading system in order to provide a more complete picture. It would be beneficial if audit reports could include more details and frequent inclusion of commentary about the risks of misstatement; explanations of changes to the audit approach, materiality or risk assessment over time. In the banking context, audit reports should analyse risks, particularly in relation to complex financial instruments, the evaluation of which is exceptionally difficult. Perhaps the reports should

⁹²⁰ Report of the Committee on the Financial Aspects of Corporate Governance ('The Cadbury Report'), London: Gee, 1992, par. 5.24.

⁹²¹ Humphrey (n 2) p. 818.

also make clear that a company engaged in aggressive, though legal, accounting. The rationale behind it would be to get far greater information, to spread knowledge, and make the stakeholders and potential investors familiar with the exact findings of audits. It would also enable these parties to compare companies in a more consistent manner.

One step towards better audit reports was taken by the Financial Reporting Council, which introduced new reporting requirements for the financial years beginning on or after 1 October 2012. In the UK, auditors are now required to comment on particular risks that companies encounter and to explain what they did to manage these risks. They are also expected to discuss which parts of a company they audited, to communicate what figure they deemed to be the lower limit for materiality, and to provide explanations as to how they arrived at this number. One concern raised regarding British rules is that they might be filled with ‘boilerplate’, providing little useful information.⁹²² It will be interesting to see the long-term impact of extended audit reports, but this is surely a good start to give firms opportunities to indicate just how diligent they have been.

Many in the auditing profession respond to criticism that audit was ‘the dog that didn’t bark’ at the onset of the financial crisis 2008 by claiming that it followed all the necessary rules.⁹²³ Adding new rules and imposing a duty to detect fraud in the hope that these will be sufficient to catch the next set of follies is likely to be less effective than reorganising the auditing practice under the suggested regime and inspiring the profession to value transparency, accountability and public interest. The proposed model can also be

⁹²² Citi Research spotted boilerplate in several audits conducted by the PwC. Each of them highlighted the same risks, potential fraud and potential overriding of internal controls, in Floyd Norris, ‘Holding Auditors Accountable on Reports’, The New York Times, available at http://www.nytimes.com/2014/05/09/business/holding-auditors-accountable.html?_r=0 accessed 17 June 2016.

⁹²³ Paul Buddery, Steven Frank and Martin Martinoff, ‘Enlightening Professions? A Vision for Audit and a Better Society’, ICAEW 2014, available at <https://www.thersa.org/discover/publications-and-articles/reports/.../Download> accessed 17 June 2016.

beneficial in decreasing the concentration of the current audit market. The next section will further explain this issue.

6.2.3. INCREASED CONCENTRATION OF THE AUDIT MARKET

The mandatory nature of public company audit contributes to the fact that the demand remains inelastic. The supply side, however, is limited to the biggest first tier audit firms. There are numerous explanations for this phenomenon, most notably a high barrier to entry for the mid-tier audit firms. Smaller audit firms are considered to lack the resources to provide audits for the largest listed companies. The Big Four audit firms are claimed to be better, and more experienced in handling big and complex clients operations, due to their technical capabilities, industry specialisation and expertise. Consequently, allowing a second-tier audit firm to audit a large public corporation could be potentially risky as a result of high cost of resources needed to perform audits for the largest organisations. According to the Oxera report, however, the majority of the surveyed corporations believed that mid-tier audit firms are technically capable of conducting audits in big corporations, but less than 10 per cent would actually consider using a mid-tier firm. This could be due to the reputation, which is considered a significant driver in the choice of auditor, ‘favouring the Big Four, whether this is based on real or perceived differences between the Big Four and mid-tier audit firms.’⁹²⁴ This implies that large corporations choose audit firms not necessarily because of their capability and price, but because of their reputations among the investing public.

⁹²⁴ OXERA (n 734) p. 3.

Another problem caused by the highly concentrated audit market is the lack of real choice of audit providers. In some sectors, such as insurance and banking, concentration is even higher than usual and the choice even more limited. In the UK, for example, only three out of four audit firms provide audits for banks. This could be of concern to companies requiring an industry-specialist auditor. Furthermore, the choice of these companies would be considerably limited, especially if they wanted to avoid the auditor of a competitor.

