Part III. Beyond the auditor: the search for solutions

Chapter 11. Auditor independence: regulation, oversight and inspection

Keith A Houghton
Christine A Jubb

Abstract

Much of what auditors do is unobservable. Indeed, what goes on in an audit has been described as 'secret audit business'. Audits in this context are of financial reports and those financial reports are the representations of the management of those companies, not the auditors. The audits of financial reports are of value in that they provide a competent and independent (of auditee management) attestation of the validity of those management representations. This attestation lowers the 'information risk' for the users of these financial reports.

There has been a marked increase in activity to regulate matters relating to independence. The proposals outlined in CLERP 9 are one example of this. The requirements in the United States under the Sarbanes-Oxley Act are a further example.

Audit firms operate in a highly regulated yet highly competitive market. Evidence exists to suggest that audit firms are active competitors in respect of audit pricing and competency, including specialist industry expertise. Until recently, there has been little or no observable evidence that audit firms compete in respect of independence.

The issues as they relate to audit independence are complex. One issue is that threats to independence are frequently subtle and difficult to observe and measure. Hence, controlling the decisions that relate to them cannot rely solely on regulation which itself inevitably relies on crude definitions and imprecise measures. Additionally, further regulation may not achieve the desired end without other processes being but in place in tandem.

This paper argues that:

1. auditors of certain classes of companies (in particular, those that are publicly traded) should be provided with incentives or requirements to have observable processes on independence
2. the means of observability should be in the form of an inspection and review process focussing on issues critical to the audit, such as independence
3. expert persons not having a current or past financial interest in the firm or in the commercial outcomes of the review should be used in the inspection and review process
4. the review process should have wide-ranging powers of inspection to examine the policies, processes, structures and 'culture' of audit firms
5. the report of the inspection and review should be made public, unedited and in full, and in a timely fashion.

The primary objectives of this proposal are to (1) make more transparent to the market for information the characteristics of the audit firms and their process to ensure audit independence, and (2) provide a rigorous oversight of independence decision-making by persons who have no commercial interest in the outcome of the decision.

Introduction – are audits different?

The regulation of audits has undergone numerous changes since audits first became a part of corporate regulation. It is common for such changes to occur after a major corporate crisis – in particular, a major business failure that gains public interest or notoriety. Where these failures are linked to the belief that there has been audit failure, legislators, corporate regulators, the community at large and the accounting profession all tend to react. Sometimes these reactions result in change to the regulation of audits.

Over time, many of the implemented changes have added to the quality of audit and auditing. However, it continues to be the case that no matter how well an audit is executed and how well the regulation of auditing is implemented, corporate failures continue to occur. This is seen by some as a sign that the audit process is not capable of delivering a product that is of value to the market for financial information. In past years this perception of lack of 'delivery' of the audit product has been described as an 'expectations gap'. It is reasonable to conclude that, at least in part, what is expected by some participants in the market is not achievable. However, there are examples of individuals who might reasonably be expected to be well-informed about the real deliverables of audits having concerns about certain of the qualities of auditing as it is currently practiced. Put another way, there is not just an 'expectations' problem but actual perceived problems with outcomes from audits. This perception is exemplified

in the United States by the collapse of Enron in late-2001 and in Australia by the failure of HIH Insurance early in 2001. The outcomes of the HIH Royal Commission detail several of these problems (HIH Royal Commission 2003).

The audit and its characteristics

An audit is a professional service provided by accountants. Much of what goes on is unobservable by anyone except those most intimately involved in the processes. In the 2003 Houghton and Trotman Review, the process has been described as 'secret audit business'. Its key characteristic is that it provides some level of assurance to users of conventional, externally-issued accounting reports that the representations made in those reports are consistent with the underlying economic realities. The demand for this service is, in many instances, involuntary because of legislative or other regulatory requirement. There are, however, occasions where an audit or similar assurance product is voluntary and is the choice of either management or others (including stock or debt holders).

It must be remembered that the financial reports of a company are the representations of the management and directors of that company. It is the board of directors that is ultimately responsible for the content disclosed in those reports. An audit is an attestation of these representations by management by the auditor and assesses the truth and fairness (or in the minds of some, validity or integrity) of those financial reports. This highlights two factors; (1) that the financial reports are indeed simply representations of management and are not primarily the responsibility of the auditor, and (2) that it is the auditor's responsibility to attest to the validity and reliability ('truth and fairness' in the Australian context) of those reports.

For the attestation to be of value in the market for financial information, it must meet two necessary conditions. First, the attestation needs to be competently undertaken and executed. It needs to be undertaken by those with relevant expertise in the practice of auditing. This will include expertise on the planning and execution of the audit itself and may include specific specialist expertise in the industry of the auditee company. To be competent, the audit will need to include relevant and applicable audit processes and methodologies and, where relevant, technologies. Secondly, for an audit to be of value it must be undertaken with judgments made and views held that are independent of the management and board of the auditee company. The auditors' judgments need to test the assertions and representations made by auditee managements.

The information value of audits

The following simple illustration shows why audits have the potential to be highly valuable in the market for financial information. Company A and Company B are two entities that operate in the same industry. They have the same financial

structure, they operate in the same industry, they have the same risk profile, cash-flow revenue streams and outlook and the like. In terms of economic substance they are identical. In this hypothetical example, a competent, independent auditor audits Company A. Company B is not audited at all. The question is, if both these companies were traded on a stock exchange, which company would have the higher share price?

Assuming the market is efficient, the answer is Company A. This is because Company A has information conveyed to the market with lower 'information risk'. If there were to be comparison between the two companies in respect of debt costs, Company A would achieve lower costs, again because the information provided to the market is with a lower level of information risk.

Recall that the financial reports produced and used by the stock market, providers of debt and others are the assertions of management. These management assertions are guided by Generally Accepted Accounting Principles (GAAP) and other factors, but they are still simply the representations of management. The processes, including various checks and balances within the auditee that produces these financial reports, do not extend to a critical professional independent review of these representations. Such a review or attestation ideally should be undertaken by persons who are (1) expert in the field, and (2) able to investigate thoroughly the company with a right of access unparalleled by anyone other than those internal to the management of the company. Only where this review and attestation process is both competent and independent of the management of the entity does it add to the market's perception that the financial reports are both valid and reliable. Financial information that is perceived to be more valid and reliable means that the information provided has lower risk. Therefore, financial reports that have attached to them a competent and independent audit have lower information risk in the market; lower risk results in higher stock price and lower cost of debt. Audits do, therefore, add value to a company and have the potential to affect stock price and debt cost.

Consider the slightly more realistic example where two identical companies both have audits, but where one company has an audit provided by an audit firm that has a reputation for high-quality auditing and the other is audited by a firm that has a reputation for providing an adequate audit. The share price difference between these two companies would not be as large as that existing for entities with a competent, independent audit compared with no audit at all, but there would still be a price difference in the stock prices traded by the two companies, other things being equal. Hence, we can conclude that differing audit quality levels have differential value-adding effects. In addition, and perhaps most importantly, the quality difference in the audit converts to a price differential in the shares traded on the stock market.

Similarly, those that trade in the debt of audited companies will attach a different risk premium between companies that are audited and unaudited, and those that are audited by what is seen as a high-quality auditor and those that are not in receipt of that level of quality. Evidence of price premiums for different auditors and their consequential effect on the various markets has been demonstrated in the auditing research literature (e.g., Craswell, Francis & Taylor 1995).

The characteristics of a valuable audit

The value of an audit arises only where the following two necessary conditions are met. That is, where the audit is competent and independent of auditee management. If an audit is not undertaken competently, then it is not of value to users. If an audit is undertaken competently but not independent of management, then the representations made are nothing more than the original views of management. In either case the audit does not lower information risk and would not be valued by the market for information.

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.

Audit as an 'experience good'

Unlike many commodities, an audit is not a 'good' that can be observed *ex ante*. An audit is referred to as an 'experience good' (Craswell & Francis 1999). That is to say, it is a 'good' whose qualities cannot be observed prior to purchase. The qualities that are crucial are frequently not observable until the good is actually experienced. This makes audit choice decisions more difficult than in many other markets for goods. Further, even after the audit is purchased and experienced, it is not always possible to observe all the relevant qualities of an audit.

It would be rare for anyone other than those most intimately involved in the audit to be in a position to observe key characteristics of the audit. Even those close to the audit (e.g., those involved in the finance function or with the audit committee of an auditee) are more likely to have some opportunity to observe aspects of competence. Even in these circumstances, it is possible that this elite group will have only a limited ability to observe the characteristics that relate to independence. 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. It is easy to understand that unless the audit firm initiates means by which the independence processes are made transparent, the market is unlikely to be optimally informed of them.

In Australia, we now have two firms that are, to some degree, seeking to make their processes, or stated processes, observable to the market. The firm first to

announce such an oversight and disclosure process was the Australian firm of PricewaterhouseCoopers (PwC). In May 2002, that firm announced the creation of the 'Audit Standards Oversight Board'. The structure and operation followed the principles laid out in submissions made earlier to inquiries emanating from Treasury and the Joint Committee on Public Accounts and Audit (JCPAA) for individual firms to establish an audit independence oversight board (Houghton 2002a & b). The first report of this board was made public and dated August 2003 (PricewaterhouseCoopers 2003). The board was initially made up of three distinguished persons, including a former partner of PwC and a former governor of New South Wales. Using a somewhat different model, the chairperson of the Australian practice of KPMG established an expert review panel to both oversight the independence processes and policies and gather evidence on their operation (see Houghton & Trotman 2002). The two members of the review panel were both persons with audit expertise and neither had a material commercial interest in KPMG. The first report of this review process was issued in October 2002.

Independence

Auditors are exposed often to potential threats to independence during an audit engagement. These threats to independence influence the audit 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; and threats issued by an auditee to terminate an audit engagement or put out for tender an audit 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. That is, the existence of a threat to independence may occur only when several factors come together. 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. Threats may be created incrementally and over a lengthy period of time. Indeed, it is possible that both auditors and auditees are not conscious of them. A further threat not well-acknowledged in professional circles relates to the fee dependence issue. Fee dependence by an audit firm may be not just from one auditee, but from a 'family' of auditees all linked by *shared directors*. While the fee earned from each auditee

may not represent a threat by itself, when linked together they do potentially pose a significant fee dependence threat in combination via shared directorships.

Testing for auditor independence

It is often said that audits are usually successfully executed, and auditors in general perform their function in a professional and diligent manner. It is our view that 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 to verify this because it is rare for the independence (and indeed competence) of an audit to be rigourously tested. The only circumstance where a comprehensive examination of the qualities of an audit occurs in a public arena is when an auditee suffers severe financial distress.[1] In the circumstances of corporate failure, there are incentives for persons outside the organisation to rigorously test the competence and independence of the audit. Given the hundreds of business failures each year, it is important to note that only in a small minority of these failures is an auditor even alleged to have not completed a competent independent audit. In some of these circumstances these allegations are not followed through. It is possible that there is no follow-through either because of the significant costs of litigation or other action, or because there is some compromise or settlement on the part of the auditor and/or the auditor's insurance company. In some cases there is significant follow-through. Through this process, a number of these cases end in settlement and/or judgment against the auditors. That is to say, on a non-trivial number of occasions in recent years, audit failure – or at least perceived audit failure – has occurred visibly in a number of jurisdictions.[2]

In respect of allegations of audit failure, there are generally two areas in which allegations are made. These two areas follow 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 judgment as to whether the audit processes have been reasonable and competently executed. With reference to issues of independence, it is not uncommon for the audit review described in the previous sentence to also attempt to cover any issues of independence. It is, however, uncommon 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 pointed to, there is often little

[1] In various jurisdictions, peer reviews sponsored by professional accounting associations may be undertaken, but rarely are the results made public.

[2] Note, however, that a settlement does not indicate a clear case of audit failure as it is possible that the cost of settlement is less than the cost of further defending litigation.

that can be identified to assert that judgments and decisions reached were made independent of auditee management.

On the whole, judgments in respect of independence are entirely in-house[3] , outside of the observability of those that may be interested in the characteristics of the decision, and more importantly, the decision-making process. In some cases it is reasonable to believe that (1) recognition of threats to independence, (2) determination of alternative courses of action, and (3) final judgment relating to decisions involving independence are all routinely made by those persons within the audit firm who (directly or indirectly) have some commercial interest in the outcome of the decision. In some but not all firms, the policies and procedures that guide the decision process are not subjected to inspection or oversight.

Put simply, 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. This will be exacerbated by the CLERP 9 definition.

Legislating for auditor independence

There are those who argue that the best way of going forward in relation to audit quality (including both auditor competence and independence) is to enhance the legislation and/or regulation of the market for audit services (e.g., Ramsay 2001). The Corporate Law Economic Reform Program ('CLERP 9') proposals are an example of regulating in an attempt to obtain greater levels of independence. There is some merit in this position.

In respect of auditor competency, it can be argued that ensuring that there is a floor level to competency below which no individual may practise is a desirable thing for those users of the service. The means by which this competency is assessed varies, but often operates to ensure that those who have inadequate expertise and/or inappropriate experience are precluded from entering the market.

There is no regulation or control above this minimum level, and indeed there is evidence of considerable variation in audit quality. It can be argued that this variation in competency comes about because of the existence of competition and the incentives that exist for especially competent audits. The competitive marketplace is the driver of this variation in competency and it is not the outcome of a regulatory or legislative requirement beyond professionally or regulatorily mandated base proficiencies.

In respect of regulating or legislating for independence, the challenges can be seen as (1) efficiency, (2) effectiveness, and (3) completeness.

[3]It is acknowledged that while being in-house, there are processes to record these in-house events and decisions; see AUP 32 'Audit Independence' (AARF 1995). This document is to be withdrawn by December 2003, given the introduction of the F1 professional requirements of the two major accounting bodies.

Defining independence

The proposed CLERP 9 Bill offers a definition of independence that has emerged from the report of the HIH Royal Commission. Section 324CA of the Bill gives a general requirement for auditor independence. This means that if an individual auditor or firm has any of the following characteristics they will be seen not to be independent: being an auditor and having a conflict of interest in relation to the auditee. Conflict of interest is defined in Section 324CB and includes:

> … if the circumstances exist … That: (a) impair, or might impair, the ability of the auditor, or a professional member of the audit team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body; or (b) would give a person, with full knowledge of the facts and circumstances, reasonable grounds for concern that the team, to exercise objective and impartial judgment in relation to the conduct of an audit of the audited body is, or might be, impaired.

This definition is wide and may give rise to a high hurdle, and if a set of circumstances was challenged it seems that the definition would give rise to difficulties for audit firms to defend their actions, even where they might have operated in good faith and with no knowledge of a conflict of interest.

Leaving aside the specifics of the CLERP 9 Bill, there are challenges in the effectiveness of regulating independence by virtue of defining what independence is and more especially what represents a real threat to it. As argued above, many independence threats are hard to identify and observe. Some have argued strongly that the joint supply of audit and non-audit services (NAS) is a threat to audit independence, but this is unlikely to be universally true. It is argued by some that the list of prohibited auditor provided NAS in the Sarbanes-Oxley legislation is a guide, but even then it is not without controversy. Taxation consulting, for example, can be 'benign' in that it can involve relatively 'mechanical' processes, or it can pose a threat to the independence of the auditor if the tax advice gives rise to the company having an aggressive tax position that needs to be provided for in the financial accounts but is not. Thus, even in this simple example we are left with the question, under what conditions does the joint supply become an independence threat? The regulation of independence may result in cases where the law of independence is substituted for the fact of independence. In this circumstance, the economy and the stockholder are, arguably, no better off than in a largely unregulated situation in which no regulated restriction is imposed externally. Rather, it is arguably more efficient for restrictions to exist that are created by market forces, especially those restrictions constructed by the boards or audit committees of auditee companies.

