



The rise of regulatory capitalism and the decline of auditor independence: A critical and experimental examination of auditors' conflicts of interests

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Abstract

This study investigates the decline of auditor independence coinciding with the rise of regulatory capitalism. A critical analysis supported by experimental evidence reveals regulatory capitalism's influence on auditor independence. Regulatory capitalism began in the United States during the 1970s when state enforced neo-liberal free-market doctrines of competition and deregulation commercialized the profession. Since then, regulatory capitalism's economic neo-liberal agenda has transformed the auditing profession and the employer firms into a transnational network of professional services firms that now promote and diffuse regulatory capitalism worldwide. Regulatory capitalism is further facilitated by the Sarbanes-Oxley Act and the PCAOB that provide interconnections of powerful non-democratic private regulators such as the IFAC and IAASB. An experiment reveals auditors' ethical predisposition to provide consistently high quality independence judgments required by IFAC's code of ethics. The majority of this sample of 174 Danish auditors was not consistently independent in the context of client economic factors, indicating that the code of ethics' appeal to auditors' altruistic behavior has failed. Moreover the transformed profession has become the transformer but at a price, the loss of public confidence and the decline of auditor independence. Conflicts of interests still abound. © 2007 Elsevier Ltd. All rights reserved.

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“The Sarbanes-Oxley act passed in the wake of the Enron and other scandals . . . Yet more needs to be done. Accountancy firms remain riddled with conflicts of interests. The most basic is that they are responsible for auditing managements that, ultimately, pay them to do so.” *Economist*, 18 November 2004.

1. The rise of auditor independence

Fairness and justice are fundamental to society’s need for auditor independence (Mautz and Sharaf, 1961) hence auditors must balance the interests of various stakeholders to ensure credible corporate transparency of corporate reporting in the public interest (Goldman and Barlev, 1974; International Federation of Accountants or IFAC, 2005). Auditors became crucial to regain confidence in the integrity and credibility of the capital markets shortly after the massive corporate collapses that triggered the 1929 Wall Street Crash. The Crash brought misery to millions of people who lost their savings, their jobs and their dignity. Enduring detrimental social, economic and psychological effects of the Crash were felt worldwide. Following the crash, the Great Depression damaged the financial systems of several countries, in turn fermenting social unrest and disillusionment that culminated in World War II (Berg-Schlosser, 1998). In the United States, President Franklin D. Roosevelt’s administration was so concerned about society’s financial security and political stability that the Securities and Exchange Acts, 1933 and 1934 were signed into law to rebuild public trust in the governance of the capital markets. These acts mandated listed companies’ financial reports to be independently audited in the public interest (Zeff, 2003b).

Influential accountants successfully opposed proposals for the U.S. government to oversee business directly or conduct audits of public companies. Instead accountants in private practice were given the monopoly franchise to perform company audits on the condition that they abide by a code of ethical conduct mandating auditor independence (see Zeff, 2003a for more discussion). This regulatory arrangement had an inherent critical flaw identified by Mautz and Sharaf (1961). They questioned the ability of professional auditors to maintain an independent mind to ‘present fairly’ in the judicial sense (Reiter and Williams, 2004) when they are economically dependent on the client management. This regulatory flaw predisposes conflicts of interests because auditors have to negotiate compensation and employment conditions with the regulated, the auditee company.

The profession’s code of ethical conduct attempts to prevent obvious conflicts of interests that may occur between the auditor and auditee company. The code also legitimates and defends the self-regulation of auditor independence that essentially relies on the personal ‘virtues’ and altruism of its members (Limperg, 1985). The notion of personal independence is further enhanced by the inexorable objectivity and neutrality engendered in the measurement expertise of the accounting profession (Chua, 1986; Hines, 1991). For several decades the profession dealt with minor scandals from time to time and audits were performed without much incident until the 1970s (Zeff, 2003a).

During the early 1970s regulatory capitalism emerged in the United States as neo-liberalism gathered the political strength to radicalize government policies. These policies changed social relationships and institutions, including the auditing profession. This study first critically examines the rise of regulatory capitalism and the decline of auditor inde-

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