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The Audit Crunch: Reforming Auditing

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THE AUDIT CRUNCH: REFORMING AUDITING

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ABSTRACT

Purpose: A research paper that seeks to stimulate debates about contemporary auditing practices.

Approach: The paper builds a generalised theory of auditing to pose some questions about the basic auditing model, notions of audit quality and the possibility that some transactions cannot be audited in the traditional way.

Findings: It is argued that the basic auditing model is flawed since it makes auditors financially dependent on companies. The conventional approach to 'audit quality' is also incomplete as it pays little attention to the organisational and social context of auditing. It also argues that as companies have diversified into new forms of investment and complex financial instruments, some transactions may be not be capable of being audited in the traditional way.

Research limitations: The paper does not offer a comprehensive critique of contemporary auditing issues. Rather is a focus on some selected issues.

Practical implications: The paper encourages reflections on contemporary practices and offers some suggestions for reforms.

Originality: The paper is a combination of theory, evidence and speculation on contemporary issues.

Keywords: Auditing model, Auditor independence, Audit quality, Banks, Agency theory, Finance capitalism.

Introduction

In market societies, people routinely have to transact with faceless corporations about whom they have little personal knowledge. In such societies, external auditing is promoted as a trust engendering technology with a capacity to promote a particular kind of social order (Power, 1999). It is actively promoted by the state and not only corporations, but significant non-corporate entities are also required by law (e.g. UK Companies Acts) to embrace such technologies. However, confidence in corporate auditing and auditor claims of being able to construct an objective state of the financial affairs of business enterprises are routinely undermined by unexpected corporate collapses, frauds, financial scandals and general crisis of capitalism. At such times, the state, accountancy trade associations and significant others seek to reconstruct confidence in auditing by tweaking institutional structures, regulatory apparatuses, codes of ethics and disciplinary arrangements for errant auditors (Sikka and Willmott, 1995).

Following revelations of frauds and collapse of US giants Enron and WorldCom, the usual flurry of political activity enacted the Sarbanes-Oxley Act 2002 (for a critique see Burrowes *et al.*, 2004), which sought to strengthen auditor independence by introducing some restraints on the auditor's ability to sell consultancy services to audit clients[1]. It also created the Public Company Accounting Oversight Board (PCAOB); an organisation specifically charged with oversight of the auditors auditing US public companies. In the UK, to shore up public confidence in auditor independence, the Auditing Practices Board issued revised ethical standards (Auditing Practices Board, 2004a). The role of the Financial Reporting Council (FRC), the main regulators responsible for accounting and auditing regulation, and its various arms, was strengthened. In particular, an Audit Inspection Unit[2] (AIU) was formed for

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[1] These include prohibition of the provision of book-keeping, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, performing management functions, human resource services, brokerage and investment services, legal services and advocating client's interests in litigation.

[2] For further information see http://www.frc.org.uk/pob/

monitoring of the audits of all listed and other major public companies. The Companies Act 2006 beefed up auditor rights and powers in relation to information from employees, officers, directors and subsidiaries. At the same time issues about the efficacy of the basic auditing model, accountability and governance of auditing firms, the auditability of global businesses and some emerging assets (e.g. complex financial instruments) received scant attention (Sikka, 2004).

Since late 2007, major western economies have experienced a deepening banking and financial crisis arising from subprime lending practices by banks, which in turn has restricted the availability of credit and has led to what has come to be described as a 'credit crunch'. The full extent of the crisis is still unfolding, but regulators have stated that off balance sheet accounting practices have been rife (Daily Telegraph, 20 December 2007; International Herald Tribune, 28 February 2008). Experts believe that many banks have been showing bad debts and investments as good and as a result may have to write-off some US$1.2 trillion[3]. Some banks and financial institutions have collapsed within a short period of receiving unqualified audit opinions (UK House of Commons Treasury Committee, 2008; United States Bankruptcy Court for the District Delaware, 2008). Central banks have been pumped vast amounts of money to bailout distressed banks and provide much needed liquidity to stave off bank collapses and the crisis from spreading to insurance, property and other adjacent markets. Amidst the crisis, attention has focused on the role of auditors because of a deeply held view that "a green light from an auditor means that a company's accounting practices have passed muster … [Analysts] say that auditors, because of in-depth knowledge of complex accounting rules and first-hand relationships with corporate management, are there to push back, examining how executives calculate numbers and assessing the financial health of enterprises." (New York Times, 13 April 2008[4]). Past experience (Sikka and Willmott, 1995) suggests that the accounting industry will seek to manage the crisis by revising

[3] http://news.bbc.co.uk/1/hi/business/7313637.stm
[4] http://www.nytimes.com/2008/04/13/business/13audit.html?_r=1&oref=slogin

accounting/auditing standards and ethical codes[5] rather than undertaking major reforms.

A comprehensive critique of the politics and problems of auditing is beyond the scope of the present paper. However it seeks to encourage debate by focusing on three issues, which are deeply embedded within the current auditing practices. These relate to the appropriateness of the basic auditing model, quality of audits and verifiability of financial statements. The auditing model, it is argued, is fundamentally flawed as it makes auditors' financially dependent upon companies and persuades them to prioritise their own economic interests at the expense of other parties which may have an interest in audits. In professional circles, audit quality is frequently associated with using appropriate techniques. Such a focus neglects the organisational and social context of auditing and thus little attention is paid to how audits are manufactured, or the incentives to auditors to produce good audits. Traditionally auditors have conducted ex-post audits and the main objective has been to verify income, expenses, assets and liabilities, which have generally been the outcome of past transactions. However, the intensification of finance capitalism has produced new complex financial instruments whose value is dependent on uncertain future events and market volatility. It is doubtful that auditors have the requisite expertise to deal with the challenges posed by shifts in capitalism.

