

Market Competition and Auditor Independence

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In the past two years, Australia and other jurisdictions have again witnessed a series of unsignalled corporate collapses. As with previous generations of corporate collapse several have been associated with questionable accounting policies and concerns with auditing quality. With the decomposition of the former global auditing firm once known as Arthur Andersen, the implications for the accounting profession are seen as more serious than ever before.

Over many decades corporate community and regulators in Australia and other jurisdictions have implemented change after high profile company failures occur. Some of the implemented changes have, over time, enhanced the quality of auditing but we continue to see unsignalled corporate failures, prompting an ongoing perception that the audit process is not delivering a product of value to the market. This perception has been described as an 'expectations gap', which arises in part because what is expected by market participants is not realistic. However, of serious concern for the auditing profession is the fact that there remain instances where people with clear understanding of audit processes and realistic expectations of audit outcomes raise concerns about audit quality.

This paper argues for the creation of a market-observable audit independence quality control process, developed under the scrutiny of market competition. Such an independence quality control process needs to infiltrate the culture of the audit firm and, critically, to underpin the culture and ethos of the audit processes. Two alternative versions of the model are proposed. One of these involves commissioning regular expert reviews focussed on independence. The second involves each firm that has publicly traded audit engagements establishing an Independence Control Board, composed of respected and knowledgeable individuals not in a position to benefit from the Board's decisions.

The model proposed to quality-control independence represents a 'market-based' solution to the challenges currently facing the auditing profession in that they rely on audit suppliers to have processes visible to the market and to respond to market pressure. The paper argues that a market-based solution is likely to engender efficiencies and transparent quality enhancements that a regulated solution of the type proposed by the Ramsay (2001) Report, the Proposals for Reform Paper No. 9 (CLERP 9) of the Corporate Law Economic Reform Program (2002), and the HIH Royal Commission (2003) will struggle to deliver because of the subtlety and contingent nature of threats to independence.

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The next section examines theories of the demand for auditing. Successive sections then explain the difficulty in evaluating the quality of audit; canvass regulatory proposals to enhance auditor independence; explain some of the workings of the proposed independence quality control processes; analyse why regulating independence will struggle to achieve efficiency, effectiveness and completeness; discuss the effect of independence quality control processes on the audit; and discuss the role of regulators and legislation in successfully implementing the proposed models. The final section summarises our recommendations, provides concluding remarks and discusses potential criticisms of the recommendations.

The Demand for Audit

The demand for audit services is, in many instances, compulsory due to legislative or other regulatory requirement, although there is evidence that without this compulsion auditing would nevertheless be demanded (Watts and Zimmerman, 1983). Theories explaining this demand centre on moral hazard and the need to monitor management as principal in a principal-agent relationship (Wallace, 1987), the desire on the part of shareholders to spread their risk by virtue of the auditor's access to indemnity insurance (Menon and Williams, 1994), and the need of the capital market for credible information in order to assess future cash flows and strike an appropriate security price (Wallace, 1987).

The Value Adding Capacities of Audit

Financial reports of a company are originated by and are the representations of the management and directors of that company. An audit attests to these representations and in Australia assesses the truth and fairness of those financial reports. Many parallel truth and fairness to validity and reliability. This highlights two factors: (i) that financial reports are indeed the representations of management and are not primarily originated by the auditor, and (ii) that it is the auditor's responsibility to attest to the validity and reliability of those reports.

Regardless of the motivation behind the demand for auditing, its value rests on two crucial requirements. First, the attestation needs to be competent. It needs to be undertaken by those with appropriate expertise (which may extend to industry specific, asset/liability or transaction expertise) (Craswell, Francis and Taylor, 1995) and may involve the necessity of having competent audit structures, technologies and processes to undertake the audit. Second, it must be undertaken independent of management. The judgement exercised by the auditor needs to test the assertions made by management and not simply concur with them. Even the insurance hypothesis, which implies that litigation against an auditor will ensue given a situation of investor loss, logically concludes that as a minimum for a successful defence the audit must be both competent and independent.

Financial information that is perceived to be more valid and reliable means it has lower risk, which results in a higher stock price than in the absence of audit.

Credible audits should, therefore, add value to a company and have the potential to affect stock price. By the same logic, higher stock prices should result when a higher quality of audit is delivered, or perceived to be delivered. Similarly, those that trade in debt will attach a different risk premium between companies that are audited and unaudited and those that are audited by a perceived high quality auditor and those that are not.