The suggested model could improve the concentration of the audit market by empowering the external public body to have a central capacity to procure audit. Auditors would then be chosen from among the in-house, first-tier, and mid-tier audit firms based on the competence and capabilities of individual firms. This would lead to a situation where audit committees would no longer be reliant on reputation and the branding of audit firms while making their choices. It would also provide the dual benefit of increasing auditor's independence, and increasing competition in the market.

6.3. CONCLUSIONS

The model proposed in this chapter provided an example of the structural overhaul of the external audit model, which moves audits to the public domain. The rationale behind this proposal is to alleviate the problems of the current audit model discussed in the previous chapters, reinstate the independence and watchdog function of auditors, provide better quality audits and restore public confidence in the capital markets. A key function in this model is played by an external, public body - the Public Auditing Board, which is in charge of appointment and remuneration of auditors carrying out audits in the public interest.

The model provides solutions to the problems analysed in chapter four, such as independence, accountability deficiencies, and excessive concentration of the audit market. It deals with independence issues in two ways. First, it addresses the ‘mother of all conflicts’ problem that arises when an audited company chooses its own auditor and pays audit fees. In the proposed model, managers no longer have any influence on the appointment and remuneration of auditors, as this becomes a prerogative of the Board. Second, auditors are not allowed to provide consulting services to the companies they audit, which secures maximum perceived independence.

Presently audit firms are granted a public franchise to conduct audits, but with conflicting private sector pressures.⁹²⁵ The proposed model holds that applying the public sector audit model for listed company audits is worthwhile, as there is a strong public interest in the efficient and effective audit of private sector companies, which can be commissioned by independent auditors working for an independent auditing body. The new model suggests certain improvements to tackle the issue of accountability deficits. To begin with, it focuses on structural reform, eliminating conflicts of interest and pervasive incentives inherent in the present arrangement which would enable auditors to conduct audits of better quality. This, in turn, should decrease auditors’ exposure to claims of negligence. To follow, the new model addresses the financial aspects, not only of shareholders, but also other core stakeholders such as employees and creditors. Following Flint, it argues that auditors should consider the interests of other stakeholders, whilst performing their public function. Furthermore, it also suggests extending the scope and subjects of audits, by requiring auditors to provide more elaborate and descriptive information regarding, for example, risks of material misstatements or the concept of materiality. Under the

⁹²⁵ Sikka (n 6).

proposed regime, the problem of excessive concentration of the audit market could be tackled by enabling the PAB to award audit contracts, not only to auditors from its in-house practice, but also to first-tier and mid-tier audit firms based on their capabilities.

CHAPTER 7. CONCLUSIONS

The integrity and public confidence in the market depend on the availability of timely and trustworthy accounting information on company financial performance. An assurance function of audit should be an essential part of the framework that supports our capital markets.⁹²⁶ However, numerous well-publicised accounting scandals, climaxing in the 2002 bankruptcy of Enron, and the financial crisis of 2008 encouraged the scrutiny of the basic auditing model. This thesis argued that the current audit model is fundamentally flawed and fails to perform its purpose of providing assurance and increased confidence in the audited financial statements. The thesis also suggested a regulatory overhaul in order to restore confidence in capital markets. The purpose of this chapter is to bring together the analyses from the previous chapters.

One of the most interesting findings of this thesis relates to the theoretical framework for auditing. Despite the importance of audit for capital markets and society, there has not been much interest in the study of its theoretical underpinning. The purpose of audit remains unclear and there is very little known of what is now called ‘field work’ in auditing. In order to clarify these issues, the thesis focused on the works of Limpberg, Mautz and Sharaf, Flint and the agency cost theory in its analysis of the theoretical framework for auditing. Following Limpberg, the importance of auditors’ independence, and that audits should adjust to the changing needs of the society, have been emphasised throughout the thesis. Furthermore, building on Flint’s work, the thesis argued that auditors should do more than merely provide an opinion on financial statements. As auditors fulfil the social function of protecting capital markets, audits should be

⁹²⁶ Michael Power, ‘Auditing and the Production of Legitimacy’ (2003) 28(4) *Accounting, Organisations and Society* 379, p.380.

performed for the benefit of numerous stakeholders, who have an interest in the audited financial statements.

The studies on regulation of audit draw significantly upon financial reporting literature. Although the latter is vast, with its focal point on political science and business, it concentrates mainly on accounting rather than auditing studies. There is not much literature that considers audit regulation in a comprehensive way. The thesis attempted to fill this gap by providing an analysis of the regulatory framework of auditing. It provided answers as to why, how and by whom audit is regulated. Perhaps the most interesting finding is that none of the general theories of regulation fully explains the reasons for the existing regulation of audit. The evidence shows that auditing theory changes in response to government regulation, which is usually altered after major accounting scandals. This goes some way towards explaining why the current regulation of audit lacks a strong theoretical grounding and is reactionary.

Another finding contributes to the debate as to how audit is regulated. Most of the studies are centred on the advantages and disadvantages of rule-based versus principle-based regulation. The thesis, however, indicated that it is difficult to favor one approach over the other, since both can be useful in the regulatory process. Moreover, regulators' efforts should be refocused on eliminating pervasive auditors' incentives to acquiesce to managers' demands and encouraging auditors to use their judgement transparently and with integrity. This would provide true independence to auditors and enhance the quality of audits, irrespectively of the type of regulation.

The thesis also examined a variety of players that participate in audit regulation. The evidence indicates that alongside the general increase in regulation, states are progressively more involved in the area of audit governance via institutions such as the

PCAOB and the FRC. The thesis also argued that whilst discussing regulatory players one should not forget about the big audit firms, which are powerful lobbyists with significant influence on governments and international financial institutions. This is important, as according to the capture theory, it may lead to the profession's control of the regulatory process and negatively affect the independence of the regulator and the quality of audits.

In order to support the main claim of the thesis, that the audit model is flawed, a considerable part of the thesis covered the analysis of the problems inherent in the audit model. The thesis focused on three areas, which, according to the literature in this area and author's perspective, have been particularly problematic in the current audit arrangements. These are: lack of auditors' independence, accountability deficits, and excessive concentration of the audit market.

As far as independence is concerned, the research findings indicated that the UK and the US auditing systems fail to deliver true independence. According to the AICPA Council, 'Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature'.⁹²⁷ Independence is also a sole justification for the existence of accounting firms. The current auditing system institutionalizes at least two potential threats to independence. Firstly, there is an inherent conflict of interest in the audit model originating from the fact that auditors are hired, paid, and fired by the companies. Clients, who have the ability to select their auditors, have many reasons to choose an audit firm based on the likelihood that the auditors will deliver a clean audit opinion. The fact that the probability of a client changing auditors increases following a critical audit report is

⁹²⁷ Carey (n 888) p. 182.

likely to reduce the auditor's desire to issue such a report.⁹²⁸ This, in turn, affects auditor's independence.

Another threat to auditor's independence is the provision of consulting services. Over the years, consulting has grown to become a significant source of income for audit firms. The increasing use of MAS could potentially compromise auditors' independence firstly by making the auditor vulnerable to economic pressures from audit clients and secondly, by creating an interest in a certain result of the audit work, i.e. by putting the auditor in a position of auditing his own non-audit work.⁹²⁹ The empirical evidence, however, is inconclusive as to whether providing consulting services affects auditors' independence. It is doubtful, though, from an independence standpoint, that the perspectives required to perform non-audit services are compatible with the strict objectivity and allegiance to public interest required of statutory auditors. Finding new and innovative ways to further the client's business goals and maximize its returns on investment are not particularly conducive to the objective, public-oriented mind-set required of auditors. The findings show that this movement has been economically driven and reflects the declining role of audit within practice.

Another clear finding of the thesis is that auditors suffer from accountability deficits in three areas: legal, professional, and social. The decline of the profession in the legal sphere lies paradoxically at the heart of the profession's lobbying activities on auditor's liability. First of all, it is very difficult for clients and non-clients to sue auditors for negligent audits. Secondly, due to the introduction of proportionate liability in the US, and limitation liability agreements in the UK, auditors can now decrease the amount of compensation that can be owed to those harmed by negligent audits. The introduction of

⁹²⁸ Moore (n 498) p. 13.