As previously noted, independence is subtle, difficult to observe and often hard to measure. Thus, it can be difficult to regulate efficiently the presence of inde-

pendence. Even if it can be regulated effectively, deciding on the threat, its measurement, etc. can cause economic inefficiencies. For example, it may be in the clients' (shareholders') best interest to have the auditor undertake certain testing of management controls, as much of that work will have been done as part of the audit. This pre-existing knowledge gives rise to 'knowledge spill-over' effects that represent an economic benefit to shareholders (Beck, Frecka & Solomon 1988). In a high-regulation environment these choices may not be available, thus driving out any such shareholder benefits.

Regulating independence

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.[4] We also believe that such regulation will inevitably lead to issues with the effective management of the independence requirements for the reasons set out below.

Ideally, we would argue independence requires contemporary decision-making that is *ex ante* rather than *ex post*. The avoidance of independence threats is better than dealing with the compromised independence in place (see, for example, IFAC n. d.; CPA Australia & ICAA 2001). It can be argued that any regulatory body or legislative board that is set up to review auditor independence will inevitably examine only independence issues which have been revealed and which are mostly gross, 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 and control.

If there is a regulatory process such as a disciplinary board or tribunal, external to the audit firms and removed from the day-to-day operations of the audit, that deals with independence threats, it is our belief that threats to independence would be revealed only after they occur and then only where there has been a damaging outcome and the facts of the case are revealed publicly. This does not aid the efficiency of the market. It also adds no confidence to the market for audit services. Additionally, it also does not enhance the value to shareholders and those that hold the debt of an auditee.

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. A decade or more ago the joint supply of audit and non-audit services was not an independence threat because the latter generally did not represent a substantial proportion of the former, but

[4]This matter is discussed later on in the chapter in respect of the special case of the joint supply of audit and auditor provided non-audit services noted in the section entitled 'The need for inspection'.

it does often now. If such legislation in respect of auditor independence had been put in place at that time, the joint supply threat would most likely not have been identified as an independence threat. Thus, that legislation would now be seen as incomplete. Additionally, as many threats are so subtle as to not be identified or validly measured, the likelihood of legislation or regulation being comprehensive is low.

Moreover, if auditor independence is enforced via a legal or regulated means, it is possible, even likely, that those in 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.

The need for inspection

Some would have us believe that if accounting firms returned to their position of just being audit providers, and not providers of many other business-related services, the threats to independence would be lowered or even eliminated. Even if this was true and even if it was possible, it can be argued strongly that it is unlikely to derive an optimal outcome. Even if firms were to be only audit suppliers, they will still be supplying a service the characteristics of which remain largely unobservable. The observability of the service provided remains a key issue for the on-going value of the audit service.

Even to those intimately involved in an audit, the characteristics of an audit are not obvious. And those that do have some chance to observe are, by and large, not the clients of the audit – i.e., the shareholders.

As argued above, regulation or legislation that attempts to define and control auditor independence is likely to be both ineffective and economically inefficient. However, with the CLERP 9 proposals implemented, the Financial Reporting Council (FRC) has responsibility to oversight auditor independence. As recently as the Auditing and Assurance Board's Consultative Meeting of 27 November 2003, the current chair of the FRC, Mr Charles Macek, noted that he believed the FRC would choose to oversee not just independence but 'other aspects of audit quality'. The corporate regulator (ASIC, the Australian Securities and Investments Commission) also represented at that meeting and observed that they were building capacity to conduct inspections. These inspections commenced in the first half of 2005. The potential overlap between the two oversight processes is obvious and the need for an understanding between the two bodies seems the only sensible way to proceed. Since then, the chair of the FRC has put the position that the AuASB has a role in auditor independence (comments made at the AuASB board meeting, 13 April 2005). The need to remove overlap is not only to stop the waste of public resources but to guard against the difficulties that might arise if one inspection process concluded that a given firm conducted

a competent and independent audit and a second inspection concluded, for the same firm, otherwise.

Perhaps one way to proceed would be for one body, the FRC, to conduct inspections and reviews of policies, procedures and the 'culture' of the audit firm, while the detail of individual audits could be reviewed by the regulator, ASIC. That is to say, the regulator could inspect using as its 'unit of analysis' the individual audit, while the FRC could inspect at the 'policy' level. Reflecting on the collapse of the US firm Arthur Andersen, either of these inspection services would have potentially observed concerns, but it may well have been the policy and 'culture'-level inspection and review that would have seen the warning signals first.

Given the potential inefficiencies and the need to overcome the 'unobservable' processes of an audit, there is a need for the higher-level review (which we propose be undertaken under the authority of the FRC) being highly transparent and the conclusions reached being open to the market for wide consumption. It seems sub-optimal to have the outcomes of an inspection service of an unobservable service itself unobservable. It is arguable that the individual audit inspection undertaken by ASIC might be optimally undertaken privately to ensure some degree of confidentiality of potentially commercially-sensitive client information.

At present the professional bodies have an inspection and quality assurance for those of their members that have public practices, but little is known of the outcomes of these reviews other than they occur at some interval and the outcomes are not readily available to the practices' client bases.

The above arguments would suggest that public-interest control of audit independence may be best affected via a process that permits or encourages both transparency and competition between firms in respect of the quality of independence policies and procedures. Such a process would need to be within an appropriate robust legislative or regulatory environment, but it is the process that affects the oversight of independence, not the legislation itself.

We argue that the preferred process is via inspection and review of an audit firm's independence policies, procedures and structure. It should also be invasive enough to permit understanding and interpretation of the 'culture' of the firm as it relates to independence.

Such an inspection and oversight service has been implemented on a voluntary basis already by some in the market. As indicated above, in Australia we have two examples of voluntary inspection and oversight processes. The first report of the KPMG review came in October 2002 (Houghton & Trotman 2002). The first report for PwC was in August 2003. The second Houghton-Trotman Report of KPMG is due for release in mid 2005. These oversight inspections and reports

are important at a time when new challenges are a part of the market for audit services. Market acceptance of them seems substantial.[5]

The voluntary oversight processes of KPMG and PwC have been an important step, but an incomplete one for the market as a whole. One might argue that these processes' quality differentiates KPMG and PwC from other audit firms. They may be a deciding factor in the choice of audit firm by some, but it leaves other parts of the market unprotected. The audit process remains unobservable for those firms that do not subject themselves to this type of oversight and review. An FRC-led transparent inspection process that reviews policies and procedures could ensure a degree of market-wide transparency. If the FRC process is not transparent in the way we suggest, it will fail to meet market expectations in the way those voluntary oversight processes voluntarily undertaken by KPMG and PwC have been able to meet expectations.

An important characteristic of the oversight and inspection process is that those reviewers undertaking this process have no commercial interest in the outcome of their deliberations. That is, the inspection process, while needing audit expertise, should not, in our view, involve persons who are or even have been partners or staff of the firm under review. It is important that this process be lead by a person or persons who are both expert in the area of auditing and independent of the commercial operations of the organisation under review. It is also important that each member of the review or inspection process not benefit commercially, either directly or indirectly, from any determination made in respect of independence. Put bluntly, independence review and oversight should be removed from those who may benefit commercially from those decisions, i.e. the partners of the audit practice.

The reasons why an inspection service with internal access to an audit firm is more effective than high-level regulation alone are as follows:

1. Independence issues, threats and potential threats can be dealt with swiftly and contemporaneously with the audit.
2. The process can deal with commercially sensitive issues without those issues becoming public or accessible by competitors.
3. The quality-control processes of the review process can be observed by the market, which gives rise to the possibility that accounting firms will compete in the market 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]The first report for KPMG was made available both in print and on the KPMG Australia website. In the first 10 days on the website, the first named author was advised that there were approximately 1500 unique downloads of the report.

5. Reward structures within audit firms can take account of decisions made by the board in achieving equity across partners responsible for practice growth.

The effect of independence inspection and review

The creation of an inspection and review process is a necessary but not sufficient condition for the effective quality control of independence in an audit process. The inspection process needs to infiltrate and observe all the relevant processes in the audit firm and to affect the culture and ethos of the quality-control processes. The culture needs to be observable, as it is this that is key to the long-term viability of quality-control processes that protect independence. Perhaps more importantly, potential threats need to be recognised *ex ante* and where possible avoided. A dilemma avoided is a more preferred outcome than a threat that is dealt with *ex post*, which might or might not involve a compromise or economic cost.

Development within audit firms: changing the culture of independence

A critical issue in respect of independence is not only the threats to independence but also the ability to recognise a potential ethical dilemma as it relates to independence, rather than just dealing with it when one occurs. Put more bluntly, if a member of the audit firm, be it a partner or employee, recognises a threat to independence before it becomes an actual issue to be dealt with, then many potential threats to independence are unlikely to become actual threats and ethical dilemmas can be minimised. To achieve this, substantial education needs to be put in place both within the firms and across the profession more generally. Such an education process would also probably be useful within the auditee, particularly to audit committee members and possibly more widely to the board of directors.

Some implementation issues

While there are many possible alternative ways to proceed, the above discussion suggests one model that warrants consideration.

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 that the existing, largely free-market approach in many jurisdictions in the world has resulted in less than optimal outcomes. This free-market approach has had significant negative economic and social effects. While the proposed model relies on competitive processes, it is necessary to have an appropriately strong legislative and regulatory

framework. Without this framework it seems possible that the inspection process would potentially fail, as some firms would seek to avoid the level of transparency that would be of benefit to the market for information. The essential framework requires as a minimum the existence of incentives or even requirement for auditors of publicly-traded companies (and possibly others where a significant public interest occurs – such as financial institutions) to be subjected to an inspection and review process. This might also be extended to the audit of other companies as well. This type of requirement may be seen as a parallel to the requirement on the part of audited corporations in many jurisdictions to establish an audit committee of the board of directors of the company.

The second regulatory or legislative requirement is to find the appropriate structure of the review and inspection service. Given the regulatory structure in Australia, it would seem that the process might be under the control and management of the FRC. Clearly some interrelationship between the review and inspection process and the corporate regulator would be desirable.

The professional bodies

The two major professional accounting bodies in Australia have a quality review program. No doubt those involved in these programs will have a view of the quality and integrity of the programs. However, the present writers know of little market evidence that these processes serve to inform the market for information. Additionally, because they themselves are unobservable processes, they do little to provide a competitive transparent environment. They do serve other processes in terms of assisting to keep their memberships on constant alert to enhance the quality of member competence, but an inspection and review process that oversees independence in a way that is observable to the market is a different objective altogether.

The auditees

The proposals do not call for auditees to establish their own quality-control procedures in respect of the independence of their auditor. Market forces will take boards and/or audit committees in this direction in any event. However, it is inevitable that with new disclosures and new information available to auditees arising from internal oversight and the proposed inspection process, some audit-related decisions will need to be considered with greater rigour and frequency than is the case currently. Inevitably, the work of the audit committee will become more burdensome, and auditees need to acknowledge this change in workload. Perhaps the most specific recommendation regarding auditees is that the workload of audit committees must now include assessing these materials on the independence of the auditor. The CLERP 9 draft legislation makes this responsibility even more onerous.

Summary of recommendations

The thrust of the model proposed here includes the following characteristics:

1. The regulatory framework should not attempt to directly and in detail define auditor independence as does the draft CLERP (Audit Reform and Corporate Disclosure) Bill. Nor should it describe or limit certain behavior of audit firms in respect of real or perceived audit independence threats.
2. The regulatory framework should be changed to encourage or require auditors entitled to undertake certain company audits (such as of publicly-traded companies) to demonstrate not only certain levels of competence, but also to develop and maintain review and oversight of their independence processes.
3. The appropriate entity, possibly the FRC, should be empowered to create and approve a review and inspection process for use by company auditors.
4. The review and inspection process should be given the capability of accessing the internal information within auditing firms and oversight the firms' processes to determine threats and perceived threats to independence.
5. The quality-control processes for independence should be observable by a wide section of the market and stakeholders in the market for audit services.

Concluding remarks

Audits require competence and independence. There are a number of mechanisms that can be used to ensure each is present. Competition has driven up the observability – or at least claimed observability – of competence, and yet this mechanism has been slow to drive up observability in respect of independence. The model proposes a solution that will create observability in respect of independence so that the market for information can be better satisfied.

The operation of the market for audit services has both important economic and social implications. Allowing the existing largely free-market approach to auditor independence is now seen as being less than optimal. 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 proposes a strong review and inspection process to enhance the quality and transparency of independence decision-making in audit firms, and greater disclosure of the auditors' skills and attributes to enhance auditor accountability.

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Chapter 12. Improving ethical judgment through deep learning

Kay Plummer

Abstract

Without ethical practice the accounting profession is unable to maintain its part in its contract with society. The accounting profession recognises a need to improve ethical practice through a broad range of strategies. Prior research using Rest's Defining Issues Test has identified education as a way of improving the ethical judgment of individuals, though there has been little Australian research aimed at identifying the educational approaches which can improve ethical judgment. There is, however, evidence that Australian undergraduate accounting students adopt a surface rather than a deep approach to learning. An examination of the description by Biggs of those who are deep learners indicates a similarity to those who perform at higher stages on Rest's Defining Issues Test. This research reports on the findings of a preliminary study that examines the relationship of the ethical judgment skills of accounting students with their approaches to learning.

Evidence is found of a moderate positive relationship between ethical judgment and a deep approach to learning. This suggests that further research examining the impact of teaching approaches that foster deep learning on changes in the ethical judgment of students may be worthwhile.

Introduction

Professionals are characterised by their unique expertise gained through education and training, a commitment to lifelong learning, service to society, a code of ethics, an agreement to abide by their profession's code, and participation in the self-governance and monitoring of the profession. Society grants professions autonomy with the condition that the expertise will be used in the public interest and that members will abide by the profession's code of ethics. Snoeyenbos, Almeder and Humber (1983) have described this as a 'social contract', in which the professional discharges his obligation by operating with high standards of expertise and integrity. When the profession does not maintain these standards the social contract is broken, and society may decide to limit the role or the autonomy of the profession. Society has placed limits on the actions of accounting

professionals in the past through legislation, and new restrictions have and are being implemented as a result of corporate failures early in the 2000s.

The directors and the auditors of collapsed Australian corporations such as One.Tel, HIH and Harris Scarfe stated that the accounts of their respective companies had been drawn up so as to give a true and fair view of the then current situation of the company, but subsequent investigation indicated that this was not the case. Directors and auditors are required by Australian corporate law to make a statement about the truth and fairness of the accounts, and the accounts have to be prepared in accordance with the accounting standards. 'Truth and fairness' is not defined in the legislation, but the accepted view is that the adoption of the accounting standards should lead to a true and fair view in all but extraordinary circumstances. In the case of the companies identified above, the accounting standards were not always followed, and the ambiguities and options embedded in the accounting standards were used by management, including accountants, to mislead the shareholders and the public.