Thus, despite the high level of regulation in many jurisdictions, the audit product is not homogenous in quality. We observe differences and if one examines both the literature and the websites of many accounting firms, one will see them competing strongly on the basis of quality differences in respect of audit competency. Many accounting firms claim industry specific expertise or other types of competency that quality differentiate them from other suppliers, although there is little evidence that firms quality-differentiate in respect of independence. In at least some cases, the client's requirement for industry specific expertise in supplying of both audit and non-audit services reduces the number of viable potential suppliers and compounds the potential for compromised independence, or at least appearances of this, when both services are concurrently supplied.

Two Pillars of Auditing: Competence and Independence

As argued above, the existence of both competency and independence are necessary conditions for the audit to be a value-adding good; one cannot be a substitute for the other. Core competencies in auditing have been analysed and documented at the commissioning of the professional bodies (Birkett, 1989 and 1992). However, despite the recently updated Professional Statement F1, an accepted definition of auditor and audit firm independence remains elusive. The HIH Royal Commission (April, 2003) recommends that all standards of independence of auditors in Australia, including those contained in legislation and professional standards such as Professional Statement F1, be consistent with a standard of independence defined as follows (Recommendation 9):

An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor's exercise of objective and impartial judgment on all matters arising out of auditor's engagement. A reference to an auditor includes both an individual auditor and an audit firm. In determining whether an auditor or an audit firm is independent, all relevant circumstances should be considered, including all pre-existing relationships between auditor, the audit firm and audit client, including its management and directors.

However, neither actual audit competency nor actual audit independence are easily discernible as the next section explains.

Audit as an 'Experience Good'

Unlike many commodities, an audit is not a 'good' that can be observed *ex ante* and so is an 'experience good' about which observable evidence is gained after it is actually experienced (Craswell and Francis, 1999). This makes auditor choice and the decision about the acceptable price of the audit more difficult than in many other markets. Even after it has been experienced, it is not easy to observe all the qualities of an audit and only those most intimately involved with the auditor may be able to observe key quality-related characteristics. This makes it very difficult for the shareholder — on whose behalf the audit function operates — to discern quality and makes the role of company insiders in putting forward an auditor for shareholder vote of increased importance.

Those intimately involved with the audit will have some limited opportunities to observe aspects of competence. However, there are only rare instances where such people are aware of auditor independence threats and can observe how the auditor deals with them. Therefore, relative to competency levels, quality of independence is difficult to observe even in the most intimate of circumstances. There is a presumption by auditees and those interested in the audit process that independence exists, but its existence is taken on trust rather than having any substantive underlying evidence for belief in it. If this trust is eroded in any way, the outcome is likely to involve scepticism and the depleted value attributed to audit will be more exaggerated than would otherwise be the case. Restoring trust in the current environment hence presents a major challenge for the profession.

An important issue is that while many professional services are 'experience goods', the provision of auditing services is unusual. Generally the provision of professional services (medical services, legal representation and the like) involves direct and full client/provider communication. There is little communication between an auditor and his or her client. More recently there is a fuller communication between the clients' representatives (the board of directors' audit committees where they exist) and the auditor. But even then it is only now that there is active debate which suggests that best practice exists where the auditee (company management) not be present when that communication between auditor and client representative takes place. Further, there has been no suggestion that then there is communication between the auditee management and auditor that the audit committee be present! The absence of a well functioning communication process makes the issues around the 'experience good' even more acute for auditing.

Competing on Competency

As can be observed in the brochures of many accounting firms, from their websites and particularly in their tender documents, audit firms compete vigorously in respect of competency. We observe that certain firms have specifically expert partners or that they have enhanced experience and competency in respect of a particular industry class or classes. They also compete on different types of audit technology, different databases of industry or general economic

information, particular information system flows, or research capability. This competition has led undoubtedly to the development of greater expertise and added to higher audit quality. There is also no doubt that audit technologies have evolved and become better focused on higher risk issues within auditees. These are the benefits of a competitive process within the market for audit services.