⁹²⁹ Freier (n 752).

the Limited Liability Partnership and elimination of vicarious liability of partners made the auditors' situation even more shielded. As Joseph Stiglitz has written:

Any incentive scheme involves carrots and sticks. There were plenty of carrots encouraging the accounting firms to look the other way. Traditionally, there had been one big stick discouraging them. If things went awry, they could be sued... In 1995, (US) Congress... provided substantial liability protection for the auditors. But we may have gone too far: insulated from suits, the accountants are now willing to take more 'gambles'.⁹³⁰

Also, disciplinary sanctions imposed by professional associations of accountants are not sufficiently severe to deter acquiescent auditors. The sanctions usually involve relatively small fines and admonishment. Hardly ever an accountant is expelled or suspended from the professional association. The occasional legal penalty and punishment of corrupt individuals are inadequate solutions to a systemic problem within the institutional structure of auditing. Consequently, this apparent success in the legislative and political spheres makes the auditors undeterred and unaccountable, and can lead to poor quality audits and the irreparable damage to the core economic interests of the accountancy profession.

Auditors also suffer from social accountability deficits, despite the fact that they have a duty to perform their function with a view of protecting public interest. This thesis argued, following Limperg and Flint, that audit function should not be reduced to lending credibility to the financial statements, but that auditors should become guardians of capital markets and public interest. The social accountability of auditors is also problematic when defining the function of audit. Auditors claim that their sole

⁹³⁰ Joseph Stiglitz, *The Roaring Nineties. Why We're Paying the Price for the Greediest Decade in History* (Penguin Books, London 2003), p. 136.

responsibility is to provide an objective opinion on whether the financial statements present a true and fair view of the financial condition of their clients. Society, on the other hand, expects them to detect irregularities, fraud, and to prevent accounting scandals, which cause substantial injury to innocent stakeholders.⁹³¹ This leads to the expectations gap, which is considered a threat to effective corporate governance and the legitimacy of the institutions of auditing.

The research findings indicated that the present, Anglo-American auditing model is flawed. Superficial reform and occasional sanctions are unlikely to fix it. To that end, the thesis explored different theoretical micro and macro audit models, as well as country-specific international options providing ideas for the new regulatory audit paradigm. Following the example of the Audit Commission macro option, the new model suggests the need to move auditing to the public domain in order to protect investors, stakeholders, and the wider community. This arrangement also reduces the aforementioned problems of auditors' lack of independence and accountability, as well as excessive concentration of the audit market. A key function in this model is played by an independent, public body, responsible for the appointment and remuneration of the auditors of the listed companies. In this arrangement, following the French model, auditors would be prohibited from selling consultancy services to audit clients. This way, the true independence of auditors would be restored for the benefit of the stakeholders. Elimination of pervasive incentives would also enable auditors to improve the quality of audits and decrease the litigation level for negligent audits against the profession. The independent appointments would also help alleviate the problem of excessive concentration of the audit market, as the state agency would be capable of procuring

⁹³¹ This was particularly noticeable at a time of the recent financial crisis, when auditors' silence contributed to the losses of depositors and customers.

auditors from among its in-house practice, first-tier and mid-tier audit firms, increasing at the same time the supply of audit services.

This thesis argued that accountability deficits should be tackled by requiring auditors to conduct audits in the interests of a wider group of stakeholders such as employees and creditors, and that audit reports should be extended in order to include more descriptive information related to, for example, risks of material misstatements and the concept of materiality. More detailed and informative audit reports would provide a more complete picture of the financial health of companies, and enable stakeholders to compare companies in a more consistent manner. It can be argued that such dramatic reforms would be very costly. It is submitted, however, that the costs of creating truly independent audits are worthwhile for the stakeholders, financial markets, and for the vast majority of citizens who invest in capital markets, either directly or by means of pension funds. The costs of the reform would be a small price to pay in order to fix the inefficient system, which offers false claims of independence, false assurance to the users of corporate financial statements, and unaccountable auditors.

The real goal of the statutory audit system is not to prevent every single case of inaccurate financial statements, but rather to prevent most instances of misstatements and to deliver high quality audits so that investors and stakeholders are reasonably assured.⁹³² The proposed restructuring of the statutory audit system could provide a long-term solution that enables production of good quality audits, prevents another Enron-type crisis, and strengthens capital markets and the economy.

⁹³² O'Connor (n 499) p. 73.

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