As a result, the Australian accounting profession is concerned that the general public could view accountants as being unethical. This is resulting in reduced professional autonomy, with CLERP 9 proposals for increased regulation of the profession, particularly with respect to independence.

Many individual accountants have in the past acknowledged a decline in the ethical standards of the profession, though they did not consider that their own standards had declined. These accountants have suggested a range of remedies to arrest the decline, including stronger professional discipline, the introduction of courses on accounting ethics within university degree programs and continuing professional development (Leung & Cooper 1995).

The professional accounting bodies in Australia have attempted to strengthen the ethics of the profession through updating the Code of Professional Conduct, and ensuring that ethics is included in both undergraduate accounting and professional qualifying programs. As a result of the timing of the introduction of these requirements, there are groups of older members who have only completed a brief study of the Code of Professional Conduct, and have not completed any undergraduate ethics education. This gap has not been addressed within the continuing professional development (CPD) programs offered by the profession, as ethics programs have generally not been available and there does not appear to have been a member demand for such programs (Plummer 2003). In 2002 and 2003 some CPD programs, which included a component on ethics, were offered at the annual conferences of the two Australian professional accounting bodies.

There has been little Australian research on how best to teach ethics in accounting education programs, but there is research that provides some insights into the

way that accounting students learn, which may be used to assist in the determination of how ethics could be taught to Australian accounting students. The research reported in this chapter attempts to determine whether or not there is a relationship between ethical judgment and approaches to learning, as this has implications for how professional programs at undergraduate and postgraduate levels could be developed. The second section of the chapter provides the theoretical background for the existence of a relationship between ethical judgment and approaches to learning. The third section describes the empirical tests undertaken and the fourth reports on the results. A summary and conclusions are included in the last section.

Theoretical background and hypothesis

Initial research in accountants' and accounting students' ethics has focused on measuring their abilities to make ethical judgments and, in a few cases, experimenting with interventions that will improve their ability to make those judgments (Armstrong 1987; Ponemon 1993a). The instruments used were initially Kohlberg's Moral Judgment Interview (MJI) and later, and more extensively, Rest's (1986a) Defining Issues Test (DIT). The DIT was developed to extend the work of Kohlberg (1984) in measuring moral judgment development. Kohlberg's work is an extension of Piaget's (1966) work on cognitive development and was initially designed to assist in the development of programs of education for moral development. The MJI was used by Kohlberg to determine the level of an individual's moral development and is based on a structured interview and takes some time to administer. The DIT is a self-administered paper-and-pencil questionnaire, and is based on Kohlberg's six-stage model of moral judgment development.

Kohlberg's model has three levels – pre-conventional, conventional and post-conventional – each of which has two stages. Both Kohlberg and Rest have described these stages differently over the years, and the short descriptions used have led to different interpretations of the developmental process. The stage model depicts a development sequence of problem-solving strategies moving from the simple to the complex; as people age and develop greater understanding, different considerations are recognised as relevant to the solution of moral problems. People operating at lower levels in the model can still make good moral choices, but their lack of understanding of complex issues may inhibit their ability to do so in certain circumstances.

There has been some controversy over Kohlberg's model with respect to the focus on issues of societal justice and the neglect of personal issues, the use of a 'staircase' stage concept, and the rarity of post-conventional thinking, its basis in foundational principalism, and the assumption that this can produce consensus. It is not in the scope of this chapter to discuss all of these issues: the arguments

and counter-arguments have been presented by Modgil and Modgil (1986), and summarised, rebutted and updated in Rest et al. (1999).

One issue that may not have been adequately covered is the emphasis on dilemmas as a means of measuring an individual's ethical approach to life. A dilemma-measurement approach does not allow recognition of the ability of individuals to live lives in which there are few dilemmas – where the habit of goodness appears to reduce the occurrence of dilemmas. Colby and Damon (1996) identified a number of these people who they considered to be virtuous moral exemplars. Virtue ethics focuses on the character of individuals and their overall approach to life, and this may not be encapsulated in a response to a small group of dilemmas taken out of context, as is used in the DIT. The moral exemplars studied by Colby and Damon did not score consistently high on Kohlberg's MJI, often only scoring at Stages 3 and 4. While this may be seen as a shortcoming of both the MJI and DIT, their use has identified that people change in the way they conceptualise and judge ethical issues and that, in particular, the DIT measures some of this change.

Rest has attempted to address some of the problems (though not the issue of a dilemma approach) that are recognised in Kohlberg's work, and in doing so has moved from the six-stage model to one of three schemas of an individual's understanding and development of cooperation within society. The three schemas in Rest's updated model are *personal interest*, *maintaining norms* and *post-conventional*. Rest focuses particularly on the maintaining norms and post-conventional schemas, as the DIT was originally developed as an instrument to measure an adolescent's movement from using conventional to post-conventional thinking (Levels 2 and 3 in Kohlberg's model). Table 12.1 provides a graphic comparison of the two models.

Table 12.1. A comparison of Rest's (1999) schema with Kohlberg's (1976) six-stage model of moral development

Level	Rest	Kohlberg
Level 1	Personal Interest (not described by Rest et al. 1999)	Pre-conventional Stage 1 To avoid breaking rules backed by punishment, obedience for its own sake, and avoiding physical damage to persons and property. Stage 2 Following rules only when it is in someone's immediate interest; acting to meet one's own interests and needs and letting others do the same. Right is also what is fair, what is an equal exchange, a deal, an agreement.
Level 2	Maintaining norms An individual recognises that society cannot exist without norms that are publicly set and apply to all, irrespective of whether they benefit all members of society.	Conventional Stage 3 Living up to what is expected by people close to you or what people generally expect of people in your role as son, brother, friend, etc. 'Being good' is important and means having

Level	Rest	Kohlberg
		good motives, showing concern about others. It also means keeping reciprocal relationships, such as trust, loyalty, respect and gratitude. Stage 4 Fulfilling the actual duties to which you have agreed. Laws are to be upheld except in extreme cases where they conflict with other fixed social duties. Right is also contributing to society, the group or the institution.
Level 3	Post-conventional An individual recognises the moral criteria that underpin the norms and uses these for guidance as they strive to achieve an ideal of cooperation within society which is shared and in which all benefit equally.	Post-conventional Stage 5 Being aware that people hold a variety of values and opinions; that most values and rules are relative to your group. These relative rules should however usually be upheld, in the interest of impartiality and because they are the social contract. But some non-relative values and rights, like life and liberty, must be upheld in any society and regardless of majority opinion. Stage 6 Following self-chosen ethical principles. Particular laws or social agreements are usually valid because they rest on such principles. When laws violate these principles, one acts in accordance with the principle. They include the universal principles of justice: the equality of human rights and respect for the dignity of human beings as individual persons.

Rest's maintaining norms schema is similar to the conventional level in Kohlberg's model and integrates such issues as:

- the need for norms, i.e. in a society-wide system of cooperation a set of norms limits the need to debate every issue
- duty orientation, i.e. a person obeys authority out of respect for the social system
- society-wide scope, i.e. individuals recognise the importance of and need for a society-wide system of cooperation
- uniform, categorical application, i.e. that the norms, laws and rules are publicly set and known and apply to all
- partial reciprocity, i.e. that individuals will obey the norms and laws and expect others to do the same even though not all may benefit equally.

An accountant who is at this level of moral development would be one who recognised the importance of various corporate and tax laws, and accounting and auditing standards, and complied with them; understanding that sometimes this compliance would benefit them and that sometimes it would not, but recognising that obeying these laws and standards is important for general harmony within society. Operating at this level may seem the ideal for an accountant, but it does not ensure that the accountant can make good decisions when there are options and ambiguities within accounting and auditing standards, nor does it ensure

that they have the ability to make good decisions when business circumstances arise that are outside of the current laws, norms and standards.

The accountant's role is to tell a story – to make an account – of a series of business activities. This story can be told from many perspectives and can therefore result in many different accounts. It is the role of the accountant to use the laws and accounting standards to determine the perspective to be taken, but these laws and accounting standards contain options and ambiguities. A higher level of understanding is required to deal with these differing perspectives, the options and ambiguities that exist within the standards, and the unexpected occurrences of business life. This higher level of understanding is encapsulated in the post-conventional schema.

The post-conventional schema integrates such issues as:

- recognition of the primacy of moral criteria, i.e. the individual recognises that they do not have to follow the norms but seeks the moral criteria behind the norms for guidance in action
- an appeal to an ideal way in which humans can cooperate
- a cooperative development of ideals that can and have been justified to a wider audience and are open to rational critique
- full reciprocity, i.e. the idea that everyone should benefit equally.

In deciding whether or not a set of accounts is true and fair, the accountant operating at this level is applying an ideal which has been developed and shared within the profession, the application of which they should be able to justify to a wider audience while being open to coherent and balanced criticism. Operating at this level would therefore appear to be the ideal at which accountants should aim.

The use of Rest's schema, with its societal basis, is also considered appropriate within the accounting domain, as many of the dilemmas that accountants face have a society-wide scope; e.g. lack of independence on an audit is a societal justice issue, as is submitting to client pressure for tax evasion. Accounting is an activity that facilitates the operation of – and cooperation within – society, and as such the ethical dilemmas that fall within it need to be considered within a society-wide scope.

Rest's schema is embedded in the DIT, the evaluation of which results in a P score. This is the relative importance a subject gives to responses appropriate for individuals who make judgments using the post-conventional schema (or Level 3 incorporating Stages 5 and 6 of Kohlberg's six-stage model), i.e. the higher the P score, the greater a subject's ability to make moral judgments based on the moral purpose behind society's conventions. Although the P score ranges

from 0 to 95, it is unusual to have someone scoring over 60. Ideally, accountants should score highly on this range.

Rest also developed a four-component model of moral action, each component of which must be present before the moral action will be undertaken. The components are:

1. *moral sensitivity*: interpreting the situation as one in which there is a moral dilemma
2. *moral judgment*: judging which action is morally right/wrong
3. *moral motivation*: prioritising moral values relative to other values
4. *moral character*: having courage and persistence, overcoming distractions, and implementing skills.

The DIT attempts to measure the moral judgment component of moral action, i.e. Component 2. Much of the research to date has focused on Component 2, with some research on Component 1 (Rest 1986a; Rest et al. 1999). There is no formal sequence for the components in the model, but some level of moral sensitivity must exist before a moral judgment can be made. It is possible to measure a level of moral sensitivity, but an instrument has not been developed that separates the moral sensitivity component from the moral judgment component when moral judgment is being measured using the DIT. In the research presented in this chapter the focus is on Component 2, as there is evidence that growth in moral judgment occurs within education (Rest 1986a; McNeel 1994; Rest et al. 1999). How much of this growth reflects a growth in moral sensitivity and how much reflects a growth in moral judgment has not yet been examined.

McNeel (1994) identified strong longitudinal growth in moral judgment development across his student subjects' four years of college, with a P score moving from an average of 35.7 to 46.4 (n = 216). In his study, McNeel examined the growth among the various major subject areas and identified this growth as being greater, and with significantly higher P scores, for seniors in psychology, nursing and English than among business and education majors. McNeel related this growth to majors in which the focus was on understanding the contradictions within each person and the variation between people, i.e. being able to take different viewpoints. This requires empathy and sensitivity to the impact of actions on others, as well as reflection and the ability to integrate the viewpoint of others with one's own world-view. McNeel also recognised that the growth could be due to the way the majors were taught, differences in the students who chose these majors, and other unidentified factors.

As an outcome of his and others' extensive research on moral development, Rest (1986a, p. 57) described people who achieve greater development in moral judgment as:

> … those who love to learn, who seek new challenges, who enjoy intellectually stimulating environments, who are reflective, who make plans and set goals, who take risks, who see themselves in the larger social contexts of history and institutions and broad cultural trends, who take responsibility for themselves and their environs. On the environmental side of the equation, those who develop in moral judgment have an advantage in receiving encouragement to continue their education and their development. They profit from stimulating and challenging environments, and from social milieus that support their work, interest them, and reward their accomplishments. As young adults, the people who develop in moral judgment are more fulfilled in their career aspirations, have set a life direction of continued intellectual stimulation and challenge, are more involved in their communities, and take more interest in the larger societal issues. This pattern is one of general social/cognitive development.

This description comes from the early research using the DIT and provides a strong connection between moral developers and learning – as does the more recent research of McNeel – and highlights the need to more effectively explore connections between learning and moral development.

Specific ethics education programs in the general population have concentrated on the discussion of moral dilemmas and conflict, and this focus has encouraged the growth of abstract moral judgment, though this is not necessarily translated into moral action (Rest 1986a). The interventions used in accounting ethics education programs initially included ethical dilemma discussion, consideration of professionalism, codes of conduct and dilemma resolution models (Ponemon 1993b). The aim of these courses appears to be that of sensitising students to the range of moral issues that they will face as accountants and giving them some tools to resolve those issues.

Some of the teaching techniques adopted by accounting and business ethics lecturers are provided in the accounting ethics education literature and listed in Table 12.2, but the literature provides little description and analysis of the teaching/learning and assessment strategies adopted in these programs, nor does it generally provide an analysis of the student responses to the interventions. This is unfortunate as it provides the accounting lecturer with little information about how to teach or not teach ethics to accountants, but it does provide accounting lecturers with a selection of techniques that can be used as a basis of research in their own classes. Providing diverse ways in which an area of study can be experienced gives the students greater opportunities to more effectively personalise the knowledge and attitudes embedded in the area of study and to

relate it to their own lives (Gardner 1999; Marton & Trigwell 2000; Marton, Watkins & Tang 1997) – that is, it can promote deep learning.

Table 12.2 provides a list of ways of teaching that have been suggested for ethics education. No one way has been identified as superior but as suggested above, ways of teaching which incorporate diversity, personalisation, integration and reflection may well provide a deep learning environment, which may foster ethical development.