Competing on Independence

Although audit firms disclose information about firm-wide competency, there is little or no observable information on the processes and outcomes in respect of independence. Auditors are exposed to potential threats to independence many times during and even before acceptance of audit engagements. These threats to independence find their way into an audit process in various ways. Examples of threats to independence include: the joint provision of audit and auditor-provided non-audit services (APNAS), the hiring of former audit staff by an auditee (or vice versa), the appointment of former audit firm personnel to the board of directors of an auditee or its audit committee, the employment of close relatives of audit partners or staff by an auditee, threats issued by an auditee to terminate an audit engagement or put out for tender an auditor engagement if an auditor does not withdraw a threatened qualification and/or comply with a particularly assertive or controversial accounting policy choice. Several of these examples do not necessarily *prima facie* pose a threat to independence but they have the potential to become a threat in certain circumstances. Put another way, a threat to independence can be a conditional relationship.

A further difficulty is that these potential threats are frequently not easily measurable. A threat to independence can be extremely subtle and it is possible that auditors themselves are not even conscious of it. Indeed, it is also possible that auditees are not conscious of it. Possibilities of these subtle threats include situations where fee dependence by an audit firm may be not just from one auditee, but from a 'family' of auditees all linked by shared directors. The presence here of a degree of subtlety cannot be over-emphasised. It can also mean that possible threats may not eventuate.

Testing Auditor Competence and Independence

The great majority of auditors are intelligent, diligent and professional people who seek to produce a competent independent audit. In the vast majority of cases it is our belief that competent independent audits are produced, however, it is difficult or even impossible to verify this because it is rare for the independence (and competence) of an audit to be rigorously tested. A comprehensive examination of the qualities of an audit only occurs in a public arena when an auditee suffers severe financial distress. However, even in some of these circumstances these allegations are not followed through, perhaps because of the significant costs of litigation or perhaps because there is some earlier compromise or settlement. In some cases there is significant follow-through and on a non-trivial number of

occasions in recent years audit failure or at least perceived audit failure has occurred in a number of jurisdictions.

There are generally two areas in which allegations are made, again relating to the two classic pillars of auditing: competence and independence. With regard to defence strategies relating to competence, it is common for auditors to obtain the services of another auditor to review the working papers and other documentation relating to an audit and reach a judgement as to whether the audit processes have been reasonable and competently executed. While it is not uncommon for this audit review to also attempt to cover any issues of independence, it is rare in our experience for evidence to be brought forward that can assist in any defence against accusations of a lack of independence. Indeed, while various forms of evidence that demonstrate the competence of an auditor can be indicated, there is often little that can be identified to assert that judgements and decisions reached were made independent of auditee management.

Usually, judgements in respect of independence are entirely in-house. Perhaps more disturbing is that: (i) recognition of threats to independence; (ii) determination of alternative courses of action; and (iii) final judgement relating to decisions involving independence, are routinely made by those persons within the audit firm who (directly or indirectly) have some commercial interest in the outcome of the decision. Auditors have mechanisms and processes to defend accusations of lack of competence. However, they appear to have few, if any, effective defences in respect of accusations of lack of independence.

Legislating or Regulating for Auditor Competence and Independence

Some jurisdictions have chosen to react to the latest generation of unsignalled corporate collapses by taking the high regulation route, others have at the time of writing simply proposed such a solution (for example Ramsay, 2001; Joint Committee of Public Accounts and Audit, 2002; CLERP 9, 2002; HIH Royal Commission, 2003). In Australia, CLERP 9 proposes to take up many of the recommendations in the Government commissioned Ramsay Report (2001). The HIH Royal Commission (2003) recommends extending the CLERP 9 proposals in several instances. For instance, in relation to auditor independence and competence, CLERP 9 recommends expanding the responsibilities of the Financial Reporting Council (FRC), currently responsible for oversight of the AASB (Australian Accounting Standards Board), to include auditor independence (Proposal 1), and amending the Corporations Act to:

- include a General Statement of Principle requiring the independence of auditors (Proposal 2);
- require the auditor to make an annual declaration, addressed to the board of directors, that the auditor has maintained its independence in accordance with the Act and rules of the professional accounting bodies (Proposal 3);
- strengthen restrictions on employment relationships between an auditor and audit client (Proposal 4). This will include a mandatory period of two years

following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a position with a client involving responsibility for fundamental management decisions. The HIH Royal Commission (Recommendation 11) recommends the period be four years and the requirement extend to key senior audit personnel. It also recommends the provision be enforceable against both the audit firm and the relevant former partner or senior audit team member. For a former partner who was not directly involved in audit of client the period of restriction should be 2 years. Additionally it recommends a prohibition on any more than one former partner of audit firm, at any time, being a director of or taking a senior management position with a client;

