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Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies

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Audit Quality and the Market for Audits: An Analysis of Recent UK Regulatory Policies

Abstract

[extract] This article sets out UK regulatory developments concerning statutory audits of companies and investigates their coherence and likely efficacy given the theoretical, empirical and practical problems of defining and assessing audit quality. Although the regulatory details in this article are drawn from the UK, some of its theoretical arguments are more generally applicable and some of the empirical literature relates to other jurisdictions.

Keywords

audit market, regulation, corporate governance, United Kingdom

AUDIT QUALITY AND THE MARKET FOR AUDITS: AN ANALYSIS OF RECENT UK REGULATORY POLICIES

*Alice Belcher**

Introduction

This article is about the relationship between the audit market and legal regulation in the context of corporate governance. The collapse of Enron in December 2001 has been attributed in large part to the way in which its transactions were deliberately constructed to improve the appearance of its financial statements. Because of the auditor's complicity in this process, Enron's collapse also precipitated the collapse of the audit firm Andersen. Gary S Robson and Gary H Roseman in their short article entitled 'With market discipline at work, is government regulation of auditors redundant?' have presented the collapse of Andersen as evidence of the market working to generate, eventually, appropriate price and quality in the market for audits. They suggest that

The market tosses out firms that do not provide a product at the levels of price and quality consistent with their industry practices and expectations. Andersen has been tossed. Any firm not mindful of recent lessons concerning auditor independence could be next.

They also state

The investing public's evaluation of auditing/consulting deals and the quality of firms' financial information will manifest themselves in share price movements.¹

The implication of these views is that an audit market functioning in the context of an efficient capital market² together make regulation of the audit process unnecessary. However, the problem with the market discipline that finally removed Andersen from the market is that it operated only after the event. Shareholders and investors, however, want some assurance before the event that

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1 Gary S Robson and Gary H Roseman 'With market discipline at work, is government regulation of auditors redundant?' *Business Quest*, 2003.

2 For a discussion of stock market efficiency see Simon M Keane *Stock Market Efficiency* Philip Allan, Oxford, 1983.

the auditors engaged by the company will provide a good quality service. Robson and Roseman's main argument is that (in their view) the market, which tends towards efficiency, is better than government regulation, which has its own costs and inefficiencies. These views were expressed in the context of the audit market in the US. However, the white paper 'Company Law Reform' published by the UK Government in March 2005 includes the following aspiration

The Government is keen to encourage confidence in the statutory audit and to ensure a strong, competitive and high quality audit market.³

This article sets out UK regulatory developments concerning statutory audits of companies and investigates their coherence and likely efficacy given the theoretical, empirical and practical problems of defining and assessing audit quality. Although the regulatory details in this article are drawn from the UK, some of its theoretical arguments are more generally applicable and some of the empirical literature relates to other jurisdictions.

The background to this investigation is the UK's history of a voluntary corporate governance code⁴ followed more recently by a series of regulatory developments arising out of the review of company law⁵ and in response to the Enron crisis.⁶ Figure 1 provides a chronology of key events. It should be noted that with more than a decade's experience of a voluntary corporate governance code, questions about the market's ability to bring about compliance remain.⁷ In the UK the recent regulatory history of the audit market has had three main elements. First, there has been a competition element as revealed in the Office of Fair Trading (OFT) report on Competition in the Professions published in March 2001. This is a document that sets out an overall approach to the issue of competition in professions generally, whereas later documents, regulations and statutory provisions have focused more specifically on the market for company audits. Secondly, there is an ongoing liability element that has its history in the *Caparo* case⁸ and was joined with the competition element when the OFT published its report *An assessment of the implications for competition of a cap on auditors'*

3 'Company Law Reform', Cm 6456 March 2005.

4 The Cadbury Code of Best Practice, now revised and renamed the Combined Code, was first published in December 1992.

5 The UK Government commissioned the Company Law Review (CLR), an independent group of experts, practitioners and business people, in 1998.

6 Enron filed for relief under chapter 11 of the US bankruptcy code in December 2001.

7 Pensions Investment Research Consultants Ltd (PIRC) *Corporate Governance Annual Review*, 2004, states '... full compliance remains at only 34% (PIRC's view), 47% of companies consider they complied fully' with the Combined Code.

8 *Caparo Industries Plc v Dickman* [1990] 1 All ER 568; [1990] 2 WLR 358.

liability in July 2004. Thirdly, there is the quality element which is at the heart of the most recent developments.⁹ The three elements are interconnected, however they can all be detected in the 2005 white paper and they provide a useful framework for organising the remainder of the article. Sections 2, 3 and 4 consider the competition, liability and quality elements of the audit market respectively and some conclusions are presented in section 5.

The Competition Element

In March 2001 the Director General of Fair Trading issued his report *Competition in professions*, ie lawyers, accountants and architects. The Office of Fair Trading (OFT) had commissioned Law and Economics Consulting Group (LECG) to act as consultants. LECG produced their report *Restrictions on Competition in the Provision of Professional Services* in December 2000. The March 2001 report expressed the views of the OFT and was written by the current Director General, John Vickers, with the benefit of having seen the LECG report.