To address the above issues, the paper is organised into three further sections. The next section offers some perspectives on company auditing. In particular, it argues that theories supporting the need for external auditing expect auditors to be independent of the company and its directors. Auditors are also expected to have pressures and incentives to deliver good quality audits. The second section addresses three themes outlined above. Firstly, it provides some evidence to support the argument that due to flaws in the basic

[5] US "Board [PCAOB] Adopts New Ethics and Independence Rule Concerning Communications with Audit Committees and an Amendment to its Existing Tax Services Rule", PCAOB press release, 22 April 2008 (http://www.pcaobus.org/News_and_Events/News/2008/04-22.aspx).

auditing models auditors have become financially dependent on companies and cannot deliver independent audits. Secondly, it argues that the association of audit quality with techniques neglects the organisational and social context of auditing. Some evidence is provided to argue that current practices are unlikely to result in good audits. Thirdly, it is argued that the traditional approaches to auditing may not be appropriate for dealing with the consequences of finance capitalism, especially as they thrive on future prices and market volatility. Therefore, it is doubtful that the resulting financial statements can be audited in any objective way. The third section concludes the paper by a summary and discussion of the issues raised. It also sketches out some possible reforms.

Perspectives on Company Audits

Agency theory is frequently mobilised to explain the rationale behind company audits (Benston, 1985; Arnold and de Lange, 2004). The theory (Jensen and Meckling, 1976) is concerned with control and asymmetry of information between the principal (shareholders) and agents (directors). Within the contemporary context of a separation of ownership and control, it is assumed that shareholders have delegated wealth to directors with instructions to maximise shareholder wealth. The successful achievement of this objective secures financial rewards for directors. However, directors can maximise their personal welfare at the expense of shareholders by presenting optimistic or even misleading financial statements. Since the agent or directors have control of information and their activities are not easily observable by shareholders, we have a classic moral hazard problem i.e. shareholder does not know the honesty and objectivity of the accounts presented. Within the agency framework, the conflict between principal and agent is managed through a variety of incentives, bonding and monitoring arrangements. One of these is to require companies and their directors to submit to an annual audit by expert auditors who are independent of the agents and able to construct an objective state of corporate affairs. In principles, such audits could be conducted by shareholders, but they may not have the necessary expertise. Therefore, shareholders seek to hire expert labour in the guise of independent

auditors. The auditors, it is argued, have incentives to behave honourably because misbehaviour can erode their reputational capital and capacity to earn economic rents. Typically, the auditors are constrained by a variety of liability arrangements which can impose substantial penalties upon them (Benston, 1985; Watts and Zimmerman, 1983).

Agency theory does not offer guidance on what an 'expert' is and how claims of expertise are enacted since these are shaped by broader social power and politics. It s widely acknowledged that through a variety of strategies accountants have mobilised the state to advance their credentials as experts and secure control of the external auditing jurisdiction (Larson, 1977; Johnson, 1982; Robson and Cooper, 1990). As independent experts, auditors claim to be able to mediate uncertainty and construct an objective account of business affairs to enable shareholders and significant others to manage risks. This construction of reality is legitimised by appeals to a variety of standards, benchmarks, techniques and bodies of knowledge, but such claims are precarious as they are routinely undermined by periodic scandals, crisis, frauds, emergence of new technologies, patterns of trade and changes in capitalist economies.

The above model of auditing is legitimised by the state and legislation (e.g. UK Companies Acts) requires all companies of significant size to submit to compulsory annual audits and publish audited accounts. This model is also exported from western to non-western countries (Bakre, 2005; Dedoulis and Caramanis, 2007). Agency theory whilst useful in explaining the rationale for external auditing does not explain how auditors might be appointed. In contemporary societies, individual shareholders are too diverse and rarely have the time or the inclination to directly recruit auditors. In any case, there is little public information about auditing firms, their mode of work, audit contract, composition of audit teams and relationship with directors, to enable informed choices to be made. Managers of institutional investors are more focused on securing a return on their investment because their own performance is judged by this measure. They are more likely to churn markets rather than become directly involved in selection and surveillance of auditors.

In common with tax, customs, health and safety, hygiene, immigration and other inspectors, company auditors could be appointed by the state, but the dominant neoliberal ideology limits its role in the economic sphere (Harvey, 2005). Under such circumstances, companies, in effect company directors, search and select auditors though their final appointment may be rubber-stamped by shareholders at annual general meetings. There is a concern that directors may shop for audit opinions and prefer to hire more compliant auditors (Lennox, 2000).

In market societies, auditors are remunerated by the client company rather than by an independent body. This, inevitably, makes them dependent upon directors for their fees and profits. Auditing firms may legitimise their status by appealing to 'professionalism', but in common with other capitalist enterprises they seek to increase profits and market share. As Hanlon (1994) notes, within major accounting firms the "emphasis is very firmly on being commercial and on performing a service for the customer rather than on being public spirited on behalf of either the public or the state" (p. 150). Auditing firms have used their control of the auditing markets to colonise adjacent markets to sell consultancy services to audit clients. The profit motive informs the dynamics of accounting firms. As a partner of a major accountancy firm put it, "a firm like ours is a commercial organization and the bottom line is that …... first of all the individual must contribute to the profitability of the business. In part that is bringing in business but essentially profitability is based upon the ability to serve existing clients well" (Hanlon, 1994, p. 121). In essence, the auditing model requires one set of entrepreneurs (auditors) to watch over another set of entrepreneurs (directors). The success of both is measured by revenues, profits and market shares rather than by pursuit of any broader social goals.

The commercialisation of audits produces fault-lines. It makes auditors dependent upon company directors for their fees and as a result they may not be able to retain sufficient distance to deliver independent audits. They may also develop strategies that maximise auditor profits, possibly by performing less stringent audits or by developing strategies which increase private profits

but reduce audit quality. The quality of audits is dependent not only on the technical skills of audit teams, but also on organisational values and labour processes embedded within auditing firms. Firms may train and educate their staff, but there is no guarantee that staff will necessarily subscribe to the values and pressures imposed upon them. Within the agency theory framework, such tendencies can be checked by a variety of incentives and pressures, including stringent liability arrangements. However, the extent of liability arrangements depends on power and politics. Auditing firms have incentives to mobilise their resources to dilute liability, especially as the arrangements can have significant effects on their profits. An examination of the social and organisational context of auditing should be a key element of any exploration of audit quality, but this is rarely the case.