- impose new restrictions on financial relationships (Proposal 5) covering investments in audit clients and loans between an audit client, and the auditor or his immediate family;
- require mandatory disclosure in the annual report of fees paid for the categories of APNAS provided (Proposal 7);
- require a statement in the annual report of whether the audit committee is satisfied that the provision of APNAS is compatible with auditor independence (Proposal 7). The HIH Royal Commission (Recommendation 10) recommends the board of directors provide a statement in the annual report that identifies all APNAS and fees applicable to each item of work and explains why those non-audit services do not compromise audit independence;
- make audit ‘lead engagement partner’ and ‘review partner’ rotation compulsory after five years (Proposal 9). The HIH Royal Commission (Recommendation 12) extends this to key senior audit personnel; and
- require accountants seeking registration as company auditors to meet agreed competency standards, to undertake to abide by an accepted code of professional ethics, and to complete a specialist auditing course prior to registration (Proposal 11).

With regard to competency, there is merit in ensuring that there is a floor or base below which no individual may practise as company auditor. Generally, this is the model used in much of the developed world.

However, there is no legislation or regulation that precludes competency quality differences above this minimum.

Regulating Independence: Effectiveness — Timeliness

If there is to be regulation or legislation in respect of matters of independence or threats to independence, we predict that there will be significant costs and problems with inefficiencies. Such regulation will inevitably lead to issues with the effective management of the independence requirements for reasons set out below. Ideally, independence requires contemporary decision-making that is *ex ante* rather than *ex post*. A regulatory body set up to review auditor independence

will inevitably examine only independence issues which have been revealed and which are mostly extreme or easily measured. Independence threats typically involve instances of subtle threats, which are not easily measured and therefore not susceptible to an effective legalistic or regulatory intervention.

If there is some outside board or tribunal that deals with independence threats, such a board would learn of threats only after the fact and then only where there has been a damaging outcome and the facts of the case are publicly, or at least semi-publicly, revealed. This would not aid the efficiency of the market nor build value for either auditee or auditor. It also does not enhance the value to stockholders and those that hold the debt of a particular auditee.

Regulating Independence: Effectiveness — Defining the Threat

As noted above, many independence threats are hard to identify and observe in practice. Consider for example of joint supply of audit and APNAS: under what conditions does the joint supply become an independence threat? If the joint supply of some tax compliance actually provides a quick value-adding solution of the auditee company is it a threat to independence? Perhaps, but perhaps not. To operate optimally, the need to define a threat might become case-specific. If by regulation or law a threat to independence is defined as existing where APNAS fees are, say, 50 percent of audit fees, then it is possible, even likely, one will observe many cases where joint supply will occur at levels of 49.9 percent. Such a situation will be legal but is it not a threat to independence? The regulation of independence may result in cases where the law of independence is substituted for the fact of independence — the economy and the stockholder are little or no better off than the current situation in which no restriction is imposed externally.

Regulating Independence: Efficiency

As previously noted, independence is subtle, difficult to observe and often hard to measure. Thus, it can be difficult to efficiently regulate the presence of independence. Even if it can be effectively regulated, deciding on the threat, its measurement can cause economic inefficiencies.

Regulating Independence: Completeness

Even if threats to independence can be identified, defined and measured in such a way that they can be subjected to legal or regulatory intervention, threats to independence change and new threats emerge. Although exceptions existed, a decade ago the level of APNAS in relation to that of audit was not an independence threat, but it is now. If legislation in respect of auditor independence had been put in place at that time, the joint supply threat would most likely have not been identified as an independence threat. Thus that legislation would now be seen as incomplete.

Also, as many threats are not identified or easily measured, the likelihood of legislation being comprehensive is low.

Moreover if auditor independence is enforced via a legal or regulated means, it is possible, even likely, that various stakeholder groups might erroneously conclude that the ‘problem’ is fixed when it is not. The evidence of the absence of a complete ‘solution’ would not be seen until the inevitable next round of corporate failures.