The OFT's message to the professions was clear

The professions should not be shielded from the competition laws that apply elsewhere in the economy.¹⁰

In order to apply competition laws to the professions, the report concentrated on identifying restrictive rules, practices and customs that appear to have significant anti-competitive effects.¹¹ However, the report did not stop with identification, it indicated that the OFT would take action to see such restrictions removed, unless the professions removed them themselves. The report states

In assessing whether such restrictions should be permitted to remain, the onus of proof should be on the proponents of the restriction. So the aim of this report is not just to identify questions for further analysis. It is to challenge restrictions on freedoms to compete. Those freedoms are rightly regarded as the norm in economic activities generally.¹²

9 These three elements can also be detected in the White paper *Company Law Reform* Cm 6456 March 2005, para 2.5 p.25.

10 Director General of Fair Trading (2001) *Competition in Professions* OFT328, March 2001, para. 11.

11 Ibid, para. 3.

12 Ibid, para, 4.

The OFT's pro-competition approach is expressed in various ways. First, the onus of proof is on those who wish to retain a restriction. Secondly, the report indicates that

In the professions, as elsewhere, there should be a presumption that such restrictions should go.¹³

Thirdly, the report states:

... from a policy perspective, they [restrictions] should be removed unless their proponents can demonstrate strong justifications for them in terms of consumer benefit.¹⁴

The OFT's declared overall aim is to 'make sure that markets work well – for the ultimate benefit of consumers'.¹⁵ The problem with this aim, in the context of the market for professional services, is that an optimum regulatory solution involves the balancing of three forms of market failure.¹⁶ This was dealt with in the LECG report, but not by the OFT report.

Market Failure and the Professions

Three forms of market failure can affect the market for professional services: information asymmetry, externalities and monopoly power. The market failure arising from asymmetry of information is due to the very nature of the services on offer. Because professional services are mainly offered by experts to non-experts, '...clients have difficulty in judging whether they have received good service and what would constitute a reasonable price'.¹⁷ Goods and services can be classified according to the ways in which purchasers can judge quality. With search goods or services, quality can be ascertained by the consumer prior to purchase. With experience goods or services, some characteristics are only learned by consumers after purchase. With credence goods, or services, quality usually only becomes apparent some time after purchase, if ever. This is described in the LECG report

13 Ibid, para. 3 (emphasis added).

14 Ibid, para. 11 (emphasis added).

15 Ibid.

16 Market failure is a phrase used by economists to denote a departure from the idealised conditions in which a collection of competitive markets operate to achieve an equilibrium allocation of resources which is Pareto optimum.

17 LECG Restrictions on Competition in the Provision of Professional Services, 2000, para. 20.

as an extreme form of information asymmetry.¹⁸ Most services provided by professionals would be credence services under this three-fold classification. When a market fails because quality cannot be judged by the consumer before purchase, the usual solution is to control quality. In the professions, quality is controlled, in part, by the requirement to pass professional examinations and engage in continuing professional development. Membership of a relevant professional body theoretically gives the consumer information about quality that an 'examination' of the services could not provide. A company audit is a **credence** service in that its quality may never be discovered by the company, the shareholders or other users of the financial statements. It may only come into question if a 'clean' audit report is followed by the collapse of the company. It is also a credence service in another sense; that is in the sense that the purpose of an audit report is to lend credence to the financial report. Information asymmetry as a form of market failure was exemplified by the Enron crisis and the resultant failure of the audit firm Andersen. The company insiders had information; corporate laws were designed to ensure that financial information was properly disclosed to the shareholders by the directors; because of the information asymmetry corporate law also demanded an independent audit of the financial information presented by the directors. In fact, information asymmetry is the reason that company law requires the audit of financial statements. The directors of a company have direct access to the internal affairs of the company, the shareholders receive information to some extent chosen and filtered by the directors, and the audit process and report are there specifically to give some credibility to financial information that shareholders may not otherwise be able to trust. The statutory audit is a possible answer to a massive asymmetry of information but only if audit reports can themselves be trusted. In the story of Enron's collapse it seems two markets failed – the market for company information and the market for audits. The capital market was not able to exert pressure on the company to produce accounts that were not misleading, and the audit market was not able to exert pressure on Enron's auditors to qualify their report on those misleading accounts. Both failures, it is submitted, were due to asymmetric information.

However, it is monopoly power that is the form of market failure that is competition law's particular concern. This form of imperfection is due to market dominance and/or restrictive practices. To the extent that quality controls are also restrictive practices, the solution for one market imperfection (asymmetry of information) can be the source of another market imperfection (monopoly power). The OFT's report appears to be based on the view that self-regulation by professions, ie a solution to inherent asymmetry of information, has produced too many restrictive practices.

The existence of externalities is the third form of market failure. The LECG report states

18 Ibid, para 35.

Although information-related problems are the most commonly cited source of market failure in the professions, two additional causes are market power and the existence of externalities.¹⁹

An externality can result in a social cost or benefit. The LECG report cites the following as an instance of an externality in the market for professional services

... a firm's trade creditors and lenders may make important decisions based on an auditor's report. The firm itself, however, may have chosen the auditor purely on price rather than relevant experience or 'quality' in order to reduce costs and increase its 'private' benefit. In this way, any adverse impact on trade creditors and lenders is external to the firm's own decision – hence the term 'externality'.²⁰

The LECG analysis suggests that, in the context of professional services, the main source of market failure is the information asymmetry inherent in the nature of the services. Monopoly power and externalities are seen as lesser sources of market failure. The OFT's approach concentrates on lessening market power. Paragraph 9 of the OFT report states:

'The concern underlying this review is that, particularly where the restrictions are imposed by professions regulating themselves, there are no guarantees

- that the restrictions on competition are the minimum necessary to achieve goals of consumer protection; or
- that they maximise overall consumer benefit by striking the right balance between consumer benefits from competition and from protection.