In capitalist societies, all economic surpluses need to be accounted, allocated and distributed to the absent capitalists. In this context, auditing processes 'watch over capital', checking and controlling the processes associated with the enlargement of capital (Johnson, 1982). Such processes require constant vigilance, especially as capitalism mutates. In the era of mercantilism and industrial capitalism, auditors developed technologies for ex-post verification of financial statements that primarily relied upon past transactions to verify income, expenses, assets, liabilities and other components of financial statements. However, the shift to finance capitalism poses numerous challenges as property rights and profits are derived from intellectual property, speculation and complex financial instruments whose value is dependent upon future market volatility. In a globalised economy, money itself is valued as a commodity and bears little relationship to the real economy. Due to technological changes money can almost instantaneously roam the world. The changes in the nature of capitalism pose new challenges to the value of ex-post audits and traditional auditing technologies. Yet the broader social context of auditing does not form any part of auditing education (Sikka *et al.*, 2007) or the regulatory reports (PCAOB, 2007a, 2007b,2007c, 2007d).

AUDITING PRACTICES

This section engages with three key issues: flaws in the current auditing model which make auditors financially dependent upon companies; the neglect of organisational and social context of auditing in discussions of audit quality; and some challenges posed by intensification of finance capitalism.

The Auditing Model

The contemporary auditing model makes auditors dependent on companies and their directors for fees and profits. As a result, auditors may become too subservient to directors and even 'bend the rules' to accommodate directors (Sikka, 2008a). One commentator noted that "In the Enron debacle, one of the most disturbing disclosures was that Arthur Andersen's technical accounting experts were overruled by the engagement partners in Houston, allowing accounting decisions to be approved even though Andersen's experts knew they were wrong" (New York Times, 26 March 2008[6]; also see Powers Jr. *et al.*, 2002). Such concerns have again been given visibility at New Century Financial Corporation, the second largest originator of sub-prime residential mortgage loans in the US, which collapsed in early 2007 (United States Bankruptcy Court for the District Delaware, 2008). The court appointed insolvency examiner's report drew attention to the perennial concerns about auditor closeness to clients. The report (p. 9) stated that

> "KPMG's [audit] engagement team acquiesced in New Century's departures from prescribed accounting methodologies and often resisted or ignored valid recommendations from specialists within KPMG. At times, the engagement team acted more as advocates for New Century, even when its practices were questioned by KPMG specialists who had greater knowledge of relevant accounting guidelines and industry practice. When one KPMG specialist persisted in objecting to a particular accounting practice ... an objection that was well founded and later led to a change in the Company's practice - the lead KPMG engagement partner told him in an email: "I am very disappointed we are still discussing this. As far as I am concerned we are done. The client thinks we are done. All we are going to do is piss everybody off".

[6] http://norris.blogs.nytimes.com/2008/03/26/when-auditors-cave/

In 2006, three auditors from the Japanese firm of ChuoAoyama PricewaterhouseCoopers were given a suspended prison sentence for their role in accounting fraud at Kanebo Limited, a major cosmetics and textiles company. In 2004, the company admitted to falsifying financial statements for the previous five years and inflating its earnings by around 200 billion yen (US$1.37 billion; £723 million). For 2002, the company reported net assets of 926 million yen ($7.9 billion) but actually was over 80 billion yen in debt. Three auditors helped the company to meet its targets by helping directors to falsify earnings of 200 billions yen. They not only turned a blind eye to the falsified books and certified them, but also worked with the Kanebo executives to produce false consolidated financial statements to cover-up losses[7] (BBC News, 29 July 2005[8]; The Japan Times, 2 September 2006[9]; Accountancy Age, 1 August 2007[10])

The cosiness of auditor-client relationship has also been documented in other episodes. For example, a UK government report (UK Department of Trade and Industry, 2001) on the frauds perpetrated by the late tycoon Robert Maxwell (RM) at his business empire drew attention to an audit strategy memo written by the audit partner of Coopers & Lybrand (now part of PricewaterhouseCoopers). It told audit staff (p. 62) that

> "The first requirement is to continue to be at the beck and call of RM, his sons and his staff, appear when wanted and provide whatever is requested. The second requirement is … to continue to avoid making errors in exceptionally difficult and exceptionally demanding circumstances".

The report concluded that auditors

> “consistently agreed accounting treatments of transactions that served the interest of RM and not those of the trustees or the beneficiaries of

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[7] In June 2006, Japanese regulators ordered ChuoAoyama PricewaterhouseCoopers to suspend part of its statutory auditing services for two months. Subsequently, the firm changed its name but many clients deserted and it was forced to fold its operations (Sikka, 2008a).
[8] http://news.bbc.co.uk/1/hi/business/4727691.stm
[9] http://search.japantimes.co.jp/cgi-bin/nb20060902a1.html
[10] http://www.accountancyage.com/accountancyage/news/2195394/misuzu-operations-formally-halt

> the pension scheme, provided it could be justified by an interpretation of the letter of the relevant standards or regulations" (p. 328)

The consequences of fee dependency affect medium-size auditing firms too. Consider the case of Versailles Group Plc, a UK company initially listed on the Alternative Investment Market (AIM), a junior stock exchange in London. The company specialised in the provision of trade finance and collapsed in December 1999 amidst allegations of fraud. In 2004 the company's founder and chairman was convicted of fraud and sent to prison for six years[11]. Attention also focused on Messrs Nunn Hayward, a medium-size firm which had held the office of the auditor since the inception of the business in 1990. A disciplinary report by the UK accountancy profession (Joint Disciplinary Schemes, 2004) noted that

> "The financial statements of Versailles for the year ending 28th February 1996 were sent by Mr Clough, the Finance Director, to the shareholders, filed with AIM and approved by the shareholders at an AGM before Nunn Hayward had completed its audit. Although Nunn Hayward question whether the audit certificate was false, in our judgment it plainly was because on its face it purported to have been provided by Nunn Hayward when in fact it had not been. The point taken by Nunn Hayward is that when in fact they completed their audit work they did approve the financial statements in the form originally filed and bearing a purported audit certificate. Mr Clough informed Mr Dales[12] that he had hoodwinked the Board into believing that the audit had been completed. The matter was discussed between Nunn Hayward's partners and they properly obtained advice from Solicitors Messrs Druces and Attlee who were informed by Mr Dales that the Finance Director had "done a wobbly". This is to be contrasted with the admitted deliberate act of hoodwinking the Board. Messrs Druces and Attlee gave advice and referred to the auditors' right of resignation but Mr Dales said that this was a big fee account and that his firm did not want to resign. The audit had not been completed earlier by Nunn Hayward because Versailles had been unable to provide access to basic documentation in spite of requests. The actions of Mr Clough should have been regarded by competent auditors as a fundamental breach of trust. Whereas Nunn Hayward did call for advice from Solicitors, Mr Dales and the firm seem to have accepted the view expressed by Versailles's legally qualified Company Secretary that "*although clearly there was a problem it was largely a technicality*

[11] http://news.bbc.co.uk/1/hi/england/southern_counties/3787901.stm; also see The Guardian, 26 May 2004.

[12] Thomas Peter Dales was the partner in-charge of the Versailles Audit.

> *provided that the audit could be completed without any adjustments being necessary to the accounts*. In fact Nunn Hayward signed their audit certificate on unchanged financial statements after little further work. Mr Nunn [another partner] carried out a "hot review". Although Druces & Attlee were advised by Nunn Hayward that Versailles were prepared to provide an indemnity and to circulate a notice with the papers for the necessary Extraordinary General Meeting explaining the circumstances and fully exonerating them, and although Druces & Attlee agreed a form of wording with Versailles, in fact no indemnity was provided and the final company circular for the AGM contained the words "due to an oversight" rather than the text agreed by Druce & Attlee "due to an oversight at the company". Thus shareholders never came close to being informed of the true situation, and Nunn Hayward adopted a craven attitude designed to minimise damage to Versailles" (Joint Disciplinary Scheme, 2004, paragraphs 50-53).

Unlike employees, pension scheme members, unsecured creditors and other risk-bearers, shareholders have the statutory rights to question auditors at AGMs. They can use the opportunity to elicit information, but whether they get frank replies is another matter. Here is an extract from a UK government report (UK Department of Trade and Industry, 1983) on the collapse of Ramor Investments Limited (formerly Bryanston Finance Limited), a secondary bank. The report (p. 283) contains the following letter written by a Price Waterhouse (now part of PricewaterhouseCoopers) partner in-charge of the audit to the company chairman.

> "Dear Mr. Smith,
>
> As arranged I am writing to let you know in advance of the Annual General Meeting on 26 July the replies I will give if I am asked by a shareholder for the reasons why my firm is not seeking re-election as auditors. If no questions are asked, then of course, no further information in addition to that contained in the Annual Report need be provided.
>
> However, if a shareholder asks further information I propose to reply as follows:
>
> "In recent years we have experienced certain difficulties in obtaining necessary information for our audit and being sure that all relevant explanations have been provided to us. In the final outcome we have been satisfied that we have received all such information and explanation; otherwise this would have been reflected in our audit report. However the situation created by these difficulties caused us to agree with the directors that we would not seek re-election at this

> meeting, a step we are permitted to take under the provisions of the Companies Act."
>
> If there should be a follow-up question asking for more information about the difficulties referred to in the foregoing statement I would propose to reply as follows:
>
> "There was no one matter which in itself caused us to reach this agreement with the directors. In view of this, there is nothing more that can be added to the answer that has already been given"
>
> I would not intend to give any more information nor to respond to any other question.
>
> Yours sincerely"

The auditing model in practice is further complicated by the fact that auditors are permitted to sell consultancy services to their audit clients. This increases auditor fee dependency upon companies and can impair their perceived and actual independence (Briloff, 1990). Mautz and Sharaf (1961) argue that effective independent auditors must have "freedom from client control …be aware of the various pressures, some obvious and subtle, which tend to influence his attitude and thereby to erode slowly but surely his independence. … Non-auditing services result in an identification of the interests of auditors and their clients … (pp. 278-279). Ever since the dawn of modern auditing, there have been concerns about the sale of non-auditing services to audit clients (Chandler and Edwards, 1994) and continue to be repeated (see Gwilliam, 1987 for a review, also see Mautz and Sharaf, 1961; Simunic, 1984; Powers Jr *et al.*, 2002). Such concerns have also been aired in critical reports published by the UK government. For example, a UK government report on the collapse of Roadships Limited concluded that

> "Independence is essential to enable auditors to retain their objectivity which enables their work to be relied upon by outsiders. It may be destroyed in many ways but significantly in three; firstly, by auditors having a financial interest in the company; secondly, by the auditors being controlled in the broadest sense by the company; and thirdly, if the work which is being done is in fact work which has been done previously by the auditors themselves acting as accountants … we do not accept that there can be the requisite degree of watchfulness where a man is checking his own figures or those a colleague .... for

> these reasons we do not believe that [the auditors] ever achieved the standards of independence necessary for a wholly objective audit" (UK Department of Trade and Industry, 1976, paras 243, 249 and 250).

Another report (UK Department of Trade and Industry, 1979) concluded that

> "in our view the principle of the auditor first compiling and then reporting upon a profit forecast is not considered to be a good practice for it may impair their ability to view the forecast objectively and must endanger the degree of independence essential to this work" (p. 271)

The UK House of Commons Select Committee on Social Security recommended that pension fund auditors should not be allowed to carry out non-auditing services for their audit clients (Accountancy Age, 12 March 1992, p 1; *Accountancy,* April 1992, p 18). However, auditing industry has used its considerable financial and political resources to resist the imposition of a complete ban on the sale of consultancy services to auditing clients though some constraints have been imposed by professional and statutory rules (Sikka and Willmott, 1995; also see the Sarbanes-Oxley Act, 2002). The issues, however, continue to resurface. For example, following the bailout of Northern Rock, a UK bank, by the taxpayer, a parliamentary hearing (UK House of Commons Treasury Committee, 2008) examined the sale of non-auditing services by auditors PricewaterhouseCoopers to the bank. The bank had relied upon wholesale money markets to fund its activities, but when the market worsened it came close to collapse and was bailed out by the state. The parliamentary reported concluded

> “We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees[13] largely comprised of fees relating to assurance services in connection with Northern Rock’s actions in raising finance” (UK House of Commons Treasury Committee, 2008, p. 115).