A Market Response to Controlling Auditor Independence

The high regulation response is not the only option. As suggested above, suppliers of audit services are reactive and proactive in supplying high competency level services, including industry specific audit services. Market responses tend to include means by which suppliers and buyers in the market use competitive processes to drive up quality and or efficiency. There are at least two closely related means by which this might be achieved.

The Development of an Independence Control Board

In advanced economies one observes boards of directors that have policy control of auditees. Conventionally these boards comprise both ‘internal’ directors and ‘external’ or independent directors. Capital market theory shows that companies with strong corporate governance and independent boards attract a higher share price. The market for information (including the capital market) rewards organisations that have good quality control processes that are independent of the internal management.

One way to proceed is that each of the larger audit firms (that is, those that have sufficient critical mass in auditing within any particular jurisdiction) establish an auditor Independence Control Board (ICB) within the partnership, possibly reporting to the Chairperson of the partnership. Such a Board should consist of persons not drawn from current (or ideally former) partners nor other employees of the organisation or similar organisations. They should be experts in one or other of several fields (auditing, commercial law, professional services, accounting or auditing standard setting and accounting policy making). This Board would for every audit consider each threat to independence that exists within the organisation in a contemporaneous and confidential fashion. The outcome of its deliberations would be a decision either to proceed or not with an audit engagement and if proceeding, to put in place certain controls and procedures that would ensure an adequate level of independence is attained.

It would be important that these ICBs be chaired by a person who is both expert in the area of auditing and independent of the day-to-day operations of the organisation. It is also important that each member of the Board not benefit commercially, either directly or indirectly, from any single decision made in respect of independence. This implies that independence decisions should be removed from the partners. The Board would have, in effect, power of veto over independence issues and ultimate control of acceptance and retention of audit engagements.

The reasons why an ICB with internal access to an audit firm would be more effective than an arrangement imposed externally are as follows:

1. Independence issues, threats and potential threats can be dealt with swiftly and contemporaneously with the audit. A decision *ex ante* in any critical matter can be made and enforced by the Board.
2. The Board can deal with commercially sensitive issues without those issues becoming public or accessible by competitors.
3. The quality control processes of the board can be disclosed and observed by the market, including by existing shareholders, which gives rise to the possibility that shareholders can better evaluate audit quality in making their resource allocation decisions than is currently the case and that accounting firms would compete on the basis of having good quality control procedures for independence, not only for competence or price.
4. Extremely subtle or difficult to access and measure issues can be dealt with sympathetically yet conclusively, and matters where there are conflicting arguments can be dealt with without reference to crude measures.
5. Reward structures within audit firms can take account of decisions made by the Board in achieving equity across partners responsible for practice growth.

Hence effectiveness, efficiency and completeness are addressed in a way that a regulatory solution cannot provide.

The existence of such a Board can (and should in the minds of many) be supported, protected and monitored by the appropriate corporate regulatory agency. With the CLERP 9 proposals to move responsibility for oversight of audit independence to the FRC, this body would appear appropriate to carry out this task. However, given its existing responsibility for oversight of accounting standard setting, it will be important the requisite audit related expertise resides in its membership and that it receives appropriate resources.

It is suggested that the professional accounting bodies could sponsor the establishment of a Board or Boards, which smaller auditing firms could utilise to act as internal ICBs. The facts of any case would remain entirely confidential and the Boards would act swiftly and contemporaneously to deal with any potential threat to independence. It is important there is no suggestion of a substantial commercial cost being incurred by declaring a threat to independence and that in fact there is a positive outcome from it. There is, however, an issue that such Boards may be inundated by requests to adjudicate. Remembering that these Boards (created by the professional bodies) are unlikely to have a detailed knowledge of the firms they are dealing with, their knowledge of the people, structures and control procedures will also be more limited.

In May 2002, the Australian firm of PriceWaterhouseCoopers (PWC) announced an application of the general model described above. The PWC application follows closely the above model and is the first such application of this process that gives audit firms a mechanism by which to be more transparent to the market. At the time of writing, little or no information on the operations of the

Board has been made public. This is unfortunate given a principal feature of the original model is to make transparent the effect of the Board.

The Development of an Expert Review on Independence

A second method of gaining market transparency by incorporating a quality control device can be achieved by the establishment of an Expert Panel (EP) to review both the processes and outcomes of independence decisions. Unlike the ICB process, the objective of an EP is not to make decisions *ex ante*, but to examine the quality control processes existing within the firm to see that appropriate checks and balances on the quality of independence decisions are in place.