Table 12.2. Ways of teaching ethics

Ways of teaching ethics	Author
Andragogy	Brookfield (1998), Leicester & Pearce (1997), Segon (1996)
Case	Buchholz & Rosenthal (2001), Loo, Kennedy & Sauers (1999), Alam (1998), Mintz (1996), Segon (1996), Leung & Cooper (1994), Welton, Lagrone & Davis (1994), Langenderfer & Rockness (1989), Gandz & Hayes (1988)
Collaborative learning	Hill & Stewart (1999), Mintz (1996), Damon & Colby (1996)
Cooperative learning	Mintz (1996)
Critical reflection and critical education	Hill & Stewart (1999), Levitt (1999), Carroll (1998), Brookfield (1998), Leicester & Pearce (1997), McDonald (1997), Segon (1996), Damon & Colby (1996)
Debate	Levitt (1999), Carroll (1998), Leung & Cooper (1994)
Decision models	Leung & Cooper (1994), Langenderfer & Rockness (1989), Gandz & Hayes (1988)
Dialogue	Brookfield (1998), Milton-Smith (1996)
Drama	Winston (1999), Basourokas (1999)
Emotion and feeling	Segon (1996)
Exhortation	Armstrong, Ketz & Owsen (2003)
Experiential learning – this includes activities like participating in community enrichment programs and service learning	Sims (2002), Buchholz & Rosenthal (2001), LeClair & Ferrell (2000), Glass & Bonnici (1999), Hill & Stewart (1999), Armon (1998), Kitwood (1998), Damon & Colby (1996), Morton & Troppe (1996)
Habit	Levitt (1999), Damon & Colby (1996)
Instruction (lectures)	Milton-Smith (1996), Leung & Cooper (1994)
Logic	Penn (1990), Colby & Kohlberg (1987), Rest (1986)
Meditation	La Forge (2000), Levitt (1999)
Mentor relationships, role models, moral exemplars	Armstrong, Ketz & Owsen (2003), Watson (2003), Hill & Stewart (1999), Levitt (1999), Damon & Colby (1996), MacIntyre (1984)
Movies and videos	Giacalone & Jurkiewicz (2001), Mintz (1996)
Presentations	Leung & Cooper (1994)
Reading stories/storytelling	King & Down (2002), Hill & Stewart (1999), Mintz (1996)
Reflection	Levitt (1999), Hill & Stewart (1999), McDonald (1997), Segon (1996)
Resolution of dissonant experiences	Brookfield (1998), Leicester & Pearce (1997)
Role plays, role taking	Kitwood (1998), Bebeau (1994), Mintz (1996), Segon (1996) Penn (1990), Colby & Kohlberg (1987), Rest (1986)

Identifying ways of successfully teaching ethics is important to the accounting profession as this will help ensure the continuance of a largely ethical profession and may address what appears to be a shortfall in ethical decision-making capabilities within the profession. In the United States, accounting students and

accountants who completed the DIT were found in general to have lower P scores than those of comparable groups (Armstrong 1987; Lampe & Finn 1992; Ponemon 1990, 1992a, 1992b; Shaub 1994), though there were some exceptions (Jeffrey 1993; Shaub 1994), and accounting students who participated in an ethics education program did not significantly improve their scores on the DIT (Ponemon 1993), apart from those who undertook an elective subject in professional ethics (Armstrong 1993). In his Australian study, Dellaportas (2002) also found a lack of growth in the DIT scores of accounting students who participated in an ethics education program. Armstrong and Ponemon (1993) concluded that traditional accounting education inhibits moral judgment development.

In the education discipline, greater moral growth has been found in interventions that provide experiences of moral challenge and accompanying moral emotions or commitments (Armon 1998), i.e. where students have been fully engaged in the subject matter and with the people with whom they were working, while in dentistry greater moral growth has been achieved through a combination of cooperative learning and role taking (Bebeau 1994).

Traditional accounting education has been identified as emphasising shallow, reiterative learning (Gray, Bebbington & McPhail 1994), where students do not fully engage with the subject and do not develop a deep approach to learning. The type of education accountants receive could therefore be inhibiting the development of moral judgment skills by not creating a need for a deep reflective approach to learning (Gray, Bebbington & McPhail 1994). Accounting lecturers could be using educational processes which encourage a surface approach to learning, and which may not be consistent with improved moral judgment in accounting students.

Recognition of a range of approaches to learning has existed for some time. For example, Ramsden and Entwistle (1981) identified a number, one of which was an 'understanding' approach, which involves the search for meaning and is related to intrinsic motivation, and corresponds to the deep approach called for by Gray, Bebbington and McPhail. Biggs (1987a) developed an instrument, the Study Process Questionnaire (SPQ), which has been widely used to identify common student approaches to learning in particular courses or classes. Biggs identified four approaches; *surface*, *achieving*, *deep* and a composite, *deep achieving*. Each of these approaches has two sub-scales, *motive* and *strategy*. These approaches are not mutually exclusive, so it is possible to score highly on more than one scale, though Biggs (1987a) indicates that students tend to favour one approach over another.

Students will adopt an approach depending upon a number of factors, some of which are personal – such as prior learning experiences, personality, intelligence and the issues that are affecting their lives at the time – and some situational.

Situational factors include such issues as subject content, methods of teaching and evaluation, and course structure (Biggs 1987b). This makes it difficult to validly compare students' scores on an SPQ across courses – and even perhaps across institutions – without taking into account the differences in the situational factors.

Students can score between 7 and 35 on each approach sub-scale, resulting in possible scores for each approach ranging from 14 to 70. Biggs (1987a) found that undergraduate students in general become increasingly surface and decreasingly deep in their orientation to learning over the course of their undergraduate studies, though his studies did not include accounting students. Booth, Luckett and Mladenovic (1999) had accounting students at two universities in Sydney complete the SPQ and a brief summary of the results is outlined in Table 12.3.

Table 12.3. Mean SPQ scores of Australian accounting students

Accounting students	Surface approach	Deep approach	Achieving approach
Males (n = 187)	51.5	43.0	44.3
Females (n = 158)	51.3	41.7	43.2
Combined (n = 345)	51.2	42.2	43.6

(Adapted from Booth, Luckett & Mladenovic 1999)

These accounting students were found to have a higher surface approach than deep approach to learning, and this is consistent with the findings of Gow, Kember and Cooper (1994). They identified a number of situational factors that encouraged a surface approach and these included 'excessive workload, surface assessment demands, lack of intrinsic motivation, a didactic teaching style, [and] high staff/student ratios' (p.118), while Jackling (2003) identified students' perceptions of good teaching, an appropriate workload in which there weren't too many topics and there was enough time for understanding, and clear goals associated with greater use by students of deep learning strategies. Some common themes in these situational factors appear to be time for reflection and integration (understanding), and good teaching.

Biggs (1987a, p. 15) described a student who adopts a deep approach as one who:

- is interested in the academic task and derives enjoyment from carrying it out
- searches for the meaning inherent in the task (if a prose passage, the intention of the author)
- personalises the task, making it meaningful to their own experience and to the real world
- integrates aspects or parts of tasks into a whole (for instance, relates evidence to a conclusion) and sees relationships between this whole and previous knowledge

- tries to theorize about the tasks – forms a hypothesis.

Similarities can be found between the different descriptions of those who achieve high moral judgment growth and the descriptions of deep learners. One example of this is that people who achieve higher levels of moral development love to learn and enjoy intellectually stimulating environments, as – naturally enough – do deep learners. Moral developers are also described as 'reflective', and deep learners, while not described in this way, are characterised as searching for inherent meaning, personalising the learning and attempting to theorise about the tasks, all of which use reflective abilities. Both groups further use reflection and integration in seeing themselves within a broad social context, relating their experiences to the wider world and recognising relationships between concepts. Therefore, deep learners and higher moral developers have a number of similar characteristics largely centred on their reflective and integrative abilities. It could therefore be expected that a deep approach to learning correlates with a higher P score. From this can be developed a hypothesis:

H_1 Students who are deep learners will have a higher P score.

Students who have a surface approach to learning are only motivated to meet the minimal requirements of the course: they balance failure with working more than necessary and operationalise this through only studying the bare essentials, focusing on facts that can be reproduced by rote learning (Biggs 1987b). As a result they do not reflect upon the subject matter of the course, nor do they attempt to integrate any knowledge gained with previous knowledge. These students are likely to reproduce the facts they have learnt but are unlikely to place those facts within a structure that can be later used to deal with other facts. They may not even have the skills of reflection and integration. These people are therefore more likely to be operating at a pre-conventional level or at the lower end of the conventional level, where there is a focus on the self and the need to do things such as obeying laws and norms because it means looking after oneself. It could therefore be expected that a higher surface approach to learning is correlated with a lower P score. The following hypothesis is therefore also suggested:

H_2 Students who are surface learners will have a lower P score.

Biggs (1987b) describes an achieving approach to learning as characterised by ego-driven motives. Students are driven to get the highest grades because of their competitive nature, wanting to do well irrespective of their interest in the material. This results in good organisation of their learning environment, time and activities. Where this ego-driven motive is strong it could be expected that these students would operate at the pre-conventional level, where ego is a major determinant of moral decisions, but these students may have also developed

some reflective and integrative skills which are necessary in some courses to achieve high grades, and these skills may have given them a deeper understanding of moral issues. It is therefore not expected that there will be any correlation between an achieving approach to learning and P score.

There has also been extensive work correlating P score with a number of demographic variables. Higher P scores are associated with age (Rest 1986a) and being a female accounting student (Ponemon 1993a; Shaub 1994). From these two, further hypotheses have been developed and will be examined:

> *H_3 Students who are older will have higher P scores.*
>
> *H_4 Female students will have higher P scores than male students.*

Findings of a positive relationship between deep learning and P score may mean that accounting educators at all levels should be looking at ways to reverse the trend to a surface approach to learning, and to provide learning activities that encourage the development of integrative, reflective practice, as this may also assist in developing moral judgment skills. While students may be using a deep approach in non-accounting courses in which they are enrolled, they are not seeing its application as relevant to accounting. They therefore do not see reflection and integration as necessary components of accounting practice and this may limit their abilities to make good accounting decisions, and good ethical decisions within the accounting sphere.

Reviewing assessment and other teaching practices, and providing examples where lecturers demonstrate reflection and integration and have students practise these with respect to accounting, are some ways in which a deep approach to learning may be fostered. Activities such as the development of 'concept maps' help students understand the basic structure of the knowledge being presented, as well as providing them with a demonstration and practice in integration and reflection. In auditing classes, for example, concept maps can be used to identify the range of knowledge areas that underpin auditing and highlight the importance of a true and fair view.

In the teaching of accounting ethics other types of activities that provide deep learning experiences could be used. One of these is the use of a movie to trigger a range of discussions and role plays. One movie that has been successfully used is *The Dish*, a gentle comedy giving a fictionalised account of the role of the Parkes radio telescope in the successful 1969 moon landing and walk by Neil Armstrong. Part of this movie tells the story of a lie told by scientists in order to protect their professional reputation. Leung and Cooper (1995) identified the issue of integrity in admitting mistakes made by oneself as being one of the key ethical issues faced by accountants in Australia, and this movie can be used to help bring this issue to life with undergraduate accounting students.

After watching the movie, some students seem to consider that it was right to tell the lie – in the movie it did seem to save the scientists' reputation – but as the students more thoroughly analyse the scenario, they see that the reputation wouldn't necessarily have been lost if the scientists had told the truth: that by lying the scientists shifted the blame elsewhere, which would have been hard on those to whom it was shifted, and that the risk to their reputations and to their continuing role in the moon mission that arose from lying was extremely high. At this point, students can then be asked to identify similar situations in which they may have been involved, such as where lies have been told to them about products and services they have purchased. Some of these situations can then be role played, highlighting the damage that such lies cause.

Undergraduate students in Australia often do not have the knowledge of accounting practice that would enable them to identify the accounting situations in which such lies might be told, but these can be described by the lecturer and the students asked to identify who might be harmed in these circumstances. In doing this they are being sensitised to the issues that arise in practice and are reflecting on the impact of these on others.

For this type of lesson to be effective, the teacher needs to be prepared with a range of questions that direct students' reflection on the issues of importance. Such lessons allow the students to experience the ethical issue in a number of ways and help them to relate it to their own lives – and to reflect on the impact of such lying on society – and in so doing they offer students a deep learning experience.

Empirical tests

The data to test the relationship between deep learning and ethical judgment was collected in 2002 and 2003, and drawn from students studying an elective second-year subject in business ethics and from students studying a compulsory third (final)-year subject in accounting theory. The students were asked to complete the SPQ, a short demographic survey and a three-scenario DIT.

The SPQ has 42 questions with responses given on a five-point Likert scale, ranging from 'Never' scored as 1 to 'Always' scored as 5. As mentioned earlier, three approaches are measured, deep, surface and achieving (the composite deep achieving is not relevant here), and each of these has two sub-scales, motive and strategy, resulting in a questionnaire with six factors. There are seven questions for each factor, resulting in possible factor scores ranging from 7 to 35 (Biggs 1987b).

The DIT contains three scenarios in which an ethical dilemma is posed. Students were asked to read each scenario and determine the action that they would take. Under each scenario there is a list of 12 statements reflecting issues relevant to

the ethical question raised in the scenario. Each of the statements represents one of the *schemas* in the model or is included as a measure of reliability. Students then had to indicate on the Likert scale the importance each issues statement had in determining their decision on the action to be taken. The four issues statements which were the most relevant to the student's decision had to be selected and ranked, 4 through to 1, with 4 being the most important and 1 being the fourth most important. Of these four, those that related to post-conventional thinking were rank-summed and the proportion of these was calculated as the P score (Rest 1986b).

The business ethics students completed all questionnaires during their class; there were 19 usable responses, after two were eliminated for choosing issues that sounded important but were meaningless. The accounting theory students completed the DIT in class and were asked to complete the SPQ after class and return it to the lecturer. Of the 13 DITs completed, two were eliminated for choosing issues that were meaningless, leaving 11 usable responses. Seven SPQs were returned and all were usable. As these were not all the same students there were only six responses that could be used to test H_1 and H_2, resulting in a combined class sample size of 25.

The variables extracted from the instruments are:

- *P score*, calculated from the results of the student responses to the three-scenario DIT
- *age*, recorded as the age within a range at the time of completing the questionnaire; the ranges were 18-20 years old (recorded as 1), 21-25 (2), 26-30 (3), 31-40 (4), and 41+ (5)
- *gender*, recorded as male = 1 and female = 0
- *deep*, the combined deep motive and strategy score on the SPQ
- *surface*, the combined surface motive and strategy score on the SPQ.

Results and discussion

Means of all P scores, and the deep and surface learning approach scores in total and for each class, were calculated and are shown in Table 12.4. The mean P score of each class differs by 4.55, with students doing the elective business ethics class having the higher P score. These students also exhibited a 4.7-higher deep approach to learning and a 7.5-lower surface approach to learning than the accounting theory class. An independent samples t-test was used to examine the significance of these differences. The differences in means between classes on the P score and deep approach were not significant, but the difference in means on the surface approach was significant at $p < 0.05$. The surface approach mean of the accounting theory class was also consistent with the surface approach means identified by Booth, Luckett and Mladenovic (1999), while the

deep approach means of the business ethics students were 5.6 higher than those of the combined accounting students surveyed by Booth, Luckett and Mladenovic.

Table 12.4. Mean scores of each class

Class	P score	Deep approach	Surface approach
Accounting theory	31.51 (n = 11) sd = 12.24	43.14 (n = 7) sd = 3.33	51.86 (n = 7) sd = 5.43
Business ethics	36.06 (n = 19) sd = 20.89	47.84 (n = 19) sd = 8.03	44.36 (n = 19) sd = 7.01
All	34.39 (n = 30) sd = 18.09	46.57 (n = 26) sd = 7.32	46.38 (n = 26) sd = 7.3

The range of situational factors impacting on the business ethics and accounting theory classes may explain the higher surface learning approach scores achieved by the accounting theory class and the higher deep approach scores achieved by the business ethics class. Business ethics is an elective, with assessment by essays and a range of in-class activities that the students generally didn't consider to be an excessive workload, and which provided a number of diverse ways of reflecting upon the subject. Accounting theory, by comparison, is a compulsory subject in the accounting core of the degree program assessed through essays, debates and a final exam. Students considered the reading workload necessary to pass the assessment events in this subject excessive. Where the workload is considered excessive, students generally do not spend additional time exploring the subject as they do not consider that they have the time to do so – that is, they take a more surface approach to the subject.

Table 12.5 provides a summary of the key correlations using the combined results of both the accounting theory and business ethics classes. The correlation of DIT P scores with approaches to learning shows a moderate, positive and significant relationship with a deep approach to learning ($r = +0.493$, $n = 25$, $p = 0.006$). The results for the sub-scale deep motive are significant ($r = +0.518$, $n = 25$, $p = 0.004$). There was also a mild significant correlation with a deep strategy ($r = +0.392$, $n = 25$, $p = 0.026$). Thus, there is some positive support for H_1, i.e. that students who are deep learners have a higher P score. Evidence of this positive relationship between deep learning and P scores suggests that it would be useful to examine the impact of teaching interventions that support a deep approach to learning within accounting and ethics courses, and the effect of these on the moral judgment ability of students. The milder correlation with a deep strategy may be the result of a lack of student understanding as to how to turn their motives into effective action, or it may be that the amount of work students do both within and outside of degree programs means that they do not have the time – or perhaps the inclination – to turn their motives into effective strategies.

There is no support for H_2 as there was no significant relationship between P score and a surface approach to learning ($r = -0.193$, $n = 25$, $p = 0.177$).

Table 12.5. Correlations of variables using the combined classes

		Deep approach	Deep motive	Deep strategy	Surface approach	Surface motive	Surface strategy
P score	*R*	0.493**	0.518**	0.392*	–0.193	–0.090	–0.227
	Sig. (1-tailed)	0.006	0.004	0.026	0.177	0.335	0.138
	N	25	25	25	25	25	25

**correlation significant at the 0.01 level

* correlation significant at the 0.05 level

There was no support for H_3 either, i.e. that older students would have a higher P score ($r = 0.089$, $n = 30$, $p = 0.344$). This is not surprising as there was very little difference in the age of the students. Further studies using a wider age-range group will be needed to examine this hypothesis.

Table 12.6. Mean scores of males and females

	Gender	Number	Mean
P score	Male	13	30.25
	Female	17	37.57
Deep approach	Male	11	46.64
	Female	15	46.53
Surface approach	Male	11	47.09
	Female	15	45.87

The data used to examine H_4 is given in Table 12.6. Female students' mean P score was 37.57, 7.32 higher than the male students' score of 30.25. These means were compared using an independent samples t-test that indicated that there was a significant difference between the means ($p < 0.10$). Therefore, there was support for H_4, i.e. that female business students have a higher P score than male business students. There were no significant differences between the means of males and females on the approaches to learning.

Table 12.7. DIT P Score means of college/university students from a range of disciplines and countries

Author	Sample	Mean P score
McNeel (1994)	US senior college students (n = 216)	46.4
Shaub (1994)	US accounting students with ethics intervention (n = 30)	44.7
Rest (1986a)	US average college students	42.3
Shaub (1994)	Senior auditing students (n = 91)	41.3
Shaub (1994)	Accounting students without ethics intervention (n = 61)	39.7
Ponemon (1993)	US graduate accounting students with ethics intervention (n = 53)	39.2
Thorne (2001)	Cooperative education students (n = 56)	38.9
Jeffrey (1993)	Senior liberal arts students (n = 41)	38.8

Author	Sample	Mean P score
Jeffrey (1993)	Lower division accounting students (n = 57)	37.6
Jeffrey (1993)	Senior business students (n = 195)	37.4
Thorne (1999)	Canadian graduate accounting students (n = 144)	37.2
Dellaportas (2002)	Aust. senior accounting students with ethics intervention (n = 47)	36.1
This study	**Aust. business ethics students (n = 19)**	**36.06**
Thorne (2001)	Cooperative education students (n = 54)	35.9
Thorne (1999)	Canadian accounting students (n = 70)	35.5
McNeel (1994)	US freshman college students (n = 216)	35.7
This study	Aust. business and accounting students (n = 30)	34.39
Rest (1986a)	**US average senior high school students**	**31.8**
This study	**Aust. accounting theory students (n = 11)**	**31.51**

The overall mean DIT P score in this study was 34.39, and this is lower than that found in Dellaportas' Australian study (2002). The differences could be because the students in the Dellaportas study had completed their ethics subject and as a result improved their ethical judgment skills, while students in this study had not completed their ethics studies. The results from this study are similar to those found by McNeel (1994) at a freshman level and are lower than a range of studies from the United States. These Australian results provide further evidence for the proposition that accounting and business students do not perform as well at ethical judgment as students from other disciplines or other countries. A comparison of DIT P score means from a number of studies that provide evidence for this proposition is seen in Table 12.7.

Conclusion

While there is support for the hypothesis that students who are deep learners will have a higher P score, it should be remembered that this is only a preliminary study and that the sample size is small; however, the results offer a promising line of enquiry into ways of teaching accounting and ethics. At this stage further research needs to be undertaken, increasing the sample size and examining the relationship between deep and surface learning and P score before and after ethics education interventions that emphasise a deep approach to learning. McNeel recognised that the growth in P score may be a result of differences in teaching, as well as a result of the types of students who select accounting as a profession and other factors such as the different extracurricular activities that business students undertake. A study examining the teaching interventions and their effect on students will enable further clarification of these relationships, and provide information to the profession and to accounting academics about ways in which the ethical judgment of members of the profession may be improved.

The lack of support for the hypothesis that students who are surface learners will have a lower P score may be a result of problems with the SPQ, as recent

research indicates that some of the strategies included within the surface learning approach underpin deep learning as well and that there may be confusion between the factors.

As Rest (1986a) suggests, moral judgment is only one factor in determining moral action: educational interventions at all levels need to also incorporate activities designed to sensitise people to ethical issues and to build moral character. Further research also needs to be undertaken to determine how this can be done within the accounting educational context.

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Chapter 13. Can we teach auditors and accountants to be more ethically competent and publicly accountable?[1]

Bryan Howieson

Abstract

Education and training in ethics has been given increased importance and urgency by recent corporate collapses of high-profile companies. These events have encouraged the media and public to question the ethical standards and behaviours of auditors and accountants. There is a high level of cynicism and scepticism in the profession that ethics can be 'taught' to auditing and accounting students and practitioners. This chapter seeks to counter these perceptions by arguing that the ethical awareness of auditors can be raised by attacking certain widely-held 'myths' about the nature and teaching of ethics. These myths include cynicism that the teaching of ethics can make any difference, or that ethics is simply a matter of personal opinion, or that the study of ethics must start with the study of ethical theory rather than practical experience. This chapter emphasises that ethics is about power relationships and responsibility, and that developing the practical skills of students and practitioners in values clarification, ethical decision-making and ethical policy-setting can not only raise ethical awareness in the professions of auditing and accounting, but also improve standards of practice. It is argued that improving ethical competence in the profession and striving for excellence in practice are not just starry-eyed ideals, but achievable with relevant curriculum planning and the use of effective teaching methods.

[1]This chapter draws heavily on experiences gained in collaboration with Ian Thompson (University of Edinburgh) in our experiments in teaching ethics to students of accounting and business, and in joint ethics consultancy to a variety of public- and private-sector organizations. I wish to acknowledge Ian's influence and inspiration behind some of the ideas I have developed in this chapter. I also thank Ian for his comments on an earlier draft of this chapter.

Introduction

Can ethics be taught? This is an ancient question that continues to exercise the minds of those in many different professions.[2] There are also many papers that have sought to explore the relationship between ethics and accounting and auditing practice. As a generalisation, many of these have tended to emphasise lamentations about the 'poor' ethical behaviours of accountants and auditors as exhibited in high-profile corporate crises.[3] Alternatively, they adopt an overwhelmingly empirical perspective and test whether various types of ethical courses or interventions can change the ethical character and behaviour of accounting and auditing students and practitioners.[4] There is very little written in the accounting and auditing literature that explores the underlying conceptual issues associated with whether ethics can be taught to accountants and auditors. This chapter seeks to explore some of these conceptual issues.

Whether ethics can be taught to accountants and auditors is viewed by many as something of an oxymoron. There is widespread cynicism about the ability to 'teach' ethics in business generally and in accounting in particular.[5] Some of this cynicism comes about, for instance, from a belief that people's ethical character is determined early in life and cannot later be changed.[6] The role of some accountants and auditors in corporate fraud and failure also tends to confirm stereotypical perceptions by the press and public that members of these professions are driven by greed rather than public interest and high moral standards. For example, Hill (1995, p. 585) has observed that 'the fruits of a profound cynicism are now with us, as prominent figures find themselves in court to defend their actions, and seem amazed that they are accused of doing anything wrong at all'. This chapter seeks to counter this cynicism by reflecting upon what ethics training might realistically and productively achieve, and by attacking misperceptions about the nature of ethics.[7]

A resolution of the question as to whether ethics can be taught depends very much on the underlying and interrelated questions of 'what' and 'how' ethics is to be taught and, as previously mentioned, what objectives can realistically

[2]Some examples of papers that have sought to explore the issue of teaching ethics within different professions and fields of employment include Gutmann (1993) on lawyers, Smith (1998) on members of the insurance industry, Thompson (1998) on politicians, and Toner (1998) on members of the US military.

[3]See, for example, Smith (2003). In a similar vein, there are a number of empirical papers that purport to demonstrate the poor moral character of accounting and auditing students; for instance, Haswell and Jubb (1995).

[4]See, as just one example, Ponemon (1993). Despite the enticing title 'Can Ethics Be Taught in Accounting?', the paper is really a report on a study of whether certain teaching interventions impacted upon the moral development and ethical behaviour of accounting students. The accounting and business ethics literature is replete with such studies. A review of the mixed results of some of this research can be found in Wright (1995).

[5]See, for instance, Henderson (1988), Luoma (1989), Piper (1993) and Hill (1995), who describe the general perceptions of cynicism about the extent to which ethics can be effectively 'taught'.

[6]Luoma (1989, p. 14), and Harris and Brown (1990, p. 855), for instance, acknowledge this as a common perception.

[7]Cynicism is not a coherent moral position. Rather, it is the adoption of an attitude of intellectual superiority that makes one invulnerable to criticism, and exempt from the responsibility to do anything about the corruption of the world. Like the ancient cynics (who earned their nick-name 'dogs' from their habit of urinating on objects of public veneration), modern cynics undermine confidence in public institutions.

be met by the teaching of ethics. Much of the emphasis of this chapter is devoted to the issues of what is to be taught and what can be achieved by the study of ethics in the context of the *applied* practice of accounting and auditing. Space does not permit an extended discussion of how ethics can be taught, although this issue will be touched upon as appropriate.

What can ethics teaching achieve?

There can be little argument with the general observation that ethics is an important component of accounting and auditing practice. Like any professional group, accountants and auditors are expected to put the public interest before their own private interests. This is reflected in the profession's Code of Professional Conduct by the principles of 'the public interest' and 'ethical behaviour' (CPA Australia & ICAA 2004). However, at regular intervals the ethical character of accountants and auditors is called into question by high-profile cases of corporate fraud and failure. In the United States, the spectacular frauds committed by executives at Enron and other companies have resulted in the Sarbanes-Oxley Act, that has sped up the process by which accounting firms split their auditing and managerial consulting activities into separate non-related entities. The Act has also seen the creation of the Public Company Accounting Oversight Board to impose a new level of regulation on auditors. In Australia, these events, along with our own corporate scandals such as the HIH collapse, have resulted in the Commonwealth Government proposing a series of major reforms to, *inter alia*, auditing practice aimed at increasing perceived and actual audit independence (see CLERP 2003). As part of these reforms, it is proposed that the Financial Reporting Council (FRC) will play a greater supervisory role of the auditing profession, including having the function of 'promoting the teaching of professional and business ethics by the professional accounting bodies, universities and other tertiary institutions' (CLERP 2003, p. 13).

To date the FRC has been silent on how it proposes to undertake this function, but should this responsibility ultimately find its way into legislation, then the teaching of ethics may be viewed as an even more important activity than at present. This of course raises important questions about what should be taught and how it should be taught.

A key point in any discussion on the teaching of ethics is an understanding about what the study of ethics can realistically achieve. Henderson (1988, p. 52) observes that:

> Those who claim ethics can't be taught are really saying it can't be taught in such a way that everyone who has had a course in business ethics will from that day forth cease and desist from all unethical activity. ... That's a tougher assignment than that given to other required courses in business schools. For example, is there any certainty that students will

> practice random-walk market theory when they become stockbrokers? Will all students be supply-side economists if they graduate from the University of Chicago? Of course not. Why, then, does business ethics evoke different expectations?

When people call for greater teaching of ethics to accountants and auditors in the hope that misbehaviour can be swept away, or, at the other extreme, express disbelief or contempt for the efficacy of ethics courses, too much or too little is claimed about the power of education. In the real world, human behaviour is complex and subject to a diverse mix of powerful risks, rewards and constraints.[8] It is naïve to expect that the usual style of training via a short-term course in ethics will reap quick changes in people's individual and corporate values and behaviours, or isolate them from the common limitations of the human condition such as fatigue or errors of judgment. With this in mind it is important to rethink both the content and methods for teaching ethics to accountants and auditors. In particular, there needs to be an acknowledgment that:

- because moral behaviour is complex and the causes of corruption in practice are multi-factorial, multi-modal strategies are needed to change individuals and the culture of business corporations and audit firms. Simple educational interventions will never be enough on their own. However, if part of a coherent package of other measures (including professional standards, corporate governance and both individual training and team-building), education and training can become very effective
- the development of relevant ethics education and training requires a lot more careful thought and planning, as well as rigorous evaluation of courses, both with respect to their content and the efficacy of pedagogical methods employed.

If the teaching of ethics will not remove all 'bad' behaviour, what then can it achieve? The answer, perhaps, lies in the exhortation of Socrates that 'the life which is unexamined is not worth living' (Plato 1999 (1871), p. 541). Although there are clearly examples of unethical behaviour that are conscious and premeditated, the majority of unethical behaviour arises because the person or people concerned do not make the effort to reflect upon their behaviour or possess the skills necessary to do so. Kidder (1995, p. 43) has referred to this as 'drowsy morality', particularly in the context of people who lack clarity about their own values, or those of their organisation or profession. He notes that the problem of drowsy morality is particularly important today because technology 'leverages'

[8]For example, see Wyatt (2004), who describes how a change in the mind-set of large accounting firms occurred, subtly over time, in which the value of 'independence' was replaced with a management consulting paradigm that emphasized the maximisation of the accounting firms' profits. The end result of this change in mind-set was the Enron, WorldCom, etc. corporate collapses and the tarnishing of the audit profession's reputation.

the consequences of moral errors (Kidder 1995, p. 34).[9] For example, one person, Nick Leeson, was able to bring down a major bank on the basis of his access to, and use of, sophisticated trading technology. Kidder (1995, p. 38) notes that three factors are important in such cases; intelligence, size and moral awareness. If Leeson lacked intelligence, then he may not have even reached the position he held in Barings Bank. If the foreign currency trading had been small, then its collapse may not have irreparably damaged the bank. If Leeson had had the necessary moral awareness to reflect on the propriety of what he was doing, then he might never have undertaken the actions he did.[10] Kidder's point is summarised when he states (1995, p. 35):

> But these days the danger lies not only in the hands of madmen, tyrants, or obvious exponents of evil. Nowadays, it also lies in the hands of more-or-less well-meaning experts – whose only failings, perhaps, are a fuzziness at the moral core and a consequent limiting of the vision. The danger increasingly lies in the hands of otherwise ordinary people – people you and I know and like. They are not willfully [*sic*] setting out to create the next [Barings or Enron]. Yet they may be operating in a systemic and personal ethical vacuum that, in the end, leaves them unable to tell right from wrong. The great danger, it seems, is that at the critical moment of decision they may simply not understand the one most crucial fact – that they are walking straight into a world-class moral temptation.