The Treasury Committee urged auditing regulators to consider the ‘independence’ issues. An immediate response from the Auditing Practices Board, an organisation responsible for formulating ethical standards and

[13] Auditors received £1.1 million for auditing and auditing related services.

dominated by major firms, was that it "had consulted widely on risk management and conflicts of interest, and received support from stakeholders for the UK's principles-based approach. There was no appetite among stakeholders for US-style regulation[14]".

Even if professional and statutory rules are enacted to enhance auditor independence, firms have found the lure of profits too strong and have frequently violated the rules on auditor independence (see Sikka, 2008a for some evidence). For example, the US arm of Ernst & Young (EY) had been fined and received reprimands for violation of US rules on auditor independence. Despite promises, it failed to improve compliance with the rules (Sikka, 2008a). Eventually, the Securities and Exchange Commission (SEC) prosecuted because the firm entered into a business relationship with software giant PeopleSoft, one of its audit clients. In a withering court judgement, the judge stated that

> "The overwhelming evidence is that during the relevant period, EY's day-to-day operations were profit-driven and ignored considerations of auditor independence in business relationships with PeopleSoft. EY's partners shared in the pooled revenues of the firm's three practice areas, and each EY partner was evaluated annually on his or her achievement toward five preset goals, one of which was sales. … EY committed repeated violations of the auditor independence standards by conduct that was reckless, highly unreasonable, and negligent. It has not acknowledged that it has committed any violations, and it has offered no assurance that it will not commit violations in the future. … This was not a situation of an isolated mistake or confusion over a complicated, technical issue. These violations occurred over an extended period. They were committed by professionals throughout the firm who exhibited no caution or concern for the rules of auditor independence in connection with business relationships with an audit client. … the firm paid only perfunctory attention to the rules on auditor independence in business dealings with a client, and that EY reliance on a "culture of consulting" to achieve compliance with the rules on auditor independence was a sham. … EY partners acted recklessly and negligently in committing willful and deliberate violations of well established rules that govern auditor independence standards in connection with business relationships with an audit client. EY's misconduct was blatant and occurred after the Commission and a court accepted EY's representations that it would observe the very same

[14] http://www.accountancyage.com/accountancyage/news/2208534/rock-rap-pwc-mps-highlight-3786442

> auditor independence rules …" (US Securities Exchange Commission, (2004).

Ernst & Young were banned for six months from securing any new audit business in the US.

Auditing firms have sought to defend their ability to sell consultancy services to audit clients by arguing that that they have devised organisational structures that separate consulting from auditing, commonly understood as 'Chinese walls', and thus minimise potential conflicts of interests. A report by a US Senate Committee examining the sale of tax avoidance schemes by KPMG noted that the firm's marketing strategies included

> "targeting its own audit clients for sales pitches … KPMG tax professionals were directed to contact existing clients about the product, including KPMG's own audit clients " (US Senate Permanent Subcommittee on Investigations, 2003, p. 4, 9).

After examination of extensive evidence, the Senate Committee stated that

> "KPMG's tax products also raise auditor independence issues. Three of the banks involved in BLIPS, FLIP, and OPIS[15] (Deutsche Bank, HVB, and Wachovia Bank), employ KPMG to audit their financial statements. SEC rules state that auditor independence is impaired when an auditor has a direct or material indirect business relationship with an audit client. KPMG apparently attempted to address the auditor independence issue by giving its clients a choice of banks to use in the transactions, including at least one bank that was not a KPMG audit client. It is unclear, however, whether individuals actually could choose what bank to use. Moreover, it is unclear how providing clients with a choice of banks alleviated KPMG's conflict of interest, since it still had a direct or material, indirect business relationship with a bank whose financial statements were certified by KPMG auditors.
>
> A second set of auditor independence issues involves KPMG's decision to market tax products to its own audit clients. By engaging in this marketing tactic, KPMG not only took advantage of its auditor-client relationship, but also created a conflict of interest in those cases where it successfully sold a tax product to an audit client. The conflict of interest arises when the KPMG auditor reviewing the client's financial statements is required, as part of that review, to examine the client's tax return and its use of unusual tax strategies. In such situations, KPMG is, in effect, auditing its own work" (US Senate Permanent Subcommittee on Investigations, 2003, p. 15-16).

[15] These are acronyms for tax avoidance schemes.

The Senate Committee recommended that the newly formed "Public Company Accounting Oversight Board should strengthen and finalize proposed rules restricting certain accounting firms from providing aggressive tax services to their audit clients, charging companies a contingent fee for providing tax services, and using aggressive marketing efforts to promote generic tax products to potential clients" (US Senate Permanent Subcommittee on Investigations, 2005, p. 8).

Audit Quality

There have been considerable concerns about quality, especially when companies experience unforeseen financial difficulties, or collapse soon after receiving unqualified audit reports (Mitchell *et al.*, 1992; Edwards and Shaoul, 1999; UK Department of Trade and Industry, 1976; 1979, 1983; 2001). A former President of the Institute of Chartered Accountants of Scotland (ICAS) said, "All of the failures we looked into would have been found if anyone other than the audit junior had looked at the bank statements. ….. One public company failed with a £50 million black hole in one of its subsidiaries. The subsidiary had net assets of £5 million – and the auditors did not find it. If they had looked at the bank reconciliation, they would have raised so many enquiries they would have found the black hole. Big firms are no longer carrying out audits. They audit in helicopters and circle clients from a few thousand feet and take pictures. No one gets out of the helicopter and kicks tyres. It's no longer audit, it's more akin to due diligence" (cited in Cousins *et al.*, 2004, p. 14). In a survey, 54% of the Finance Directors of major UK companies felt that the quality of audits had declined noticeably. The views included, "The days when the auditors used to carry out stringent checks are well gone …. These days the auditors ask questions to the company accountant and accept their word ….. Audits try to avoid "dangerous" areas and have more opt-out clauses to put the onus on the management. Many are concerned about the use of audit as a means of getting into a company to sell other services" (Accountancy Age, 6 November 2003).