A point of differentiation between the EP Model and the ICB Model is that the EP Model would review the processes within the firm rather than actually take decisions *ex ante*. In effect, it becomes an oversight of the processes within the firm and outcomes, to the extent they can be observed, rather than actually taking the decisions that relate to independence. One advantage of the EP Model is that it may seek a positive review of existing processes and can survey or sample those processes and outcomes that might emanate. There is thus less opportunity to hide ongoing independence disputes after the fact than if they were dealt with *ex ante*. Another difference between the two is that the EP Model would have a clear timetable and set of objectives with clearly defined outcomes and publicly available conclusions within specified time periods.

The EP Model relies heavily on two things:

1. The availability of people truly expert in the field of auditing who would also have or could develop methodologies for conducting such an enquiry.
2. Terms of reference giving expert reviewers clear authority to undertake the review with ability to access information, assimilate it, test it and then distribute results to appropriate stakeholders.

In the second half of 2002 the Australian practice of KPMG announced an Expert Review Panel. The KPMG application was, however, not only in respect of independence but also of conflict resolution and of a number of quality control processes. It was, by any measure, far-reaching and included evidence gathering of a number of different types but was not comprehensive. It did not test the audit methodology used by that firm worldwide and did not examine specific cases or clients, including audit outcomes from these. The absence of these is consistent with the profession's own internal quality reviews. Putting aside the practical difficulties of including these additional aspects, incorporating some or all of these in the terms of reference of a review would be beneficial.

The publication of the Report of the review came approximately three months after it was commissioned. The first named author was advised that in the first ten days after the KPMG Expert Panel Review's publication on KPMG's website, the Report was down-loaded from unique IP addresses over one and a half thousand

times — evidence of market interest in such a transparent process and for providing information to the market about quality control processes, particularly those that relate to independence.

An additional advantage of the EP Model is that the review of the firm and its processes can detect the extent and culture of the organisation in its care, and sensitivity over the threats to independence, in a generalised way. Major disadvantages are that such reviews would not deal with independence *ex ante* and would not specifically deal with particular cases unless it was so agreed in the terms of reference.

Effect of Independence Quality Control Processes

The creation of a market-observable audit independence quality control process is a necessary but not sufficient condition for the effective quality control of independence in an audit process. The independence quality control process needs to influence all the processes in the audit firm and to affect the culture of the audit processes. The culture needs to be affected by the independence quality control process and ensure that threats are identified, considered and dealt with. Perhaps more effectively, potential threats need to be recognised *ex ante* and, where possible, avoided.

In recent times some accounting firms have employed incentive structures which resulted in those involved in the audit (either partners or employees) benefiting from referrals from an audit client also purchasing consulting activities. On occasion this consulting work was undertaken within a separate division of the accounting firm and in some cases it may have been undertaken within the audit division. Irrespective of where the work is performed, the use of an audit engagement to generate fee revenue for non-audit work, particularly if audit personnel remuneration is influenced by this work, immediately gives rise to a potential threat to the independence of the audit process. The issue of including fees for non-audit work in the basis for remuneration of partners is something of which the HIH Royal Commission (2003) was highly critical. This is a situation not adequately recognised as a threat in the current (recently revised) Professional Statement F1 of Australia's major accounting bodies.

Use of the audit process to lever additional revenue is seen by some as a potentially questionable practice and throws open substantial questions with regard to the integrity and independence of the audit. There is a fine line, however, between using the audit process to generate revenue and identifying issues that the client may then choose to deal with by outsourcing consultancy. At the very least independence quality control processes set up within firms need to review the incentive structures within each of the firms.

The Roles of the Stakeholders

The Role of Regulators and Legislatures

While the basis of the model is that auditor independence is essentially an economic problem, it is clear from current evidence in other world-wide jurisdictions that the existing co-regulation approach has resulted in less than optimal outcomes, with significant negative economic and social effects. While our proposals rely on competitive market processes, it is crucial that an appropriate strong legislative and regulatory framework exist. Without this framework it is possible that audit firms might revert to current behaviour. The essential framework requires the existence of compulsion for auditors of listed (publicly traded) corporations (and others where there is a strong public-good issue, such as deposit taking institutions) to access a competitive auditor independence quality review process. So a further qualification for undertaking company audits is the ability to access a regulator-recognized independence quality control process. This compulsion is a parallel to the requirement for larger publicly traded corporations in many jurisdictions to have boards of directors that have at least a majority of independent directors, a more direct parallel being the requirement of such companies to establish an audit committee of the board of directors.