One concern of this author is that the principles²¹ to be applied by the OFT may not 'strike the right balance'. Another concern is that, although the approach appears to draw its legitimacy from economic theory, there is one relevant economic theory that is absent from the discussion: the theory of second best.

19 Ibid, para 39.

20 Ibid.

21 That the onus of proof should be on those who wish to retain a restriction; a *presumption* that anti-competitive restrictions should go; and that restrictions should be removed unless their proponents can demonstrate *strong* justifications for them – as identified above.

The Theory of Second Best

The argument in favour of interventions (such as that of the OFT) to offset market imperfections or distortions is that, once distortions have been dealt with, the 'invisible hand' will operate to allocate resources optimally. However, the whole pro-competition initiative becomes questionable under the general theory of second best. This theory suggests that moving one market towards perfect competition will not unequivocally move the entire economy towards a better outcome. The idea can be found in the work of Pareto, the economist whose name is used as the label for an optimum allocation of resources (given certain assumptions) – Pareto optimality. In 1909, Pareto suggested that free trade may not be preferable to protection and that individuals may not end up in a better position if one of several distortions to resource allocation were eliminated.²² The general theory of second best was formalised, as a mathematical model, in 1956 by Lipsey and Lancaster and it is their seminal article that is usually cited.²³

The idea that a set of perfect markets can be trusted to produce an optimum allocation of resources is simple and powerful. The theory of second best is messy and equivocal. It does not produce a neat solution, and it cuts across the intuitively attractive notion that a move towards market perfection is always a move in the right direction; the proposition at the heart of competition law. It suggests that moving the market for professional services, or the market for cars, or any other single market, towards perfect competition will not unequivocally move the entire economy towards a better outcome. There may be other arguments for improving competition in the market for professional services, but these arguments need to be made on a case by case basis and with appropriate empirical evidence.

The specific restrictions identified in *Competition in the Professions* as having their origins in professional rules of accountancy bodies were

- Prohibition on advertising fee comparisons
- Prohibition on seeking the business of potential clients by telephone, sometimes known as 'cold calling'.

22 V Pareto Manuel d'Economie Politique, 1909. cited in P Bohm 'Second Best' in Palgrave's Dictionary of Economics.

23 RG Lipsey and K Lancaster (1956-57) 'On the General Theory of the Second Best' *Review of Economic Studies*, 11-32.

- Prohibition on making or receiving payment for referring clients to accountancy professionals.²⁴

The initial OFT report in March 2001 was followed by a progress statement in April 2002. The progress statement acknowledges that these three matters had been dealt with in a way that met OFT concerns, at least by the ICAEW,²⁵ the largest of the UK accountancy bodies.²⁶

The Liability Element

Even as liberalising changes were being put in place by the accountancy bodies, Enron's collapse was in progress and the world's 'big five' accountancy firms were about to become the 'big four',²⁷ with the failure of Andersen. A market that was already relatively concentrated was about to become more so. In response the OFT was asked to look into the possibility of putting a cap on auditors' liability in order to promote competition.²⁸ In the UK historically auditors have not been allowed to place limits on their liability. The courts have however been a limiting factor in negligence claims against auditors. Auditors will only be found liable in the UK if the plaintiff is owed a duty of care, and the conditions applied by the courts for such a duty to exist severely limit the number of potential claimants arising out of any one audit.

This means that the circumstances in which UK auditors will be liable and the categories of potential litigants are much narrower than those applicable, for instance, in the US. Despite the fact that the risks of litigation are so much lower in the UK, there was a concern that the failure of Andersen could make UK audit

24 Competition in the Professions: progress statement OFT 385, April 2002, para 3.3, p.10.

25 Institute of Accountants in England and Wales.

26 *Competition in the Professions: progress statement* OFT 385, April 2002, para 3.4, p.10.

27 Pricewaterhouse Cooper LLP, Deloitte & Touche, KPMG LLP, and Ernst & Young LLP are the 'big four' also known as the 'final four'.

28 *An Assessment of the implications for competition of a cap on auditors' liability* OFT 741, July 2004

The OFT report states explicitly that it will '... focus on the potential pro-competitive impacts rather than any shortcomings in the way the courts handle claims'; para 3.7, p 6.

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firms wary of taking on, or retaining, risky clients.²⁹ If the Andersen failure might have reduced the willingness to supply audit services, it was suggested that the possibility of capping liability might have the opposite effect. The OFT assessment considered the following as possible pro-competitive reasons for capping auditors' liability

a reduction in the barriers to entry and growth facing smaller audit firms, the maintenance of competition between larger audit firms, including for non-audit work, and less risk of collapse of one of the Big Four.³⁰

It has already been established that the OFT's general approach is heavily in favour of competition, but even with this background the OFT's assessment was that 'It is likely that allowing audit caps would be competitively neutral overall.'³¹ Despite the OFT's conclusions, limiting auditors' liability has become part of the UK Government's audit market policy

... the Government is now persuaded of the benefits of change. The reforms will have three key parts – firstly, legislating to allow shareholders to agree limitations to the liability of auditors; secondly, some specific improvements to the quality of the audit process; and, thirdly, the establishment of an on-going process by which further enhancements to quality and competition can be identified and then implemented. The Government sees these three parts making up a balanced package of measures to improve the audit market.³²

Legislative provisions appear in chapter 6 the Companies Bill currently (early February 2006) being debated in its committee stage by the House of Lords. The explanatory note to the Bill states

847. This Chapter will make it possible for auditors to limit their liability by agreement with a company, but the agreement will not be effective if it is not fair and reasonable.