What counts as 'quality' in auditing is inevitably the outcome of power, politics and social relations (Power, 1999; 2003), but a dominant view is that 'quality' or objectivity is constructed by using appropriate auditing techniques and having a good set of working papers to demonstrate professional judgement (Auditing Practices Board, 2004b). This worldview is deeply embedded within institutions and a variety of auditing standards that require auditors to evaluate internal controls, conduct analytical reviews and make assessment of whether a business is a going concern. Such strategies lay claims to knowledge bases, equate quality with compliance with techniques and rules and portray auditors as experts who can mediate uncertainty and construct an objective state of business affairs. The technicist view of audit quality is further enforced by regulatory reports which list the failure of auditing firms to use prescribed techniques or adopt commonsensical steps (for example, see PCAOB, 2007a, 2007b, 2007c, 2007d).

Regulators pay little attention to social and organisational context of auditing. Little connection is made between the profit motive of accounting firms and how accountants are socialised in serving the clients (Anderson-Gough *et al.*, 2000). Company audits, in common with other products and services, are manufactured within a social and organisational setting, which naturalises worldviews and values and also have unanticipated outcomes. For example, audits are generally labour intensive and within firms there are pressures to increase profits. Individuals are subjected to performance appraisals and often their promotion and financial rewards depend on contribution to profits. Firms can increase profits by charging higher fess, but in a competitive market clients may be able to resist such moves. Firms might use more audit juniors or change the mix of junior and senior staff to reduce costs. An alternative is to squeeze time budgets and expect audit staff to work week-ends and evenings to complete the tasks. Firms may also undertake less stringent audits. A body of research (for example, see Willett and Page, 1996; Otley and Pierce, 1996; McNamara and Liyanarachchi, 2008) has consistently suggested that tight time budgets have dysfunctional effects on audits. Faced with inadequate time budgets, many audit staff admit to adopting irregular

practices, ignoring awkward and time-consuming items, falsification of audit work and what Otley and Pierce (1996) describe as "premature sign-off and other forms of audit quality reduction behaviour" (p. 46). The pressures to come under time budgets, may help to increase profits and mediate internal performance appraisals, but they also pose questions about the relationship between profit and audit quality.

In principle, the pressures to dilute audit quality could be checked by stringent liability laws, but these have also been diluted in recent years. Traditionally, auditing firms have traded as partnerships with each partner having 'joint and several' liability (Napier, 1998). However, as corporate clients and accounting firms grew in size and significance, accountancy firms demanded and secured a series of liability concessions (for details see Cousins *et al.*, 2004; Sikka, 2008b). In the UK, these include the right to trade as limited liability companies and enabling companies to purchase insurance cover for auditors. The House of Lords' judgement in *Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568* stated that generally auditors owed a 'duty of care' to the company only (as a legal person) rather than to individual shareholders. The UK courts have also embraced the concept of 'contributory negligence[16]' to reduce redress against negligent auditors. A UK government inquiry noted that there is little or no "evidence suggesting that the courts in the UK have made, or are liable to make, excessive damages awards against auditors" (Office of Fair Trading, 2004, para. 1.2). However, following their US successes, auditing firms have secured further concessions in the UK as well. The Limited Liability Partnerships Act 2000 further diluted the principle of 'joint and several' liability and possibly reduced incentives for partners to police each other (Sikka, 2008b). In 1995, the US Private Securities Litigation

[16] The principle was applied in the case of *Barings PLC v Coopers & Lybrand [1997] 1 BCLC 427; (In Barings plc (in liquidation) v Deloitte & Touche; Chancery Division 11 June 2003*. The court concluded that auditor negligence was "limited in extent and technical in nature". Most of the losses due to fraud were attributed to mismanagement of Barings by its directors. In October 2003, Mr Justice Evans-Lombe ruled that application of the principles set down in his judgment meant that Deloitte & Touche (Singapore) is liable for only approximately £1.5 million. The original claim brought by the liquidators, KPMG, was for £1.3 billion (also see Accountancy Age, 19 June 2003).

Reform Act enabled accountants and other professionals to negotiate a form of proportional liability and secure limits on their liability to shareholders. The UK Companies Act 2006 also followed suit and, subject to shareholder approval, auditors can negotiate financial limits on their liability with company directors.

The dilution of auditor liability has been cited as a major factor for a number of US audit failures. According to Joseph Stiglitz, former chief economist and senior Vice-President of the World Bank, "there are plenty of carrots encouraging accounting firms to look the other way … there had been one big stick discouraging them. If things went awry, they could be sued … In 1995, Congress adopted legislation intended to limit securities litigation … in doing so, they 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" … (Stiglitz, 2003, p. 136). Amidst the current banking and financial crisis, commentators have noted that court judgements and laws "have raised the bar for proving securities fraud and made it next to impossible for investors to sue parties like law and accounting firms that may have known or assisted in any shenanigans" (Business Week, 13 March 2008[17]). It is difficult to think of any economic theory or evidence that suggests that the raising of liability thresholds or shielding producers of goods and services from lawsuits somehow improves quality of goods and services. Nevertheless, auditing firms are now pursuing a 'cap' on liability (for example see, Accountancy Age, 27 October 2006; Financial Times, 3 October 2006; 19 December 2007).

Auditability

Traditionally auditors have tended to verify financial statements by referring to a variety of evidence ranging from invoices, board minutes, contract notes, costing records and even market values. Such practices are increasingly problematised by transformations in capitalism where tangible things are

[17] http://www.businessweek.com/magazine/content/08_12/b4076000177741.htm

increasingly replaced by intellectual property (patents, logos, trademarks, copyrights, etc.) and complex financial instruments. Companies are keen to improve their reported performance by including such items in their financial statements, but in the absence of active markets it is almost impossible to verify the valuation of company specific intellectual property. Even greater challenges are being posed by instances where there are active markets.