The second regulatory or legislative requirement comes in the form of approval for and/or registration of the quality control processes. Ideally such processes could be registered with a corporate regulator and should possess certain minimum standards in respect of membership, procedures and authority. Ensuring that the decisions of the quality control processes are enforceable and enforced is part of this framework. It may be that the FRC play this regulator role in addition to its other proposed CLERP 9 duties. This would result in less reliance on the existing and relatively unobtrusive quality control processes run by the two major professional bodies. Having a process such that the decisions are reported to the market in a way that does not compromise client confidentiality but informs the market that the quality control processes actually 'bites' seems an important characteristic of the process.

The Role of the Audit Firms

Each of the large audit firms would establish a market responsive quality control process. The guidelines, under which these processes are established, the credentials of the members involved, the mechanism by which determinations are arrived at, and the means by which an appropriate culture is created within the firm, are all necessary components of the proposed model. Firms need to be competitive in respect of the independence control processes, and not just competitive in respect of competence and price.

The Company Auditees

The proposed model does not call for auditees to establish their own quality control procedures in respect of the independence of their auditor. However it is inevitable with new disclosures and new information available to auditees that some audit-related decisions will need to be considered with greater rigour and frequency than is currently the case. Inevitably the work of the audit committee will become more burdensome and auditees need to acknowledge this change. Perhaps the most specific recommendation regarding auditees is that the workload of audit committees now include an ongoing assessment of the independence of the auditor. CLERP 9 proposes to require this assessment explicitly where a committee exists, and in its absence the task becomes that of the board of directors. Additionally, especially if suggestions such as those presented here are not universally accepted, audit committees should evaluate as far as possible the procedures in place within the audit firm to make independence related decisions.

Summary and Conclusions

The proposed model includes the following:

1. The requisite regulatory framework is to impose a general requirement that auditors be independent of the management of auditees and that auditor decision-making be independent of auditee management.
2. The regulatory framework changes need not involve defining auditor independence in detail. Nor should they describe or limit certain behaviour of audit firms in respect of real or perceived audit independence threats.
3. The regulatory framework should be changed to require auditors entitled to undertake company audits to not only demonstrate adequate levels of competence, but also to have access to a recognised independence control process.
4. The appropriate corporate regulator, suggested here to be the FRC, should be empowered to approve independence quality control processes for use by audit firms.
5. Each audit firm should establish an audit independence quality control process.
6. Audit firms should compete with each other in respect of their independence quality control processes, as they presently do in respect of price and competency.
7. The quality control processes for independence should be observable by a wide section of the market and stakeholders in the market for audit services

Audits require competence and independence. There are a number of mechanisms that can be used to ensure each is present. Competition has driven up competence but this mechanism is not observable in respect of independence. The

models propose a market-based solution that will ensure competition on competence and independence as well as competition in respect of price.

In addition to focusing on competing over independence our model suggests that — to ensure a fully informed market — communication, market transparency and accountability are needed.

It can be argued that the efficient and effective operation of this market needs the provision of a carefully constructed regulatory framework. The recommended model would benefit from a regulatory framework that oversees strong competitive processes to enhance the quality and transparency of independence decision-making in audit firms, and greater disclosure of auditors' skills and attributes to enhance auditor accountability.

Against this proposal lies the prospect that the market is not sufficiently mature or sophisticated to evaluate auditor independence, even when information on the within-firm processes is transparent. There is also the possibility that being 'in-house' it will be viewed with scepticism by stakeholders who have lost faith in the profession to alone deliver meaningful reform in this area. Additionally, the advent of independence quality processes across suppliers of audit services challenges current commercial imperatives, and will require a shift in culture within the firms that may be too difficult for the firms to make, even given the impetus of recent concerns over the efficacy of audit. Many will argue that market failure has been demonstrated too often in this area and that depending on a market-based mechanism, particularly when it emerged voluntarily only after a severe shock, to provide a solution to such an important issue is fraught with danger. However, the inefficiency and economic dysfunction that often accompanies imposed regulation also needs to be considered in evaluating the model proposed in this paper.

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