848. It achieves this by defining the 'liability limitation agreement' - a contractual limitation of an auditor's liability to a company, requiring member agreement - as a new exception to the general prohibition, restated here, on a company indemnifying its auditor. The court will be able to set aside such a limitation

29 This argument seems somewhat spurious as the duty of the auditor is to report their opinion as to the truth and fairness of the financial statements. For risky clients the obvious solution is to qualify the audit report if necessary.

30 An Assessment of the implications for competition of a cap on auditors' liability OFT 741, July 2004, para 4.1, p.7

31 Ibid, para. 1.9, p. 2.

32 Company Law Reform, Cm 6456 March 2005, para. 3.5 (emphasis added).

as ineffective if it purports to limit liability to an amount that is not fair and reasonable in all the circumstances.

The effects of these provisions, if they pass into UK law, remain to be seen.

The Quality Element

The quality of the audit process is the final element to be considered. This is a topic that has been the subject of theoretical and empirical research over several decades. This section of the article describes the types of research that has been conducted before setting out the recent UK measures aimed at improving or ensuring audit quality.

Research on Audit Quality

Contributions to the theoretical literature include economic models. This type of model usually investigates a limited number of variables while making strong assumptions about other factors. For instance, Frantz constructed a model of auditor's employment prospects as a function of skill, assuming no imperfection in the assessment of negligence or in the quality prescribed by the prevailing auditing standards.³³ The model is developed by introducing one or other form of imperfection and considering situations where skill is observable or not and finally considers the auditor's incentive to invest in skill. Another example of this type of research is De's and Sen's model that emphasizes the moral hazard of auditing and suggests that there is a disincentive for audit firms to initiate costly efficiency-improving changes in their technology.³⁴ The main limitation of this type of research is its need to work at a very abstract level in order to produce tractable equations.

For empirical work to be conducted on audit quality the concept needs to be defined and either measured directly or measured via a proxy variable. An early and much cited theoretical article by De Angelo defined audit quality as the likelihood that financial errors or omissions will be detected and reported.³⁵ This definition is often referenced although sometimes it is slightly restated. For instance, Goodwin and Seow state that '... a high quality audit has been regarded as one where the auditor both discovers misstatements (discovery) and is willing

33 P Frantz, 'Does an auditor's skill matter? Responses to and preferences amongst auditing standards' *International Journal of Auditing*, 1999, 3, 59-80.

34 S De and P.K. Sen, 'Legal liabilities, audit accuracy and the market for audit services' *Journal of Business Finance and Accounting*, 2002, 29, (3) and (4), April/May, 353-410 at 390.

35 L De Angelo (1981) 'Auditor size and audit quality', *Journal of Accounting and Economics*, 3, 183-99.

to report those misstatements (independence)³⁶ De Angelo's theory of audit quality is that large auditors have more incentive to issue accurate reports because they have more valuable reputations. This has been called the reputation hypothesis. A competing theory is the 'deep pockets' hypothesis put forward by Dye.³⁷ According to this theory auditors with more wealth at risk from litigation have more incentive to issue accurate reports. Large auditors have deeper pockets and so more incentive to be accurate. Lennox has distinguished between the two hypotheses pointing out that the reputation hypothesis suggests large auditors should be subject to less criticism and less litigation whereas the deep pockets suggests that large auditors could be subject to more litigation (when they fail to issue a qualified report when justified).³⁸ He conducted empirical research designed to test the two hypotheses against each other. His results support the deep pockets hypothesis, but not the reputation hypothesis. However, he points out that both hypotheses are consistent with the broad proposition that large audit firms provide higher quality audits. This broad idea, which can be based on the work of De Angelo or Dye, has led empirical researchers to use audit firm size as a proxy for audit quality. Chaney and Philipich state that '... audit quality is usually operationalised in research studies as a Big 8 or Big 5 dummy variable'.³⁹ This means that until Andersen's collapse empirical studies would count its clients, including Enron, as recipients of high quality audits.

