Regulating audit quality: Restoring trust and legitimacy

Claus Holm, Mahbub Zaman

Abstract

The global financial crisis, corporate failures and scandals in many countries raise significant questions about the effectiveness of financial reporting and auditing. Auditing firms, professional and regulatory bodies are often subject of criticism and face pressures to restore confidence in auditing. The crisis in confidence has spurred a move away from ‘self-regulation’ to greater emphasis on ‘independent’ regulation of auditing in the UK. Marking a significant development in the regulation of auditing the FRC sought to codify audit quality and issued the ‘Audit Quality Framework’ (FRC, 2008). This coincides with various measures adopted in many countries aimed at restoring trust in auditing and governance. Hitherto, however, no audit regulatory body has tried to codify audit quality.

In this paper we examine stakeholder views on audit quality as represented in the responses to the FRC (2006) consultation. Examining the codification of audit quality in the UK in the aftermath of corporate scandals our paper focuses attention on the rhetoric and legitimisation associated with the regulation of audit quality. Our analysis focuses on the extent to which respondents – audit firms, professional bodies, and investors – considered the FRC proposals sufficient for addressing concerns about audit quality. We used impression management and legitimisation as a framework to analyze stakeholder responses. The framework enabled us to go beyond the factors identified by the FRC. Our analysis shows that there are

1. Introduction

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* Corresponding author at: Manchester Accounting & Finance Group, Manchester Business School, University of Manchester, Crawford House, Oxford Road, Manchester, M13 9PL, UK. Tel.: +44 1612750440.
E-mail address: mahbub.zaman@mbs.ac.uk (M. Zaman).

1 For example the Auditing Practices Board, a body responsible for setting auditing standards, assumed greater responsibility and became an operating body of the UK Financial Reporting Council.
underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and transparency of the audit process and of audit firms that have not received much regulatory attention. We find that in response to institutional pressures respondents aligned themselves with the audit quality rhetoric to legitimise themselves and protect their image. Our paper shows that audit firms and professional bodies advanced various points indicating the need for FRC to address additional issues in order to improve audit quality. To legitimise its existence, the auditing profession has a vested interest in convincing users that accountants can be trusted. In pursuit of that the auditing profession engaged in modes of impression management which at the institutional level enabled symbolic displays pertaining to diligent public service for the benefit of outsiders but which had limited practical implications for how audit work is actually performed. Our analysis further reveals that corporate malpractices continue to raise questions about audit quality and evoke varying response from auditors, regulators, and users of audit. Increasing demands are made on the profession to respond to the wishes of audit beneficiaries. Although the profession has apparently responded to some of the concerns it has failed to address the fundamental issues underlying the growing criticisms concerning audit quality.

Our paper contrast with existing research on audit quality which has paid limited attention to the regulation of audit quality and how interested parties, in particular audit firms and professional bodies, seek to influence that process. In the extant literature audit quality is mostly conceptualized in terms of output measures. Definitions employed usually embrace dimensions of auditor competence and independence (Watkins, Hillison, & Morecroft, 2004). Researchers often focus on outcomes that are associated with auditing. These include for instance the association between the existence of auditing in particular environments and improvements in the credibility of financial statements, often measured in terms of earnings quality (see for example, Abbott, Parker, & Peters, 2004; Van Tendeloo & Vanstraelen, 2008), the accuracy of the auditor’s judgements and issuance of correct opinion on financial statements (Knechel & Vanstraelen, 2007); litigation against audit firms; enforcement actions by regulatory bodies, e.g. in the case of the US Securities and Exchange Commission (SEC) sanctions (Palmore, 2000); and business failures often following a ‘clean’ report (see Francis & Krishnan, 2002).

A limited body of research focuses on audit firm and team characteristics affecting audit quality (Beattie & Fearnley, 1995; Bierstaker & Wright, 2001; Carpenter, Dirsmit, & Gupta, 1994; Frantz, 1999). Most research on audit quality adopt archival method and tend to focus on differences in audit quality due to differences in audit firm characteristics, often using various measures of size and market concentration (see Moizer, 1997; Watkins et al., 2004). Notwithstanding the fact that Francis (2004) observes that we know more about audit quality than we might have originally suspected, it is important to recognise that audit quality is a nebulous concept. Given its socially constructed nature, it is almost impossible to reach a common understanding of what audit quality is and hence to measure improvements in practice. In most cases it is unobservable to those not involved in the audit process, the only observable outcome of the audit process being the audit report (Eliisfen & Willekens, 2007; Manson & Zaman, 2001).

In contrast to research examining the effects of audit quality on for example financial reporting, our focus on the regulation of audit quality contributes to the existing literature and recognises that audit quality has been a matter of concern and regulatory attention for some time. Over the years there have been numerous attempts to improve audit quality. In the US for instance prior to the Enron/WorldCom debate the Panel on Audit Effectiveness (POB, 2000, 2) considered at length the nature and quality of the audit. It noted that:

Several major instances of misstated earnings resulted in headlines reporting massive declines in market capitalization. If share prices decline when companies’ results fail to meet expectations, they decline even more precipitously when the market learns that previously issued audited financial statements are unreliable. This frequently leads to restatements of those financial statements, suggesting that the financial reporting system may not, in fact, promote the most efficient allocation of capital.

The Panel on Audit Effectiveness further noted that restatements raised the question “Where were the auditors?” and in an effort to improve the quality of auditing made recommendations which included a call for auditors to perform some “forensic-type” procedures on every audit to enhance the prospects of detecting material financial statement fraud. The Panel called for auditing and quality control standards to be made more specific and definitive to help auditors enhance their professional judgement. In specified areas the Panel suggested audit firms should review, and where appropriate, enhance their audit methodologies, guidance, and training materials. A system of peer reviewers to “close the loop” by reviewing those materials and their implementation on audit engagements and then reporting their findings was also recommended. The Panel also urged audit firms to put more emphasis on the performance of high quality audits, communications from top management, performance evaluations, training, and compensation and promotion decisions.

In the UK the Institute of Chartered Accountants England and Wales (ICAEW) formed the ‘Audit Quality Forum’ in 2002 to promote auditing and contribute towards restoring confidence in auditing and governance. In its publication “Audit Quality” the ICAEW (2002) observed that auditors provide a quality service to shareholders if they provide audit reports that are independent, reliable and supported by adequate audit evidence. Six factors contributing to audit quality were identified: good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices, and effective quality control and monitoring review process.

In a related consultation paper “Reporting on Audit Quality Monitoring”, the UK Professional Oversight Board (POB, 2006) suggested measures to improve audit quality. These included extended public reporting on Audit Inspection Unit (AIU) findings, and sharing information on AIU findings with audit committees. The FRC recognised that audit quality is
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پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات