

# Chapter 15. Conclusion: Restorative strategies

**Keith A Houghton**  
**Colin Dolley**

The focus for the discussion of ethics and auditing has been the recurring financial failures of large public companies not only in Australia but also in the Anglo-American accounting world. To the extent that these failures are evidence of systemic problems in the auditing and accounting profession, it is unlikely that regulatory responses that do not take account of the systemic issues will lead to an improvement in financial reporting and auditing. This summary is based around three themes developed in the book: frameworks for understanding the role and duties of the auditor, the analytical and empirical review of the underlying issues in financial reporting and auditing, and finally some proposals to support improvement in financial reporting and auditing.

On one level, the role and duties of auditors can be explained in a relatively straightforward manner. Hamilton and Stokes (Chapter 4) outline the role of the auditor using an economics of auditing approach. Within this framework, a firm has an incentive to enter into contracts with external auditors in order to reduce the contracting costs between the firm and external parties such as creditors. Ethics has a role in this contracting process in that it bears on the fairness of decisions made by contracting parties in the completion of the contract.

In the legal context, Bottomley (Chapter 1) sets out the statutory functions and powers of the auditor, as well as the duties of the auditor imposed by common law. Bottomley identifies the more recent reforms to the statutory independence requirement of auditors and concludes that auditor independence has become 'a much more complex regulatory goal'. Underlying the economic and legal framework understanding the nature of auditing are some fundamental issues about the audit firm-client relationship and the way in which it impacts on auditor independence, as well as the financial reporting climate in which the auditor is required to engage.

One approach to the examination of financial crises is an understanding of the financial reporting climate in which auditors engage. Campbell (Chapter 5) identifies two issues: the role of the auditor and the audience for audit reports. Campbell returns to the concept of a 'true and fair view' as the basis for an ethical scheme to assist in understanding the audit process. He finds this concept attractive because it associates the auditor's role with developing (or destroying) the trust which is critical to business relationships. A true and fair view concept

also raises issues about the potential conflict in the representation of financial information for different stakeholders.

In contrast to the notion of a true and fair view that reflects economic reality, McBarnet (Chapter 2) draws attention to behaviours where financial reporting may be 'technically proper and perfectly legal', and yet exploits gaps and loopholes in regulatory statements. This view highlights the situation that whilst there may be a few spectacular corporate failures, there is an underlying approach to financial reporting that seeks to exploit gaps in accounting rules and principles. Despite commitments in corporate ethical codes to compliance with the law, these commitments do not require company managers to abide by the spirit of the law. A similar theme is pursued by Cooper (Chapter 8), who detects that 'materialism' represents a fundamental change in corporate and professional culture. Cooper further asserts that the declining ethical standards of auditors and accountants can be viewed against the inclusion of materialism in professional culture.

An example of the flexibility in accounting standards and auditing is provided by Johl, Jubb and Houghton (Chapter 10). Their study was motivated by the criticism of auditors, including international auditors, of the variability of audit quality following the Asian financial crises. Johl, Jubb and Houghton examine earnings management by Malaysian companies prior to and following the Asian financial crisis. They found evidence of higher levels of earnings management prior to the crisis, but there was no association with earnings management and the post-crisis period.

As noted by Bottomley, auditor independence is a complex matter. Two aspects of auditor independence explored in the book are the provision of services to the client other than audit services, and the relationship between companies with interlocking directorates and auditors.

Spence (Chapter 6) identifies the situation in which auditors provide both audit and other financial services to the same client as a conflict of interest. Spence proposes that the best way to deal with conflicts of interest such as these is to avoid the arrangement where possible. The next best solution is to disclose the conflict so that the relationship between the parties is transparent. However, Spence argues that apparent conflicts of interest can generate ethical problems because of the uncertainty created in the minds of users of financial statements about the credibility of the financial reporting process.

It is significant that in his review of the literature on auditor independence and the provision of non-audit services, Ikin (Chapter 14) concludes that there is evidence that financial statement users perceive that the provision of non-audit services does impair auditor independence. There is little evidence from auditors on the impact of non-audit services on their professional judgments, and what

evidence there is is inconclusive. However, the evidence on other aspects of auditor independence and non-audit services suggests that auditor independence is not impaired. Ikin concludes that the provision of non-audit services is not associated with issues such as audit firm tenure, the propensity to issue an audit qualification and earnings management.

Auditor independence can also be weakened by the fundamental relationship between the audit firm and the corporate client where the audit firm is economically dependent on the client. Professional accounting societies state that auditor independence is associated with objectivity in decision-making. The question arises as to what extent the auditor's decision-making is influenced by client management bargaining power. Windsor (Chapter 9) reports that the results of two experiments indicate that auditors' objective thinking is influenced by client economic variables.

There may be situations in which the engagement of an audit firm by a client company is not an independent decision. That is, there may be directors that are members of the board of a number of companies that are able to influence the decision through their 'personal attachment' to appoint an auditor. In their review of prior research, Courtney and Jubb (Chapter 7) report findings of a positive association between companies with interlocking directorates and the choice of audit firm. Courtney and Jubb investigate whether companies with interlocking directorates will be associated with audit firm tenure, and find that auditor-director links are positively associated with audit firm tenure. Such a finding lends support to the view that longer audit firm tenure may be associated with attenuated auditor independence.

As noted above, professional accounting bodies state that auditor independence is associated with objectivity in decision-making. Professional bodies develop codes of professional conduct to support objectivity in decision-making, as well as including sessions on ethics and accounting in professional training. As part of the reforms to auditing practice, it is proposed that the Financial Reporting Council (FRC) promotes the teaching of business and professional ethics.

Plummer (Chapter 12) examines improving the ethical judgment of individuals in the context of undergraduate accounting education. In particular, Plummer explores the relationship between ethical judgment and approaches to learning. One approach – deep learning – occurs where a student has an intrinsic interest in the academic task and relates the task to their experience. Plummer finds a moderate positive relation between ethical judgment and a deep approach to learning, and suggests that further research on this relationship may be worthwhile.

Howieson (Chapter 13) argues that the development of ethics education requires multimodal strategies and careful thought and planning. According to him, the

outcomes of such well-planned ethical training can result in increased sensitivity to ethical issues, develop people with the tools and skills required to deal with more difficult ethical problems, promote the development of moral courage, and broaden auditors' understanding of ethics to embrace it as excellence in professional performance.

A number of authors are wary of increases in regulation as a response to the current crisis in financial reporting and auditing. Cooper notes that the response to previous financial crises' increased regulation has been ineffective. Hamilton and Stokes review the positive accounting theory approach to the political process and note that regulatory reform may not always be in the public interest. They suggest that such a view of the regulatory process is consistent with the selective use of research evidence. From their review of the auditing literature, Hamilton and Stokes argue that the regulatory reforms are unlikely to result in more efficient solutions in that they provide lower contracting costs for participants in the audit contract.

Proposals to increase the independence of the audit profession (Simnett and Smith, Chapter 3) and to signal the independence of audit firms (Houghton and Jubb, Chapter 11) are cognizant of the requirement to develop regulation of auditing that is in harmony with the efficient operation of the audit market.

Simnett and Smith examine a proposal to improve the independence of the audit profession. In a number of countries, a public oversight board has been proposed to achieve the outcome of increased transparency and independence for the audit profession. Members of a public oversight body are selected on the basis that they are independent of the audit profession. Simnett and Smith compare and contrast public oversight board proposals across the dimensions of selection of board members, whether there should be separation of oversight and standard-setting, the extent of disciplinary and investigative powers, and the scope of the board's activities. They conclude that the proposed Australian public oversight board will achieve the objective of increasing investor confidence without reducing market efficiency. Tensions that may arise with an Australian public oversight board are with it being a local oversight board while auditing standards are developed by an international body, and concern also the scope of the board's activities across a range of organisations and across a range of assurance standards.

Houghton and Jubb develop a proposal that is designed to provide information to the market about the independence of audit firms. Such information would have value in the marketplace because auditor independence, in the absence of such information, is typically *ex ante* unobservable. The information about the independence of audit firms would be based on a report by external inspectors on an audit firm's processes to determine threats and perceived threats to audit

independence. Houghton and Jubb propose that the requirement for a review and inspection service be under the control of the FRC.

The way in which the future of audit may be crafted will depend in large part upon regulatory imposition, and entrance or exits from the audit for market services from both the supply and demand side. In respect of the matter of auditor independence – the key component to auditor quality – the present state of play in Australia has a mixed and somewhat confusing set of overlapping responsibilities and authorities. For example, at one level the FRC has a high-level responsibility and substantial authority in respect of the area, given the relevant legislation. However, in respect of audits of corporations, the Australian Securities and Investments Commission (ASIC) also has legal authority, and in recent times has used that authority to perform inspections on the larger audit firms with regard to their audits of organisations formed under the Corporations Act. It is understood that these inspections will be complete and that a report, which will be available to the public, will be in place by the middle of 2005. Additionally, the two major professional bodies, the Institute of Chartered Accountants in Australia (ICCA) and CPA Australia, have professional guidance and quality assurance reviews that also in part touch on the area of independence. These quality assurance programs also cover areas of auditor competence, and indeed management of accounting firm practices. In the recently revised structure and operation of the Auditing and Assurance Standards Board (AuASB), it too has responsibility for providing guidance and even setting standards in respect of independence. This was recently confirmed by the chairman of the FRC, who at the April 2005 board meeting of the AuASB made it clear that both auditor competence and independence were components for the work program of the board. It is also understood that the FRC has a memorandum of agreement with the two professional bodies, the AuASB and direct oversight of the AuASB. It should take command of the issue of independence and harness the energy of all these organisations to ensure that the market for audit services has good quality controls and processes in respect of auditor independence. In the eyes of some, this will cut across the long-standing tradition of the professional bodies being responsible for ethics. It is understood that tension between the professional bodies and the corporate regulator, ASIC, has meant that a shared understanding of the guidance on ethical behaviour has not been established, and indeed if this disagreement exists between these powerful and important organisations, the present regime dominated by the Professional Standard F1 is unlikely to be sustained or sustainable.

## **What is the future of audit?**

Many of the contributions to this book state that there is clearly a degree of instability, even turmoil, within the market for audit services, including behaviours

within that market. The regulatory framework for going forward is unlikely to be perceived as being clear-cut by many and the challenges are no less than they were a decade or even two decades ago. Indeed, we now know more about behaviours, and possessing that greater knowledge provides more questions than solutions in respect of the ethics of auditors and their behaviour, particularly relating to independence. All of this leads to the conclusion that the country requires a more comprehensive investigation into what is the future of audit. To this end, the two professional bodies and other stakeholders are challenged to create, fund and implement research programs that will provide both a clear pathway and structure so that auditing will have, and be seen to have, a future contribution to the Australian economy and society.

The contributions of the authors to this book have been both important and thought-provoking. These debates lead to further questions – important questions that need to be addressed by those in the market for audit services and those who seek to regulate this market.

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