Chaney and Philipich studied the market's response to events marking Andersen's demise.⁴⁰ Their article presents event studies of four event dates during the Enron crisis when information was released that damaged Andersen's reputation. The

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- 36 J Goodwin and J.L. Seow, 'The influence of corporate governance mechanisms on the quality of financial reporting and auditing: perceptions of auditors and directors in Singapore' *Accounting and Finance*, 2002, 42, 195-223.
- 37 R Dye, 'Auditing Standards, Legal Liability and Auditor Wealth' *Journal of Political Economy*, 1993, 101, 887-914.
- 38 CS Lennox, 'Audit quality and audit size: An evaluation of the reputation and deep pockets hypotheses' *Journal of Business Finance and Accountancy*, 1999, 26 (7) and (8), Sept/Oct 779 -805. This article makes reference to a number of previous empirical studies.
- 39 Paul K Chaney and Kirk L Philipich 'Shredded Reputation: The Cost of Audit Failure' *Journal of Accounting Research*, 2002, 40, (4), 1221- 1245. A more sophisticated approach is offered by Yi Meng Chen, Robyn Moroney and Keith Houghton, 'Audit committee composition and the use of an industry specialist audit firm' *Accounting and Finance*, 2005, 45, 217-239; this is a study of the top 510 companies listed on the Australian Stock Exchange where audit quality is proxied by a range of measures of the use of an industry specialist audit firm. They conclude that clients of industry specialist audit firms tend to have relatively more independent audit committees, at 236.
- 40 Chaney and Philipich, *op. cit.*

study is of the impact of these pieces of bad news on the share prices of Andersen's other clients, across the US and in the Houston area.⁴¹ The results show a significant negative response for Houston clients and a lesser but still significant response to Andersen's other clients to the document shredding announcement, 'suggesting that the investors downgraded the quality of audits performed by Andersen'.⁴² However, Chaney and Philipich also point out that 'The Enron audit was the fourth major audit failure affecting Andersen since 1999'.⁴³

A further form of empirical research on audit quality uses questionnaires to discover perceptions about audit quality. Results of such questionnaires are sometimes reported as stand alone results and sometimes used as the basis for further regression analysis. Recent examples of this sort of research include Goodwin's questionnaires sent to chief internal auditors in the public and private sectors in Australia and NZ asking about the relationship between the audit committee and the internal audit function;⁴⁴ Chen et al's research on whether big 5, local audit firms and regulators in China have the same perceptions of what constitutes audit quality;⁴⁵ and Sucher et al's questionnaires sent to financial executives in the Czech Republic asking about factors associated with audit quality.⁴⁶ Sucher et al suggested that the factors associated with quality were: technical competence of partner; technical competence of audit team; quality of relationship with respondent; speed problems are communicated; amount of disruption caused by audit; understanding of respondent's business; generation of useful ideas for improvement; speed of reaction to respondent's request; and value for money. An amalgamation of the results of questions on these factors was used as the audit quality variable in further analysis.

41 The Enron audit was conducted from Andersen's Houston office.

42 Chaney and Philipich, *op. cit.* p 1244

43 *Ibid.* p 1224.

44 J Goodwin, 'The relationship between the audit committee and the internal audit function: Evidence from Australia and New Zealand' *International Journal of Auditing*, 2003, 7, 263-278.

45 CJP Chen, A Shome and X. Shu, 'How is audit quality perceived by big 5 and local auditors in China? A preliminary investigation' *International Journal of Auditing*, 2001, 5, 157-175.

46 P Sucher, P Moizer and M Zarova, 'Factors affecting the assessment of the quality of a company's auditors: The case of the Czech Republic' *International Journal of Auditing*, 1988, 2, 7-20. Factors that were associated with quality were technical competence of partner; technical competence of audit team; quality of relationship with respondent; speed problems are communicated; amount of disruption caused by audit; understanding of respondent's business; generation of useful ideas for improvement; speed of reaction to respondent's request; value for money.

A final category of research on audit quality is research that focuses directly on the quality of audit decisions or judgments. This literature was reviewed in 1998 by Trotman.⁴⁷ Techniques used in this form of research are laboratory based. Broadly, all research under the heading 'judgment decision making' involves participants being given audit tasks and being observed as the tasks are conducted. Tasks focus either on the discovery of a misstatement or the auditor's willingness to report, or can involve both elements. Trotman's review describes six types of study. First, there is policy capturing research in which mathematical representations of auditor's judgment policies are derived from judgments made by participants given cues presented to them. Second, there is work on heuristics and biases in information processing based on the work of Kahneman and Tversky.⁴⁸ In the context of audit quality, research participants are given information and asked to make estimates. Tendencies to over- or under-estimate under particular conditions can then be assessed. Third, there is work that observes auditors as they search for and select information and as they generate hypotheses. This work has used verbal protocol studies that ask auditors to think aloud through a problem and then ask for their most likely hypothesis for the cause of an error. Also, eye-movement protocols have been used where lengths of time used focusing on or moving between pieces of documented information can be measured. Fourth, there is work on the relationship between audit quality and the auditor's knowledge or memory. Subjects are designated as experienced or inexperienced for the 'knowledge paradigm', or novice or expert for the 'memory paradigm'. This type of research is based on the idea that auditor performance is a function of ability, knowledge, environment and motivation, but concentrating in these experiments only on ability. Fifth, there is research on group decision making. In the context of audit quality this has been done by asking one subject to make an audit decision, for example should stock be written down, and then have a group review the decision. Finally, there is research that investigates decision aids used by auditors. This work investigates both the proposed decision aid and the auditor's ability to operate the aid properly. Trotman's review suggests that more work could be done on other factors that could affect audit quality especially environmental and motivational effects, for instance, the need to justify decisions, repeat audits, and monetary incentives.

The research on audit decision making, as described in Trotman's review, can be seen as part of wider developments in 'behavioural' research that can all be traced back to Kahneman and Tversky's article published in 1972.⁴⁹ This line of work has

47 KT Trotman, 'Audit judgment research – issues addressed, research methods and future directions' *Accounting and Finance*, 1998, 38, 115-156.

48 D Kahneman and A Tversky (1972) 'Subjective probability: a judgement of representativeness' *Cognitive Psychology*, 1972, 3, 430-454.

49 This was followed by M.H. Bazerman, 'The Relevance of Kahneman and Tversky's concept of framing to organisation behaviour' *Journal of Management*, 1984, 10, 333-

led not only to research on auditors' assessments of risk in their decisions but also to research on investors' assessments of risk that has come to be known as 'behavioral finance'.⁵⁰ Both in relation to auditors and investors there is evidence that the errors made about risk tend to be systematic, and therefore will not cancel each other out.⁵¹ These 'self-serving biases' as they apply to the conduct of an audit have been explored by Bazerman, Loewenstein and Moore⁵² who argue that 'good' accountants can do 'bad' audits. These authors go so far as to suggest that

... even seemingly egregious accounting scandals, such as Andersen's audits of Enron, may have at their core a series of unconsciously biased judgments rather than a deliberate program of criminality.

Although a defence of Andersen may be misplaced, the article's two main points bear consideration in any policy-making aimed towards enhancing audit quality. The first point is that accounting involves a degree of ambiguity which can be an opportunity for biased decisions. In the UK the requirement for auditors to report on the overall truth and fairness of the financial statements offers theoretical protection against a choice or combination of choices that exploit accounting ambiguities to produce misleading accounts. The second point is that human behavioural tendencies may bias the auditor's judgment

Research shows that self-serving biases become even stronger when people are endorsing others' biased judgments – provided those judgments align with their own biases – than when they are making original judgments themselves.⁵³

The very nature of an audit is to assess the judgments that someone in the client firm has already made. Factors operating in an audit context that may produce self-serving biases in favour of agreeing with client-generated figures in the accounts include; attachment to the client due to the financial benefit of the arrangement, the familiarity of an ongoing relationship, the tendency to respond more to immediate consequences (damage to relationship with the client) than to

343 and R Thaller, 'Toward a positive theory of consumer choice' *Journal of Economic Behavior and Organisation*, 1980, 1, 39-80.

50 Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance*, Oxford, Oxford University Press, 2000.

51 L Babcock and G Loewenstein, 'Explaining Bargaining Impasse: The Role of Self-serving Bias' *Journal of Economic Perspectives*, 1997, winter.

52 MH Bazerman, G Loewenstein and DA Moore 'Why Good Accountants do Bad Audits' *Harvard Business Review* November 2002, 97-102.

53 Ibid. p 99. This claim is based on experiments done in the context of legal negotiations see L. Babcock and G Loewenstein 'Explaining Bargaining Impasse: The Role of Self-Serving Biases' *Journal of Economic Perspectives*, winter 1997.

longer term ones (damage due to issuing a clean report when a qualification was warranted) – called discounting: and escalation due to the cumulative effect of overlooking a series of small, individually insignificant, problems in a client's practices. Attachment, familiarity, discounting and escalation⁵⁴ are all reasons for even good auditors failing either to challenge management or to follow through a challenge with an audit qualification. The same problems of challenge and follow through also apply to the independent directors who are members of audit committees.

Recent UK Regulatory Measures

The quality element was addressed in the UK via two reports both published in January 2003. A Financial Reporting Council (FRC) appointed group chaired by Sir Robert Smith produced a report entitled Audit Committees Combined Code Guidance with the aims of providing guidance for company boards making arrangements concerning audit committees and guidance for directors serving on audit committees. In accordance with the recommendations of the Smith Report a new version of the Combined Code was issued in July 2003 which strengthened the role of the audit committee.⁵⁵ The functioning of audit committees depends to some extent on governance rules and to that extent the strengthening of the rules in the Combined Code is to be welcomed. However, the main method used by an audit committee is to question. Indeed, there are several lists of suggested questions available to audit committees.⁵⁶ In the end the functioning of an audit committee depends on judgments made by the independent directors who are members of the committee, and these judgments are susceptible to the problem of self-serving bias already discussed above. According to Spira much depends on how willing these directors are to 'dissent'.⁵⁷

The second report of January 2003 was the Department of Trade and Industry (DTI) Review of the regulatory regime of the accountancy profession (Swift

54 MH Bazerman, G Loewenstein and DA Moore, 'Why Good Accountants do Bad Audits' *Harvard Business Review* November 2002, 97-102, use these headings.

55 The following new provisions were introduced into the Combined Code following the Smith Report: D.3.1- audit committee to be at least 3 independent NEDs. At least 1 to have significant recent relevant financial experience. D.3.2 – audit committees to have written terms of reference. D.3.3 - audit committees to have sufficient resources. D.3.4 audit committee to have a section in directors' report. D.3.5 Chair of audit committee to be present at the AGM to answer questions.

56 The accountancy firm KPMG has issued a list of 91 questions. The ICAEW has issued a list of 81 questions.

57 LF Spira, 'Audit committees: begging the question?' *Corporate Governance an International Review*, 2003, 11, (3), 180-88.

report).⁵⁸ Where the recommendations of this report needed statutory measures such provisions were included in the Companies (Audit, Investigations and Community Enterprise) Act 2004, (the C(AICE) Act) 2004. The Financial Reporting Council (FRC) is an umbrella organisation which, under the new statutory framework for the accountancy and audit profession, is the UK's independent regulator for corporate reporting and governance. The FRC has various operating bodies including the Professional Oversight Board for Accountancy (POBA) and, under the POBA, the Audit Inspection Unit (AIU). The POBA provides independent oversight of the regulation of the auditing profession by the recognised supervisory and qualifying bodies and has statutory powers under section 46 of the Companies Act 1989, as amended by section 3 of the C(AICE) Act 2004. The AIU has the function of monitoring the quality of audits of 'economically significant entities'⁵⁹ and has quasi-statutory powers under paragraph 10A of Schedule 11 of the Companies Act 1989, as inserted by section 1 of the C(AICE) Act 2004. The AIU has so far made one annual report dated 31 June 2005 covering work over the period June 2004 – March 2005. For this initial period the Unit focused exclusively on the Big 4 firms and the audits of 27 of the larger listed companies were reviewed. The scope of future inspections as agreed with POBA will be much wider as it aims to cover all listed companies and other major public interest entities over the next two years.⁶⁰ However, even with this wider scope the AIU's reviews will mainly focus on the work of only 9 audit firms. The Big 4 firms audit 83% of listed companies and 85% of other major public interest entities, and 5 other firms (the Mid 5') audit a significant number of entities in the AIU's scope.⁶¹

In addition to defining the scope of its work, the AIU uses its initial report to set out its approach to the monitoring task it has been given. The Unit's approach will be based on the following characteristics

- Focus on the quality of auditing, with our recommendations to firms prioritised on this basis;
- Thorough, robust and challenging approach to inspection visits;
- Wide-ranging reviews of firmwide procedures, including an assessment of how the culture within firms impacts on audit quality;
- Selection of major audits for review which is largely risk-based;

58 Review of the regulatory regime of the accountancy profession, January 2003 www.dti.gov.uk/cld/accountancy-review.pdf

59 Financial Reporting Council Regulatory Strategy, December 2004, p.13.

60 Audit Inspection Unit, 2004/5 Audit Quality Inspections, Public Report, June 2005, para 2.2.– see report, appendix A.

61 Ibid 2.1

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- In-depth reviews of major audits, focusing on the quality of the group audit, including critical assessment of the key audit judgments made and a detailed review of compliance with UK Auditing Standards; and
- Review of the quality of reporting to the Audit Committee.⁶²

Although the inspection unit is part of the new regulatory system aimed at improving audit quality, the report does not define audit quality. Instead it refers to key inputs to the process that are ‘factors driving audit quality’. These factors fall under the following basic headings; leadership, human resources, ethical policies, performance and internal monitoring. The report also refers to the AIU’s role in monitoring compliance with various pronouncements on the conduct of audits that the report refers to as ‘regulatory’ although they are more in the nature of professional rules. For the period covered by the AIU’s first period of work this self-regulation comprised

- The Auditors' Code issued by the APB (Auditing Practices Board);
- The UK Audit Regulations and Guidance;
- UK Auditing Standards and other APB pronouncements; and
- Ethical guidance issued by the relevant professional body.⁶³

The AIU reported several problems arising out of its 27 reviews. In reviewing key audit judgments it found that

... as a result of insufficient documentation in many cases, it was often necessary to form a view as to the appropriateness of such judgments on the basis of oral explanations provided to us. In two cases we believed there was sufficient doubt as to whether the accounting treatment adopted, balance sheet presentation and/or disclosures provided complied with UK GAAP. We therefore referred these cases to the FRC's Financial Reporting Review Panel (the issues concerned did not affect reported profits in either case).⁶⁴

This illustrates the very indirect way in which the so-called regulation of the accounting and auditing profession might be brought to bear on specific problems. In order for any action to be taken under the new regulatory framework, an AIU review must discover a problem, for instance an inappropriate accounting treatment in a set of accounts that had received an unqualified audit report. The

62 Ibid para 3.3 (emphasis added).

63 Ibid, para 4.1

64 Ibid, para 5.3.1 (emphasis added). The report identifies further problems with audit documentation at para 5.3.6.

AIU must then consider the problem significant enough for it to be referred onwards to the FRC's review panel.⁶⁵

Although the new regulatory framework has a much stronger statutory backing than was the case when the accountancy bodies were entirely self-regulated, even the latest white paper acknowledges that the regulation is 'light touch'

the Financial Reporting Council's powers of oversight and enforcement have been substantially increased and extended by the C(AICE) Act. But it remains a light-touch, market-led regulator, which derives its funding equally from listed companies, the accountancy profession and Government and which, through its Council and Board, operates with the full cooperation and involvement of companies, investors and the profession⁶⁶

Many of the recommendations of the Review of the regulatory regime of the accountancy profession have been introduced not by the FRC, or one of its operating bodies, but by the accountancy bodies and audit firms 'overseen' by the FRC, for example auditor partner rotation⁶⁷ and a two-year cooling off period for audit partners planning on leaving to join an audit client.

Conclusions

The aim of this article is to examine the efficacy and coherence of recent regulatory developments in the UK concerning statutory audits of companies given the theoretical, empirical and practical problems of defining and assessing audit quality.