Ethics training can help combat this 'drowsy morality' by assisting accountants and auditors to become more aware of the personal, organisational and professional values they bring to their work, and which serve as the basis for their public accountability. It can also attempt to sensitise them to the need to employ these values in the work environment and to reflect upon the consequences of the potential courses of action they face in any particular circumstances. In the 'real world', time or other pressures can create incentives for professionals to approach their work with a drowsy morality, but the colourful words of Henderson (1988, p. 53) should warn them otherwise: 'There is tremendous pressure upon corporate executives to manage only to the quarterly bottom line. That's like jumping off a tall building and boasting half way down that "everything's all right so far".'

Kidder (1995, Chapter 1) points to a second and related benefit of the teaching of ethics which is providing people with the skills and tools needed to deal with the more difficult ethical decision problems. He distinguishes between 'right-versus-right' choices and 'right-versus-wrong' choices. He argues that the latter category is the less problematic type of ethical problem for most people because

[9] Kidder (1995) uses the example of the Chernobyl nuclear disaster to illustrate the leveraging effects of technology.
[10] Of course, Leeson's behaviour was not discouraged by an organisational culture that emphasized and rewarded 'profit' above other objectives and values.

a moment of simple reflection is usually enough to recognise that the 'wrong' option is indeed 'wrong'. Kimm (2003, p. 65) has sought to demonstrate this by noting:

> ... typical ethics subjects like whistleblowers or lying in negotiations are challenging but not at the heart of business ethics. Enron, while deliciously salacious, is mundane from a business-ethics point of view. It's pretty straightforward – they did wrong. A more interesting ethical dilemma may be: Is sub-prime lending ethical? Many low-income borrowers could not get access to capital without these loans, but at what point do the loans become emblematic of predatory lending?

Right-versus-right choices, on the other hand, are far more difficult because they involve the decision-maker being forced to make trade-offs between core values.[11] When faced with such difficult choices, many people may lapse into a sort of moral paralysis, unable to make the choice one way or the other. Although training in ethics may not necessarily reduce the emotional pain of such choices, it can offer systematic problem-solving-based models that offer some hope and direction for decision-making. This issue will be pursued further later in this chapter when the issue of ethical 'dilemmas' is addressed.

The teaching of ethics can also encourage the development of moral courage. Moral courage is, of course, important to auditors when they are expected to 'take a stand' against unscrupulous or domineering CEOs who are proposing to 'cook the books' or indulge in other clearly unethical behaviour. However, moral courage is also important in less dramatic and mundane circumstances where conflict between parties is less apparent or not readily observable. Consider, for example, the so-called 'Abilene Paradox' that is described by Harvey (1974, p. 66) as follows: 'Organizations frequently take actions in contradiction to what they really want to do and therefore defeat the very purposes they are trying to achieve'. The Abilene Paradox argues that there are circumstances in which individual organisational members privately believe that an action or activity is inappropriate (and even, perhaps, unethical) but they collectively (e.g., during meetings) support the action in public. In the words of Harvey (1974, p. 73, emphasis in original), 'each person in a self-defeating, Abilene-bound organization *colludes* with others, including peers, superiors, and subordinates, sometimes consciously and sometimes subconsciously, to create the dilemma in which the organization finds itself'.

[11] Kidder (1995, p. 18) suggests that such trade-offs are typically between truth versus loyalty, or individual versus community, or short-term versus long-term, or justice versus mercy. In addition, one might also consider the difficulties of 'wrong-versus-wrong' decisions in which one might be forced to choose between the 'lesser of two evils'.

The Abilene Paradox is thus self-destructive and has the potential to lead people who are otherwise ethical into unethical actions.[12] Harvey (1974, pp. 70-2) suggests that the Abilene Paradox arises because of four factors:

1. *action anxiety*: the individuals become anxious about taking the 'right' action in contradiction to what is presently happening in the organisation
2. *negative fantasies*: the individuals anticipate and emphasise only negative outcomes if they act the 'right' way
3. *real risk*: taking the 'right' action might risk the individual being in a worse position (e.g., sacked) than if the current set of circumstances were left to run their course
4. *fear of separation*: individuals don't wish to risk being ostracised by their work colleagues and others (a very real problem faced by whistleblowers, for instance).

Managing the Abilene Paradox clearly requires someone in an organisation to have the moral courage and sound ethical arguments to confront the collective 'wisdom', as well as the skills to manage this process. Ethics teaching that emphasises the development of 'virtues' or characteristics that promote agreed standards of excellence offers the possibility that auditors, who must promote and maintain independence, can be equipped to handle situations exhibiting the Abilene Paradox. Again, this issue is addressed later in the chapter.

Given that the teaching of ethics offers value to students and practitioners of accounting and auditing, what needs to be taught to convey these benefits?

The next section of the chapter reviews a variety of common attitudes to ethics and approaches to teaching ethics to accountants and auditors and highlights the more significant limitations of these approaches. This is followed by an alternative view about what aspects of ethics might be taught to maximise the benefits to students and practitioners alike in the applied disciplines of accounting and auditing.

Some typical ways in which ethics is taught to accountants and auditors

In practice, a variety of educational styles and methods are used in the teaching of ethics in accounting and auditing to university students and practitioners. However, there are some common themes found in the great majority of accounting ethics courses around Australia that are identified below. These are teaching ethics as synonymous with *ethical theory*, *rules*, *individual judgment* (inter-personal relativism), or as *dealing with 'dilemmas'*.

[12]Harvey (1974), for example, uses testimony from the Watergate hearings to demonstrate that although the majority of conspirators claimed that they each privately objected to their collective actions, they were not prepared to voice these objections because of their fears concerning the expected reactions of the other conspirators and President Nixon.

It will be argued that none of these approaches is either effective or efficient in the education or training of people for a practical profession like accounting. A focus on any of these approaches will do little to enhance either the competence of practitioners in ethical decision-making or give them confidence that they have a better understanding of applied ethics. Instead, they each tend to create a disjunction between ethics and the practice of accounting and auditing, as shall be seen.

Ethics as ethical theory

Almost invariably, undergraduate courses in accounting or business ethics begin with an analysis of ethical theories such as utilitarianism and deontology, among others. As a teacher, one of the things one discovers early is the need to match one's material to the appropriate level of the audience. If we are honest, the great majority of accounting and auditing students have not undertaken studies in these disciplines to become philosophers and may have little, if any, background in ethics traditions (Sommers 1993, p. 7). As such, unfortunately they quickly lose interest in any 'theoretical' material that does not seem to be immediately related to the practice of accounting and auditing. By starting with ethical theories that many students find less than accessible, teachers lose the attention and interest of their students, and this makes it more difficult to reach out to them later when they are asked to apply these theories to case studies and other activities. The problem is exacerbated because the specialised language of philosophy is seen as irrelevant and alien to accounting students and this prevents them from taking applied ethics seriously. In the words of Hill (1995, p. 585): 'As Socrates pointed out long ago, ethics is not a theoretical science, which can be taught and learnt as dispassionately as mathematics. It is practical, and so engages teacher and pupil in an entirely different way'. By beginning with the theoretical we immediately disengage students from what is practical in ethics, and strengthen the illusion that knowledge of ethical theory is a key to competence in ethical decision-making.

In addition, a more powerful reason why teaching ethical theory is inappropriate, and 'puts the cart before the horse', is that many people learn, without being exposed to moral theory, to exercise what Aristotle calls 'prudence' or practical wisdom. This he defines as the ability to integrate both theoretical knowledge and skilled practice, and to combine the intellectual and moral virtues in such a way that we are able to make sensible decisions. This means being able to apply universal principles to particular situations in such a way that we choose the best available means to achieve a good outcome (if that is at all possible). To be able to exercise the virtue of prudence certainly does not require a prior knowledge of Kant, Mill or even Aristotle. Ethical theory only becomes relevant when

we seek meta-ethical means to justify the ethical policies we adopt either as individuals, or as societies.

The above remarks should not in any way be viewed as an attack on the role of ethical theory, but rather as a plea to remember that the audience of accounting and auditing students or practitioners are focussed upon more immediate concerns in their proposed or current workplaces, and good teaching would dictate that the relevance of one's material should be readily recognisable and accessible. For instance, it is not necessary to use the formal language of ethical theory to communicate the essential elements of different theoretical models. Utilitarianism can be dressed in the language of 'consequences' and 'costs and benefits', or 'inputs', 'outputs' and 'outcomes'. Similarly, deontology can be expressed in terms of 'duties' or 'responsibility' and 'accountability'. In this way these terms can be made more accessible and relevant to students and practitioners, and they would be more readily able to identify with them in discussions of organisational policy. If it is felt to be necessary or helpful to introduce students to the philosophical underpinnings of applied ethics, and to introduce them to moral philosophy, then ethical theory can be taught in a course on accounting and auditing ethics. However, experience suggests that this is best done towards the *end* of the course, when students have become familiar with the language of 'consequences' and 'duties' in using practical decision models. The relevance of meta-ethical debate about moral theory can then be more apparent and helpful to students.

As discussed later in this chapter, rather than begin a course with ethical theories, it is better to begin with a discussion of the nature of ethics, highlighting the role of ethics in personal and business 'communities' as well as the importance of developing practical skills in the application of ethics.

Ethics as rules

The importance of rules in ethics is another theme that is typically overemphasised in the teaching of ethics to accountants and auditors. Usually this means focusing upon the rules contained in the accounting profession's Code of Professional Conduct and sometimes includes references to legislation and corporate codes of conduct. Indeed, some textbooks on ethics and accounting/auditing discuss virtually nothing but the application of professional rules and codes of conduct.[13] Rules are, of course, a very important element of ethics. They are an efficient means by which any community (such as the accounting profession) can communicate its expectations as to what behaviour promotes the community's interests and what to avoid. However, a course in ethics that explicitly or impli-

[13]See, for example, Windal (1991), Mintz (1992) and Maurice (1996). Of course, not all accounting ethics books discuss only compliance with professional rules, but even ethics training for entrance to the professional accounting associations is dominated by a focus on candidates' compliance with codes of professional conduct and other professional pronouncements.

citly equates ethical behaviour with compliance with professional rules could leave students with the following narrow perceptions:

- that compliance with rules is the same as ethical behaviour. Ethics and rules, however, are different. We use our ethical principles and values to judge the appropriateness of any rule. If, in our minds, we conflate rules with ethics, then we lose our ability to object to any particular rule as inappropriate, unfair, or unethical
- that rules are the starting (and ending) point for any ethical question and that rules are objective measures of ethical standards. In fact, rules are the result of prior value judgments (either by ourselves or those that came before us) as to what is good and right for our community. In this sense, rules are no more objective than any other value judgment, although they do reflect the community's consensus view about good behaviour
- rules-based decision-making creates a black and white ('right' *or* 'wrong') mentality that does not admit that solutions to ethical problems might lie somewhere along a good/bad continuum. Accountants and auditors who are trained to view ethical issues within this concrete framework are likely to suffer a moral paralysis when encountering problems for which there is no readily apparent rule. In such cases they may be unable to reach a decision, or may focus on an ill-considered 'quick fix'
- an overemphasis on 'codes' of behaviour tends to reinforce a perception of ethics as being punitive and does not promote the positive aspects of ethics that are designed to promote the well-being of an accounting firm and its clients, as well as standards of excellence in the profession. As Thompson (1998, p. 50) notes, 'The negative connotations of codes, associated with the codes of civil and criminal law, tend to focus attention on crime and conflict, rather than on the skills that are necessary to build and change the culture of moral communities'
- the possibility that professional ethics is confused with professional etiquette. Professional etiquette is an accepted set of behaviours about polite conduct between members of the profession. Etiquette is one important manifestation of ethics because important ethical principles such as respect for persons underlie polite (and thus respectful) behaviour (Chismar 2001). However, the great majority of the contents of the accounting profession's Code of Professional Conduct reflects etiquette between members of the profession (or other professions such as lawyers) rather than more explicit guidance on the relationship between professionals and their clients. For example, the Australian profession's Code of Professional Conduct consists of six major sections of which only Section B, *Fundamental Principles of Professional Conduct applicable to all members*, and Statement F1, *Professional Independence*,

can be said to explicitly concern themselves with the professional accountant's duties to his/her clients.

Teaching ethics by the rulebook only raises awareness of one aspect of professional ethics. Compliance with the rules does not guarantee that accountants and auditors will behave ethically. In the words of Russell (1992 (1954), p. 40):

> Nine of the Ten Commandments are negative. If throughout your life you abstain from murder, theft, fornication, perjury, blasphemy, and disrespect towards your parents, your Church, and your King, you are conventionally held to deserve moral admiration even if you have never done a single kind or generous or useful action. This very inadequate notion of virtue is an outcome of taboo mentality and has done untold harm.

Ethics and individualism/relativism

One of the more serious objections to the current approaches to teaching accounting and auditing ethics relates to the very common remark in ethics classes that 'there is no "right" answer' to an ethical problem. The general basis for such a statement lies in the belief that everyone is entitled to his or her opinion about what is right and wrong. Although respect for others' opinions is a laudable principle, it does leave students of ethics with the very unproductive and incorrect impression that 'anything goes' in ethics.[14] Such a perspective on ethics is based on two presumptions. First, that ethics is a matter personal to the individual and is akin to issues of personal taste and preference, a perspective that Thompson, Melia and Boyd (2000, pp. 63-4) describe as the 'privatisation of ethics'. They note that such a conception of ethics runs counter to the majority of our Western tradition, where ethics has in fact been seen as a community issue. Henderson (1988, p. 53) also rejects the individualistic notion of ethics and states 'ethics, like politics, is a public matter for open discussion by all'. Allowing students to view ethics only within the private rather than public domain risks the chance that they are unable to properly appreciate the full extent of the role of the accountant and auditor in business. Further, saying any opinion is okay and that there is no one right answer rapidly generates frustration among students of ethics because the question of what is appropriate behaviour in any particular case remains unresolved – and unresolvable! Such frustration only assists in perpetuating the perception that ethics cannot be taught.

[14]Sommers (1993, pp. 7-8) takes issue with the 'everyone's view is valid' approach. She states:

> … it seems to me that the hands-off posture is not really as neutral as it professes to be. … One could also make a case that the new attitude of disowning responsibility probably contributes to the student's belief in the false and debilitating doctrine that there are no "plain moral facts" after all. In tacitly or explicitly promoting that doctrine, the teacher contributes to the student's lack of confidence in a moral life that could be grounded in something more than personal disposition or political fashion.

The second, and related, presumption underlying the 'anything goes' approach to ethics is an appeal to ethical relativism. Relativism, the view that all moral points of view are equally valid, extends beyond the individual/interpersonal perspective just noted to include cultural and philosophical relativism (Thompson, Melia & Boyd 2000, pp. 20-1). Relativism allows, for instance, the position that a specific behaviour (e.g., bribery) is 'unethical' in one culture but 'ethical' in another where it is the accepted norm. Consequently, the acceptance of a relativistic perspective tends to mean that students' thinking is dominated by concentrating on what makes people different and fails to recognise that there may also be common ethical ground. Harris and Brown (1990, p. 857) note that relativism can be an attractive 'cop-out' to those people who find reflection on ethical issues just too hard. Luoma (1989, p. 14, emphasis in original) rejects relativism: '... an ethicist responds that it *is* possible to make judgments about cultural norms and to establish moral standards that are universal. An ethicist believes that ethics "is not culturally relative," and most ethicists reject any assertion that morality is relative to individual standards of conduct'.