The 1990s are characterised by a major shift (in the Western world) from industrial capitalism to finance capitalism where money itself has become a commodity (Bello *et al.*, 2000; Stiglitz, 2003; 2006; Morris, 2008; Soros, 2008). Due to technological developments, money can easily roam the world. Rather than directly investing in the production of goods and services, corporations make money by placing clever bets (gambling or hedging) on interest rate movements, exchange rates, security prices, derivatives, commodities and land speculation. The outcomes of such bets could be anything from zero (even negative) to several million pounds/dollars and depend upon future events, cash flows, volatility and rapid, often unpredictable, changes in global markets. In addition, there have been major changes in the way banks and financial institutions conduct business. The traditional business of lending money to buy property is no longer seen as a long-term 'investment', but as a short-term 'transaction'. Rather than waiting 25-30 years for repayment of secured loans, banks have resold and repackaged the original loans many times over. Such transactions are underpinned by very few assets and their value is dependent on ever rising property values, plentiful supply of money and cheap credit (Morris, 2008; Soros, 2008). The dynamics of such markets are only partially understood. According to Nick Leeson, the man who brought down Barings bank (Leeson and Whitley, 1996), "the regulators, auditors and compliance officials are constantly playing catch-up. Their understanding and knowledge of the markets and instruments being traded are just not keeping pace" (Daily Mail, 15 September 2007[18]).

[18]http://www.dailymail.co.uk/pages/live/articles/news/news.html?in_article_id=482060&in_page_id=1770

Transformation of capitalism, market volatility and its consequences for auditing practices rarely form any part of professional accounting education (Sikka *et al.*, 2007) even though auditors routinely report on businesses deeply involved in such markets. Consider the case of Long Term Capital Management (LTCM), a US based hedge fund that collapsed in 1998 (Dunbar, 2001). LTCM board of directors included experienced bankers, financiers and Professors Myron Scholes and Robert Merton, joint winners of the1997 Nobel Prize in Economics. They are also credited with developing the 'option pricing theory', a model that takes account of market volatility to derive valuation of complex financial securities (Black and Scholes, 1973; Merton, 1973). LTCM essentially placed clever bets, or arbitraged, on the price of government bonds and corporate securities. It boasted returns of 40% on its investment and always received a clean bill of health from its auditors. In 1998, increased market turbulence due to financial crisis in East Asia and Russia made its financial position uncertain and it was bailed out by the US Federal Reserve in a $3.6 billion rescue operation. Due to market volatility, seemingly solid valuations of financial instruments melt into air. Evidently, even Nobel Prize winners in economics had difficulty in gauging market turbulence and arrive at an objective valuation of complex financial instruments. It is doubtful that auditors are more knowledgeable, or can make better assessment of market volatility to verify valuation of complex financial instruments.

Some questions about the auditability of financial enterprises are once again raised by the current financial crisis emanating from the mortgage lending practices by banks and trade in the related complex financial instruments. Bear Stearns was America's fifth largest bank. It accounts for the year to 30 November 2007 showed net income of $233 million and total assets of $397,091 million, compared to earnings of $2,054 million and assets of $350,433 million the year before. It boasted a return of 18% on its equity. On 25 January 2008, the accounts received an unqualified audit report from its auditors Deloitte & Touche. However, Bear Stearns soon ran into financial difficulties and could not sustain its financial position. The bank was said to be

hours from collapse (The Times, 3 April 2008) and support from the US Federal Reserve, it was bought by JP Morgan Chase for $2 a share[19], valuing the bank at around $240 million. Just a few days earlier, the bank had a share price of $140 and a market value of $25 billion (The Guardian, 17 March 2008).

Carlyle Capital Corporation was a thriving AAA rated $22 billion (£11 billion) hedge fund, registered in the tax haven of Guernsey. Its parent company Carlyle Group had more than $75 billion (£37 billion) under its management. On February 27 2008, Carlyle Capital Corporation published its annual accounts for the year to December 31 2007. These accounts contained an unqualified audit report and were audited by PricewaterhouseCoopers. In the middle of major financial crisis, the accounts noted (p. 5) that directors were "satisfied that the Group has adequate resources to continue to operate as a going concern for the foreseeable future[20]". It is not unreasonable to assume that the available evidence must also have persuaded auditors to corroborate the same. The accounts noted (p. 24) that the company paid $2.5m in fees "principally ... to our independent auditors, our external legal counsel, and our internal audit service provider[21]". However, less than two weeks later, in a press release on March 9 2008, Carlyle Capital Corporation announced that it was discussing its precarious financial position with its lenders. On March 12, the company announced that it "has not been able to reach a mutually beneficial agreement to stabilize its financing. The Company expects that its lenders will promptly take possession of substantially all of the Company's remaining assets[22]" and was placed in liquidation (also see The Guardian, 14 March 2008; The Times, 14 March 2008; Washington Post, 14 March 2008).

With mortgaged debts of over $35 billion, Thornburg Mortgage was America's second-largest independent mortgage provider. On 27 February 2008, its

[19]An investor outcry forced JP Morgan to increase the offer to $10 a share (The Times, 3 April 2008).
[20]http://www.carlylecapitalcorp.com/Financial%20Documents/2007/item10272.pdf
[21]http://www.carlylecapitalcorp.com/Financial%20Documents/2007/item10272.pdf
[22]http://www.carlylecapitalcorp.com/News/Press%20Releases/2007/item10304.html

accounts for the year to December 31 2007, audited by KPMG, were published. They contained an unqualified audit report even though the company was facing large margin calls. On 7 March, a press release by the company announced that "it has received a letter dated March 4, 2008, from its independent auditor, KPMG LLP, stating that their audit report, dated February 27, 2008, on the company's consolidated financial statements as of December 31, 2007, and 2006, and for the two-year period ended December 31, 2007, which is included in the company's Annual Report on Form 10-K for 2007, should no longer be relied upon. As a result, the company's Board of Directors determined that the financial statements for the year ended December 31, 2007, should be restated[23]" (also see New York Times, 7 March 2008; The Times, 19 March 2008). Subsequently, Thornburg Mortgage raised $1.35 billion to manage its immediate crisis (International Herald Tribune, 1 April 2008; New York Times, 2 April 2008). Faced with the relative worthlessness of audit reports one commentator added that "The life-cycle of companies is plummeting … there is no aspect of accountancy or auditing even in these troubled times that addresses human talent and managerial effectiveness. Audit is totally focused on verifying the numbers. It does not seek to measure the things which, as we have just seen, really matter because they really make a difference …the conventional audit is probably no longer worth paying for" (London Evening Standard, 23 January 2008[24]).