In section 2 it was argued that the audit market, as part of the market for professional accounting services, is subject to a major source of market failure in the shape of asymmetric information. It is submitted that, because of the nature of audit as a credence service, regulation by the audit market is extremely unlikely to ensure high quality audits. In particular, a policy approach that focuses on competition may be in tension with quality enhancement. The UK OFT policy approach to competition in the professions has been criticised on two bases.

65 The Financial Reporting Review Panel operates both proactively in selecting accounts to review and in response to complaints. If significant misstatements are found in a set of accounts after a detailed panel review, the Panel can make a press release of its findings to alert investors. 3 press releases were made in the period to 31 March 2005.

66 Company Law Reform, Cm 6456 March 2005, emphasis added.

67 A five year maximum for the audit engagement partner, seven years for other key audit partners.

First, under the general theory of second best an individual measure that attempts to increase competition may not in fact move the economy as whole in a Pareto-improving direction. Second, the nature of professional services, including audits, as credence services means that market failure through asymmetry of information is a major problem. To the extent that quality controls are also restrictive practices, the solution for one market imperfection (asymmetry of information) can be the source of another market imperfection (monopoly power). The OFT's pro-competition policy for the professions does not give enough weight to quality control as a solution to the major problem of asymmetric information. Instead it puts the onus of proof on those who wish to retain a restriction by the presumption that such restrictions should go and the requirement that proponents of restriction demonstrate strong justifications. On a purely practical level, there is nothing in the OFT's policy that suggests it could change the basic structure of the market in which the Big 4 dominate and the Mid 5 cover virtually all other audits of economically significant entities.

In section 3 the policy on auditors' liability was investigated. The OFT conducted An Assessment of the implications for competition of a cap on auditors' liability and concluded that allowing audit caps would be competitively neutral overall.⁶⁸ Despite this neutrality, the UK government has introduced provisions in the Companies Bill to permit auditors to introduce a 'liability limitation agreement' into their contract with the company they are auditing. The theoretical literature on audit quality has provided two hypotheses linking large audit firms with higher quality audits; the reputation hypothesis and the deep pockets hypotheses. When Lennox tested these two hypotheses against each other he found support for the deep pockets hypothesis, but not for the reputation hypothesis. As the 'liability limitation agreement' provisions have not yet passed into UK law their impact remains to be seen. However, the inclusion of such an agreement in the auditor's contract will effectively make the firm's pockets less deep.

In section 4 on the quality element some of the conceptual, theoretical and empirical literature on audit quality was presented and the UK's new framework for regulating audit quality was described. Regulation of the audit process in the UK has been strengthened in the wake of the Enron collapse, but the self-serving biases and other problems identified by Kahneman and Tversky, described by Bazerman, Loewenstein and Moore, and evidenced in the audit decision making research reviewed by Trotman, will continue to affect auditors and possibly audit committee members. The new Audit Inspection Unit's stated monitoring methods include a 'thorough, robust and challenging approach to inspection visits'. To the extent that this regulatory approach requires those working on the inspections to 'challenge', this process may also become susceptible to the same sort of self-serving biases.

68 Ibid, para. 1.9, p 2.

The funding of academic research increasingly demands that it has value to policy makers.⁶⁹ At the same time policy making is increasingly attempting to make the claim that it is evidence-based.⁷⁰ However, in the field of audit quality and judgment decision making there appears to be some distance between academic work and the recent efforts of UK policy makers.

69 This must be demonstrated on the standard application form in use by all the UK's government funded research Councils.

70 SM Nutley, HTO Davies and I Walter, 'Evidence-based Policy and Practice: Cross Sector Lessons from the United Kingdom' *Social Policy Journal of New Zealand*, 2003, 20 (June), 29-48

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| Figure 1 Chronology | |
|----------------------------|---|
| Date | Event |
| 1992 | Cadbury Code of Best Practice published |
| 1998 | UK Company Law Review commences |
| December 2000 | LECG report to OFT: Restrictions on Competition in the Provision of Professional Services |
| March 2001 | OFT Report on Competition in the Professions published |
| November 2001 | Measures introduced by ICAEW (the largest UK accountancy body) to remove restrictive practices come into force |
| December 2001 | Enron enters chapter 11 |
| April 2002 | OFT Report Competition in the Professions: progress statement published |
| July 2002 | Sarbanes Oxley Act signed into law in US |
| January 2003 | The Swift Report - Review of the regulatory regime of the accountancy profession www.dti.gov.uk/cld/accountancy-review.pdf |
| January 2003 | The Smith Report - Audit Committees Combined Code Guidance published - www.frc.org.uk/publications/content/ACReport.pdf |
| July 2003 | Revised and strengthened version of the Combined Code on Corporate Governance published. |
| July 2004 | OFT Report: An Assessment of the implications for competition of a cap on auditors' liability |
| 2004 | Companies (Audit, Investigations and Community Enterprise) Act 2004 introduces statutory measures bringing stronger regulation of the accounting and audit profession. |
| December 2004 | Financial Reporting Council Regulatory Strategy published. Functions relating to audit quality are to be exercised by the following operating bodies of the FRC: The Professional Oversight Board for Accountancy (POBA) and the Audit Inspection Unit (AIU). |
| 2005 | Draft Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 published |
| March 2005 | White paper 'Company Law Reform' published. |
| June 2005 | Audit Inspection Unit, 2004/5 Audit Quality Inspections, Public Report published |
| January /February 2006 | Companies Bill reaches it Committee stage in the House of Lords |