This chapter endorses that sentiment on the grounds that relativism is an unproductive basis on which to create incentives for accountants and auditors to reflect upon the ethical dimensions of their behaviour and decisions. The benefits of highlighting the role of universal ethical principles are explored later in this chapter.

Ethics as 'dilemmas'

One final methodological problem in the contemporary teaching of accounting and auditing ethics is the overwhelming tendency to portray all ethical issues as 'dilemmas', whether they are true dilemmas or not. Academic literature, the media and teaching materials nearly always use this term to describe an ethical issue. The problem for teaching ethics is that the term 'dilemma' immediately conveys connotations that *all* ethical issues are difficult and, strictly speaking, irresolvable.[15] This perception is exacerbated in a teaching environment that explicitly or implicitly promotes individual and relativist views of ethics. One teacher of ethics has concluded (Sommers 1993, p. 7): 'I have come to see that dilemma ethics is especially lacking in edificatory force, and indeed that it may even be a significant factor in encouraging a superficial moral relativism or agnosticism'.

She goes on to note that case studies which portray ethics as dilemmas do not provide incentives for students to fully explore the ethical implications of decision-making (Sommers 1993, p. 12): 'In a dilemma there is no obvious right

[15]'In a course specifically devoted to dilemmas and hard cases, it is almost impossible *not* to give the student the impression that ethics itself has no solid foundation' (Sommers 1993, p. 6, emphasis in original).

and wrong, no clear vice and virtue. The dilemma may engage the students' minds; it only marginally engages their emotions, their moral sensibilities'.

To combat the negative and perhaps even defeatist mind-set created by calling all ethical issues 'dilemmas', it would be more helpful for the ethical development of members of the profession to assist them to see that most ethical quandaries can be recast as 'problems' to which we can apply appropriate problem-solving methods. Kidder (1995, p. 23) recognises that even the majority of the more difficult 'right-versus-right' ethical issues can be transformed into 'an ultimately manageable problem, bearing strong resemblance to lots of other problems and quite amendable to analysis' using well-established problem-solving methods.[16] Adopting problem-solving methods encourages the positive view of ethical decision-making that it is a practical and everyday type of activity and largely avoids the possibility of moral paralysis. Problem-solving methods are also very familiar to accountants and auditors from their technical training and can be easily modified to incorporate ethical considerations, thus combating the laziness associated with drowsy morality. Practical skills in ethics are explored further in a later section of this chapter.

Revising our approach to teaching ethics to accountants and auditors

The discussion so far has sought to demonstrate that many of the common approaches and methodologies for teaching ethics to prospective and practicing accountants and auditors are not productive of the desired behaviour change or skills acquisition because they:

- 'mystify' ethics by abstracting the theoretical aspects of ethics from people's real world experiences
- equate ethics with compliance with professional rules, so encouraging rigid and mechanistic thinking about ethics
- encourage cynicism, confusion and frustration about ethical decision-making by promoting ethical relativism and representation of every case as a 'dilemma' rather than as a problem which requires a practical solution.

The remainder of this chapter sets out to counter these limitations by presenting an alternative methodology for teaching ethics within the applied context of accounting and auditing that draws upon Aristotelian traditions and virtue ethics.

The nature of ethics

It has previously been argued that far too much emphasis is placed upon the privatised view of ethics where the centre of attention is the individual and an

[16] Also see Thompson, Melia and Boyd (2000, pp. 10 & 63).

introspective consideration of ethical issues. This in turn promotes an unproductive relativism in the discussion of ethics. Aristotle's approach to ethics is a powerful methodology for awakening accountants and auditors to their responsibilities in the business and wider community.

Ethics is fundamentally about what is good and right for human beings. As such, it demands a consideration of what factors will encourage the flourishing of society and what factors inhibit society's development and well-being. Reminding accountants and auditors that ethics is a community enterprise, not a matter of individual opinion, highlights the service role of these professionals in the efficient and effective operation of our market-based system.

Accountants and auditors operate in teams. Of necessity, ethics cannot be treated as a matter only for the individual – as the Abilene Paradox demonstrated, a failure to take the 'right' action/decision is often a collective responsibility. Adopting an approach that emphasises the communal context of ethics (whether that be work teams, departments, accounting firms or business corporations) means that accountants and auditors must take responsibility for building a culture within that community that fosters and develops personal and community integrity, competence and excellence.

Aristotle saw ethics as a question related to how power was shared among the members of society and how power was employed to benefit or harm society's well-being.[17] The notion of how power is exercised dovetails very well with the everyday activities and responsibilities of accountants and auditors, who are frequently in positions of power relative to clients, investors and others because of their technical expertise, legal duties and access to privileged information. Without the ability to consciously reflect on how their actions or inactions might harm others, accountants and auditors can (and have) misused their power to harm investors and other parties.

Finding common ground

If ethics is concerned with the flourishing of communities and the exercise of power within and across communities, this is also true for the business community and its customers. It is important for students to identify what common ground exists for rational deliberation about ethical issues within the community in question. This is particularly important as an antidote to the prevalence of the entrenched ethical relativism within the profession and among students and the general public.

For good practical reasons, we are taught to be 'tolerant' or 'accepting' of the opinions and practices of people of other countries (e.g., to minimise conflict and promote understanding). However, in liberal societies we advocate tolerance

[17]See Aristotle (2003 (1976)).

as a moral principle that should be applied universally. This viewpoint shows respect for others – which is commonly viewed as an important ethical behaviour, and relates to a universally recognised moral principle; that is, respect for persons and their rights.[18] The downside, however, of tolerant acceptance of diversity is that it tends to treat moral and cultural differences between communities as fundamental rather than focussing attention on the basic commonalities between peoples that make it possible for people around the world to, for example, sign up to the UN Universal Declaration of Human Rights. Uncritical relativism encourages the misconception that anything goes in ethics and any viewpoint is acceptable (or at least must be 'tolerated'). As mentioned before, taken to its extreme, this relativism paralyses moral discourse and in fact is ultimately a nonsense. If it were true that *everyone's* ethics were different, then it would be impossible to reach agreement on any matter (except, perhaps, by chance) – we would not be able to make international treaties, conduct business overseas, have institutions like the United Nations, and so on. Fortunately, many philosophers and commentators have been able to demonstrate that there are a number of principles and values that are shared across all societies[19] around the world as a result of the fundamental commonalities of human life.[20]

In our teaching and consultancy, Ian Thompson and I have found it beneficial to distinguish between 'fundamental ethical principles' and 'cultural values'. Fundamental ethical principles are the underlying universally shared common ground of ethics across all cultures. Values are a community's expression as to the specific qualities and conditions they perceive to be necessary for that community to flourish. Principles are the starting point from which social duties and responsibilities are derived on the basis of each community's experience as to what values will promote its particular well-being. When we observe differences in values across communities, it is not because each community has fundamentally different ethics, but rather the differences are the result of each community giving different priority to different fundamental ethical principles, and/or finding different ways to translate these principles into the idiom of their own language and culture. In the light of the universal demands of *beneficence*, *justice*, and *respect for persons*, the communities make their own choices about how their well-being is best promoted, given each community's history, environment, resources and values.[21]

[18]See, for example, Chismar (2001).

[19]For a more detailed discussion see, for example, Luoma (1989, p. 14), Sommers (1993, pp. 6-7), Kidder (1995, pp. 88-92), ICAA (1997, pp. 15-16), and Thompson, Melia and Boyd (2000, pp. 17-18).

[20]We share many common life experiences, trials and tribulations from birth to death.

[21]For instance, the emphasis on individual rights in the United States reflects an emphasis on the principle of respect for persons, while the dominance of the State in Soviet Russia reflected that community's emphasis on a principle of beneficence (care).

These three fundamental ethical principles represent the moral common ground and are described in Table 13.1, 13.2 and 13.3 below:[22]

Table 13.1. The principle of beneficence

PRINCIPLE OF BENEFICENCE (or principle of responsible care)
Duty of the strong to do good to others (beneficence) and avoid doing them harm (non-maleficence), e.g. to dependants, clients and customers.
Duty of care, on the part of the strong to protect the weak and the vulnerable.
Duty of advocacy, defending the rights of those unable to defend their own rights.

Table 13.2. The principle of justice

PRINCIPLE OF JUSTICE (or principle of universal fairness)
Duty of universal fairness or equity, viz. both justice in terms of equality of opportunity for individuals and equitable outcomes for groups.
Duty to treat people with dignity, treating them as ends in themselves, never simply as means to some other end, i.e. the duty not to exploit other people.
Duty to avoid discrimination, abuse or prejudice against people on grounds of race, age, sex, class, gender, religion, etc.

Table 13.3. The principle of respect for persons

PRINCIPLE OF RESPECT FOR PERSONS (or principle of respect for the rights of others)
Duty to respect the dignity, freedom and rights of other people as persons, e.g. the right to know, the right to privacy, etc.
Duty to promote the happiness, well-being and autonomy of other people – to assist them to develop their potential.
Duty to be truthful, honest and sincere with other people – honesty is a demand of respect for other people, just as lying or deceit shows contempt toward other people.

One important attribute of these principles is that they are an effective means of demonstrating the relationship between ethics and power. The principle of beneficence reflects our reciprocal duty to use power responsibly for the good of one another, rather than to do harm, for we are all weak at times and must rely on the protective care of others when we are vulnerable and need help. The principle of justice requires power-sharing as expressed here by the test of universalisability. Justice demands that any rule we apply to our own actions should also be capable of being applied equally to everybody else. Finally, respect for persons is about empowerment of other persons to enable them to achieve their own fulfilment. When placed within the context of everyday working scenarios, these power-related principles can be a very effective means of encouraging accountants and auditors to reflect upon the ethics of their relationships with clients and others. For example, an accountant who is acting as liquidator for a company has a duty under the principle of beneficence to ensure that he or she uses their power as liquidator to maximise the value of the liquidation process (rather than realising assets at minimal prices for the benefit of him or herself

[22]These principles have been successfully employed in teaching and consultancy. For example, the three fundamental ethical principles were adopted by the WA Government as the major component of its Code of Ethics for the state's public sector and the principles have been used by Western Australia's public-sector agencies in the development of their agency-specific Codes of Conduct; see Public Sector Standards Commission (1995a, 1995b). In an accounting context, we have also used these principles in the development of training materials for the ICAA's Professional Year Ethics Module; see ICAA (1997).

or friends and acquaintances) so that employees and creditors (who have little or no power in such a situation) can receive their entitlements or have their debts repaid. Similarly, when an accountant is asked to prepare a tax return on behalf of a client, justice demands that that return is prepared with the same competence and quality as for any other client and in compliance with the taxation laws. In a situation where a client approaches an accountant for assistance in establishing a new business, the principle of respect for persons would demand that the accountant take all reasonable steps to transfer whatever skills and knowledge are appropriate on running the business to the client. This empowers the client to take charge of his or her own affairs, rather than being left dependent upon (and at the mercy of) the accountant. Gutmann (1993, p. 1769), for instance, writing in the context of the legal profession, has recognised the ethical importance of empowering one's clients by joining with them to understand their needs rather than the professional imposing his or her perceptions of what is in the client's best interests: 'If [professionals] do not deliberate with their clients, if they pursue their own independently-arrived-at conception of their clients' interests ... then they act paternalistically, treating their clients as children ... using them as mere means rather than ends in themselves'.

Although knowledge of the fundamental ethical principles is advantageous to accountants and auditors, these principles on their own are not sufficient for promoting ethical behaviour and quality accounting and auditing practice. At least two further components are needed. First is the development of an understanding as to how these principles are to manifest themselves in the practical context as one's personal, organisational and professional values. Second is the need to develop and practise the application of these values using systematic methods for decision- and rule-making within organisations and the profession so as to promote the well-being of these communities.

Ethics as excellence

One of the great advantages of teaching ethics from an Aristotelian perspective is the ability to highlight the role of ethics as a practical vehicle for promoting excellence of performance in one's profession for the good of the community. Aristotle's discussion of 'virtues' is of particular relevance in applied disciplines such as accounting and auditing because it requires us to give consideration to what 'virtues' or competencies, or knowledge and skills, promote excellence in accounting and auditing practice. Aristotle distinguished between intellectual and moral virtues – the former relate to competence in the application of technical knowledge (e.g., accounting and auditing standards) in a systematic way, while the latter include courage and temperance for self-discipline and justice. As mentioned previously, prudence or practical wisdom is the key virtue of being able to combine both the intellectual and moral virtues to achieve a good

outcome in any specific case. Competency in the intellectual and moral virtues and skill in practical wisdom allow people to achieve self-fulfilment and the well-being of their firm and the wider community.

Virtue ethics relates well to the notion of 'professionalism' and 'professional behaviour' by combining technical competencies with moral competencies. As Gutmann (1993, p. 1760) observes in the context of the legal profession and as paraphrased below:

> Far worse than being a zealous [accountant] is being a lazy or incompetent one, unwilling or unable to take on someone else's [affairs] as your own. [Accountants] who [work for] their clients simply for the sake of making a living, and therefore do not [serve] them well as long as they can get away with it, use their clients merely as means to their own self-interested ends.

Ethics training based on what 'virtues' are necessary to become an 'excellent' accountant or auditor is also able to immediately engage students and practitioners alike because it emphasises the relevance of ethics to the workplace. Sommers (1993, p. 8) has noted that:

> Once the student becomes engaged with the problem of what kind of person to be, and how to *become* that kind of person, the problems of ethics become concrete and practical and, for many a student, moral development is thereafter looked on as a natural and even inescapable undertaking.

By focusing on both intellectual and moral virtues, virtue ethics is also an effective means of broadening accountants and auditors' understanding of ethics beyond mere compliance with standards and rules that predominately reflect the intellectual and technical expertise of accounting and auditing practice. Only a little reflection is needed to recognise that the combination of the intellectual and moral virtues is absolutely fundamental in the context of auditing – an audit only has value if the auditor is both technically competent (an intellectual virtue) *and* independent in attitude (a moral virtue).

Emphasis on practical and applied skills

The discussion of Aristotle's virtues indicated the importance of the virtue of prudence or practical wisdom in the development of excellence in accounting and auditing practice. An auditor who possesses outstanding technical skills but lacks moral virtues could cause untold damage, while an auditor who lacks technical competence but has strong moral virtues may be unable to implement his or her laudable objectives. Prudence can develop over time in the light of our experiences, but this can be a serendipitous and *ad hoc* process. One major benefit of ethics training can be the education of accountants and auditors in

practical skills designed to develop these professional skills in practical wisdom. As the virtue of prudence is designed to assist in the marriage of both intellectual and moral virtues, these practical ethical skills can also reinforce the message that ethics is a part of all everyday activities, not a subject divorced from day-to-day life. Kimm (2003, p. 66) has reinforced this point when he states: 'A framework for evaluating ethical issues should be a part of our tool kit right next to Porter's Five Forces. By making ethics a consistent part of our analysis of any situation, we incorporate it into our operating principles'.