SUMMARY AND DISCUSSION

This paper has sought to raise some questions about the appropriateness of the auditing model, audit quality and the auditability of some transactions and businesses. It is common practice for the state to appoint and remunerate auditors for health and safety, hygiene, taxes, immigration and many other fields. In such arenas, auditors are neither directly selected nor remunerated by the auditee. As a result they are independent and are indeed respected and often feared. However, neoliberal ideologies limit the role of the state and

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[23] http://investor.thornburgmortgage.com/phoenix.zhtml?c=117476&p=irol-newsArticle_print&ID=1116530&highlight=

[24] http://www.thisislondon.co.uk/standard/article-23433688 details/It's+still+the+human+element+that+counts/article.do

it is not permitted to directly appoint or remunerate auditors for large companies. Instead, companies and their directors select and remunerate auditors. Such an auditing model is fundamentally flawed and cannot deliver independent or searching audits. The flaws are further compounded by permitting auditors to have direct economic interest in corporate transactions through the sale of consultancy services. The commercialised auditing firms always have to keep an eye on profits and on occasions appease and even collude with directors. They have also been willing to violate rules and laws. Over the years, attempts have been made to delegate the task of auditor selection and remuneration to audit committees and non-executive directors, but these are not separate from the company. In any case, many non-executive directors are dependent on executive directors for their nomination and appointment and cannot easily go against the interests of executive directors.

The contention of this paper is that the current auditing model is flawed and cannot be repaired. One alternative is for the state to appoint auditors of major companies. Following the UK's Local Authority Finance Act 1982, the Audit Commission[25], a state body, has appointed and remunerated auditors[26] for hospitals, local authorities and public bodies (McSweeney, 1988; Kelly, 2003). Auditors are generally banned[27] from selling consultancy services to audit clients. In addition to financial statements, they also have to report on the efficiency and effectiveness of the client. The drafters of legislation also envisaged a similar arrangement for audits of major companies (Heseltine, 1987), but this never came to fruition. Such a system could be selectively applied to large corporate bodies and was envisaged in the 1930s legislation that created the US Securities Exchange Commission (SEC). In the words of Lynn Turner, for chief accountant of the SEC: "when the legislation creating the SEC was first drafted in the early 1930s, it included a provision making the

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[25] Its role was extended and consolidated by the National Health Service and Community Care Act 1990 and the Audit Commission Act 1998.
[26] These can be private accounting firms or auditors appointed by the state.
[27] They are permitted to prepare information for some statutory returns for total fees of £25,000 or less.

SEC the auditor for public companies. Then, at the last minute, the legislation was changed. …Toward the tail end of the Congressional hearings on the Senate side, the head of the New York State Society of Certified Public Accountants – who was also the head of Haskin and Sells – now Deloitte Touche – went down to Washington and testified and convinced the guys to let the CPA firms to do the auditing. The legislation was revised and hence the external auditing function that we have today[28]."

It is feasible for regulators such as the US Securities Exchange Commission (SEC) and the UK Financial Services Authority to directly appoint and remunerate auditors. The regulators could also have a dedicated workforce of auditors focusing on banks, financial institutions and other organisations considered to be sensitive to the economy. Instead of annual ex-post audits, these auditors could conduct continuous audits and attend not only to traditional financial statements, but also to a variety of regulatory matters. There will inevitably be resistance to such proposals on ideological grounds, or the claims that the state apparatuses are somehow more bureaucratic and inefficient. Whilst the proposals may not be a panacea for the problems afflicting the auditing industry, at the very least it can give auditors independence from company directors and may persuade them to adopt more stringent strategies. They can also strengthen regulation of sensitive industries.

Overall, little is known about how audits are produced or manufactured within auditing firms. The contention of this paper is that organisational value systems are a key ingredient of the production of 'quality' and should be examined. The commercial concerns inform every aspect of auditing. This paper has highlighted just two variables which have a bearing on audit quality. These relate to time budgets and auditor liability. It is difficult to see how

[28] Lynn Turner Says Unless Big Four Change, Bring on SEC as Public Auditor 21 *Corporate Crime Reporter* 8, February 14, 2007; available on http://www.corporatecrimereporter.com/turner021407.htm (accessed on 24 March 2008).

commercialised auditing firms can ignore either of these concerns. Regulators could highlight the impact of these and other variables, but they rarely feature in any regulatory report. Public information could help to expose some of the predatory organisational values to public scrutiny, but accounting firms publish little meaningful information about their culture, operations or relationship with company directors. Even if an Audit Commission type of solution (see above) is adopted, some concerns with time budgets would remain as no organisation could commit itself to an open-ended approach. Nevertheless, this need not be constrained by commercial concerns. The liability problems would not vanish with the appointment of company auditors by an independent public body, as they too could be sued for negligence. Some may argue that the likelihood of massive lawsuits would dissuade the state from venturing into the auditing market, but public auditors relating to customs, taxation, immigration, health and safety, etc., can already be sued for negligence and failures, though the claims from audit failure of companies may be much larger. In any case, private sector auditing firms have been driving down their liability and the equivalent liability obligations could be embraced by the state with the added benefit that auditors would be independent of audit clients. There may also be benefits in that the regulators may gain early insights into the problems afflicting banks and financial institutions and may be able to adopt more effective regulatory strategies. Hopefully, a vigorous debate would further explore the issues.

Traditionally auditors have relied upon tangible evidence to verify financial statements. Such approaches are increasingly problematised by shifts in capitalism where money is made through complex financial instruments and clever bets. The value of such contracts depends on future uncertain events in highly volatile markets. The paper drew attention to major financial institutions whose asset values collapsed within days of receiving clean audit reports. Perhaps, the time has come to acknowledge that some aspects of financial statements can no longer be audited by traditional auditing technologies. It may be preferable to provide relevant information to stakeholders and invite them to arrive at their own preferred valuations. Such

developments may be resented by auditors whose ‘professional’ and expert credentials are based upon the claims that they can somehow construct an objective state of business affairs. Inevitably, the future of auditing practices will be shaped by power and politics.

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