There are three important and interrelated skills:

1. skills in clarifying and applying personal, organisational and professional values in everyday practice
2. skills in making responsible and accountable decisions ethically
3. skills in developing sound, ethical organisational and professional rules.

Space considerations do not allow a detailed overview here of each of these skills but some general comments might be helpful. When the accounting profession, for instance, promotes in its Code of Professional Conduct the fundamental values of 'the public interest', 'integrity', 'objectivity', 'independence', 'confidentiality', 'technical and professional standards', 'competence and due care' and 'ethical behaviour' (CPA Australia & ICAA 2004), it does so because of the belief that these values represent key virtues that promote excellence in the practice of accounting and the well-being of the accounting profession. When a new member joins the profession it is important for him or her to understand what these values represent and how they manifest themselves in day-to-day accounting and auditing practice. It is important, therefore, that induction into the values of the profession should help build the consensus and commitment of all partners in the business to the same values, and to prevent these being dismissed as simply 'motherhood statements', serious work needs to be done by work teams to operationalise these values.

If an accountant or auditor does not truly adopt these values as his or her own, then that person may be unable to act in ways that promote the well-being of the community. Similarly, the accountant or auditor will have his or her own values and must also understand, and operate within, the values of his or her organisation. An inability to clearly understand and own these various sets of values can create confusion or result in conflict if the values are not congruent. Various techniques of values clarification can be used to assist accountants and auditors to understand these different sets of values and to reflect upon how they might be used to promote the well-being of their organisation and profession.

If values are well understood, they can be used to assist accountants and auditors in their day-to-day decision-making. The 'drowsy morality' mentioned previously

in this chapter occurs, in part, when people and communities do not adopt systematic methods for approaching ethical issues. Lack of a clear decision model perpetuates the myth that ethical issues are unresolvable dilemmas and means that decision-makers are not always able to discern relevant and practical courses of action or identify competing duties. Once ethical issues are viewed as 'problems' rather than 'dilemmas', they can be analysed using standard decision-making methods and models. One well-known model for incorporating ethics into decision-making is the so-called 'AAA model' (May 1990, pp. 1-2), which suggests seven stages to the decision-making process:

1. determine the facts
2. define the ethical issue
3. identify major principles, rules, values
4. specify the alternatives
5. compare values and alternatives, see if a clear decision emerges
6. assess the consequences
7. make your decision.

One might argue about the relative merits of alternate decision models[23] , but the key issue remains that training accountants and auditors to use systematic methods to make decisions ethically allows for more reflective, consistent and justifiable decisions that will tend to maximise well-being, or at least minimise harm.

Finally, a few comments should be made about rule- and policy-setting within organisations and communities. Much has been made here about ethics as the promotion of a community's well-being. To help achieve this, communities (whether accounting firms, the accounting profession or society in general) put in place rules. Just as decisions should be informed by the values to which the community aspires, rule-setting also needs to build upon accepted and well-understood values. This process, too, should be systematic and reflective to ensure that the rules are inclusive and do indeed promote the community's flourishing. As accountants and auditors work in a world of considerable regulation (such as legislation, accounting and auditing standards, and professional by-laws and regulations), ethics training should also develop skills in setting rules and policies on an ethical basis. This will assist accountants and auditors to develop policies that promote the well-being of their work teams, organisations and the profession, and also provide them with the tools to make informed judgments and to present justifiable evidence in advice to governments and to others on matters of public policy.[24]

[23]For example, the DECIDE model reported in Thompson, Melia and Boyd (2000, pp. 280-1) has the advantage that it includes a feedback loop with which decision-makers can learn from their prior decisions.
[24]A more detailed discussion on the ethical development of policy and rules can be found in Thompson (1998) and Thompson, Melia and Boyd (2000).

Conclusion

This chapter has argued that ethics can be taught to students and practitioners of accounting and auditing. However, to do so it has been argued that realistic expectations need to be placed upon what outcomes courses on ethics can practically achieve and the need for accountants and auditors to develop their own practical wisdom in the context of their work experiences. Contemporary approaches to teaching accounting and auditing ethics tend to be unproductive by abstracting ethics from its practical applications. They typically present all ethical decisions as 'dilemmas', the resolution of which depends more on an individual's tastes and preferences than as problems to be resolved by applying commonly shared ethical principles with appropriate skill and judgment. To counter this perspective, it has been suggested here that the teaching of ethics needs to be firmly grounded and integrated into the practical and applied experience of accounting and auditing students and practitioners. The emphasis must be upon the development and practice of the applied skills of values clarification, ethical decision-making and ethical policy-setting. This approach is founded upon traditional views that ethics is a community enterprise about how power is to be used responsibly and distributed among members of the community. Ethics as a community enterprise challenges ethical individualism and relativism and allows the opportunity for students to explore the common ground between people, rather than to simply concentrate on what makes them different. The approach promoted here also reflects the perspective that, as members of an applied discipline, accountants and auditors are rightly concerned about developing those practical virtues or characteristics that lead to excellence in their profession. These arguments are summarised in the following table that Ian Thompson and I have published elsewhere (ICAA 1997, pp. 13-14).

Table 13.4. Nature of ethics

WHAT ETHICS IS NOT	WHAT ETHICS IS
ETHICS IS NOT simply about matters of a private nature or about personal feelings, attitudes and values.	ETHICS IS a community enterprise, based on universal principles and reasoned public debate.
ETHICS IS NOT about mysterious occult processes, feelings in the gut, or privileged access to moral truth.	ETHICS IS about real power relations between people and the basis of power-sharing between them.
ETHICS IS NOT exclusively a business for experts, for religious authorities, lawyers, philosophers or gurus.	ETHICS IS about participation in a moral community and ownership of the policies it develops.
ETHICS IS NOT about endless disputes, disagreements and dilemmas, nor about grandstanding our opinions.	ETHICS IS a problem-solving activity based on knowledge of principles and skills in their application.
ETHICS IS NOT a matter of innate knowledge, special powers of intuition or supernatural revelation.	ETHICS IS an educational process in which we can discover what it means to be responsible moral agents.

The teaching of ethics is a challenging activity – it requires creativity on the part of the teacher as well as the sensitivity and composure needed to assist those students who would prefer not to be shifted from their 'comfort zone'. Although the teaching of ethics to accountants and auditors cannot eliminate all cases of professional misconduct, it can assist in minimising such occurrences by waking

professionals out of their state of drowsy morality and inspiring them to develop their professional competence (or virtues) and promote excellence in accounting and auditing practice.

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Chapter 14. Do auditor provided non-audit services (APNAS) fees impair auditor independence?

Christopher Ikin

Abstract

For over 40 years there has been active debate about whether joint provision of audit and non-audit services by a company's incumbent auditor compromises auditor independence in fact and/or appearance. This chapter analyses the existing literature in the English speaking world and concludes that while there is some evidence supporting a *perceived* threat to auditor independence, no substantial evidence exists that there is any threat to independence *in fact* as a consequence of the auditor's fee dependence.

Introduction

For more than 40 years, regulators, the accounting profession and academics have been debating and researching whether the joint provision of audit services and non-audit services by a company's incumbent auditor compromises auditor independence in fact or in appearance. Regulators have reacted promptly to recent corporate scandals, despite the lack of convincing corroborative evidence from the auditing research literature. In this chapter I analyse that body of literature which investigates whether auditor independence is impaired as a consequence of the auditor's fee dependence on auditor provided non-audit services (APNAS). I conclude that while there is some evidence supporting a *perceived* threat to auditor independence, no substantial evidence exists that supports the notion that there is any threat to independence *in fact* as a consequence of the auditor's fee dependence on APNAS.

This review of the APNAS fee research literature is not exhaustive – it excludes, for example, the experimental markets literature and the analytical literature. My intention is to provide an overview and to draw insights from its major findings and propose avenues for future profitable research. The subject matter is both topical and important, as regulatory agencies and professional bodies rush to shore up public confidence in the auditing profession after some notable

and highly visible company (and audit) failures. Such reactive responses need to be tempered with insights and evidence from academic auditing research. Research into auditor independence is currently blossoming and it is timely that results to date be brought together and evaluated. Two review articles have appeared recently (Simnett & Trotman 2002; Nelson 2004), but neither deals specifically with APNAS fee dependence nor covers the same breadth of research paradigms.

The rest of the chapter is set out as follows. I begin with a brief overview of the historical setting, and an indication of the current economic climate and theoretical underpinnings that have given rise to the present debate. The next sections describe the literature according to their different perspectives on the way the problem might best be investigated. Archival studies about financial statement users' perceptions of auditor independence in the presence of APNAS, archival studies into independence *in fact*, and a small body of literature that investigates the relation between APNAS and independence from a purely audit firm/audit partner point of view are all discussed in turn. Finally, I draw some conclusions and offer some suggestions for future research.

APNAS and conflicts of interest

Background

The first requirements for compulsory audits conducted by independent auditors arose as a result of the share speculation and corporate fraud in the 1920s. Requirements appeared in legislation to regulate the formation, conduct and dissolution of companies and to regulate the capital markets.[1] About this time, too, the professional bodies became active in setting standards of conduct for members in public practice.[2]

Fundamental to the notion of auditor independence is the recognition that the added credibility that an external audit brings to a company's financial statements, and the investing public's perceptions of that credibility, are beneficial to an efficient capital market. In a sense, the accounting profession has been trusted by the public to be a 'gatekeeper', protecting investors' confidence that company financial statements are true and fair. The accounting profession, and since 1984 the US courts[3], have upheld the dual elements of auditor independence – independence in fact and independence in appearance.

[1]In Australia, prior to the enactment of the *Uniform Companies Act 1961*, the various State Companies Acts, from as early as 1920, contained basic requirements for auditor independence. In the United States, the first independence rules were promulgated by the Federal Trade Commission (the forerunner of the Securities and Exchange Commission (SEC), which was established in 1934), soon after the enactment of the Securities Act (1933).
[2]The American Institute of Certified Public Accountants (AICPA) was established in 1921 (although it had various predecessors in several states). In Australia, the ICAA was founded by Royal Charter as a national professional accounting body in 1928.
[3] *United States v. Arthur Young and Co.*, 465 U.S. 805 (1984)

For the past 50 years it has been recognised that the notion of independence demands that the auditor should not be a material investor or borrower in, or a director or employee of, the audit client. However, as public accounting firms increased their revenues from performing APNAS for their clients, and as the number of large audit firms gradually fell (from eight in 1960s to five by 2000 and four by 2002), questions were repeatedly asked about the extent of real competition in the market for audit services and the extent to which fees paid to auditors might be compromising auditor independence.

Greater APNAS (both in terms of variety and dollar-value) meant that investors became sceptical about how auditors, who were increasingly promoting themselves as 'one-stop shops' for all professional services, and providing client management with a wide portfolio of services that helped ensure the auditee operated effectively and that its financial statements were trustworthy, could remain truly objective when it came to audit matters. This scepticism was derived from a number of concerns including the possibility of (1) fee dependence, (2) auditors having to attest to their own recommendations, (3) auditors usurping some managerial functions, and (4) auditors acting as advocates for the company.

This chapter addresses only the first of these concerns.

Current environment

An economic analysis of auditor independence in the United States was commissioned by the AICPA in 1997 (Antle et al. 1997). The Executive Summary reported, *inter alia*, that (1) non-audit service fees are material (accounting firms earn substantial and growing revenues from supplying non-audit services) and that all the real growth in 'Big Six' audit firms' revenues since 1990 was attributable to non-audit service fees, (2) there is a strong intuitive case for economies of scope between audit and non-audit services, and (3) there was no evidence that the supply of non-audit services threatened auditor independence – references to APNAS are absent in all auditors' professional indemnity insurance policies and virtually all negligence suits against auditors.

At least in the United States, nearly all audit firms have now segregated their core audit, accounting and tax divisions from their other consulting activities by selling or spinning off their consultancy divisions into legally separate entities.[4] However, consultancy fees have continued to rise through the mid-1990s to the early 2000s.

Banker, Chang and Cunningham (2003) provide descriptive statistics showing that, between 1995 and 1999, US public accounting firms had grown management

[4]Arthur Andersen was the first. It formed Andersen Consulting (now Accenture) in 1989. KPMG sold off a fifth of KPMG Consulting to Cisco Systems in 1999, Ernst & Young spun off their consulting arm to form Cap Gemini Ernst & Young in the mid-1990s, but sold out completely to Cap Gemini in 2000, PricewaterhouseCoopers sold PwC Consulting to IBM in June 2002, and Deloitte Touche Tohmatsu spun off Deloitte Consulting in February 2002.

advisory services at the expense of audit and accounting services (and tax services) over that period. Data collected on 64 auditing firms showed that, on average, while total firm revenue had almost doubled (from US$269.7 million in 1995 to US$485.3 million in 1999), audit and accounting services fees had in fact fallen (from US$49.5 million in 1995 to US$42.2 million in 1999). On a per company basis, since fees disclosures were made mandatory in the United States in 2000, levels of APNAS fees seem to be about equivalent in dollar terms to audit fees. Francis and Ke (2003) report a mean fee ratio (APNAS/total fees) of 51.9% (based on 1588 observations in 2000), Reynolds, Deis and Francis (2004) report a fee ratio of 49.1% (based on 2507 observations in 2001), and Larcher and Richardson (2003) report a fee ratio of 48.3% (based on 5103 observations in 2000 and 2001).

In Australia, where the level of audit APNAS fees has long been a disclosure requirement for listed companies, Carson et al. (2003) report that over the 16 years to 1999, APNAS has become a material component of total fees paid to auditors and continues to grow. By 1999, the mean APNAS fee per listed company client was $117 800, with a mean APNAS fee ratio of 49.4% (compared to averages for the whole period of $93 600 and 38.8% respectively). Carson et al. note that there is a robust positive association between APNAS and audit fees, suggesting that audits are not being used as loss leaders in order to obtain access to more lucrative consulting fees. They also observe some differences in the pricing of audit and APNAS between the big accounting firms – some earn premia on audit fees while those that don't appear to have higher APNAS fee revenues. More recent statistics show an interesting reversal of the trend occurring in 2003. The *Business Review Weekly* (Walker & Andrews 2004) reports that for Australia's top 100 companies (by market capitalisation) there was a huge, 32.7% reduction in APNAS fees between 2003 and 2002. At the same time audit fees increased nearly 10%.

A number of very public accounting scandals[5] in the last five years have caused regulators to turn their eyes again towards the auditing profession. In the United States, the Independence Standards Board (ISB), which was set up in 1997 by the SEC and the AICPA, was effectively disbanded in 2003 when the SEC issued its own Auditor Independence Rule (SEC 2003). In 2002 the Sarbanes-Oxley Act was passed by Congress, imposing onerous rules governing the way companies and auditors interact.

Increased public awareness in Australia has seen two government enquiries into the role of auditing in financial reporting (Ramsay 2001; JSCPAA 2002), the reissuance of the joint professional accounting bodies' ethical rules relating to

[5]For example, in the United States, Enron, WorldCom, Tyco, Adelphia, HealthSouth, Xerox and Arthur Andersen, and in Australia, HIH Insurance, One.Tel and Harris Scarfe.

auditor independence in May 2002, and introduction of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill – 'CLERP 9' – into Parliament in 2004.

These developments have affected the provision of APNAS to audit clients by (1) the proscription of some types of APNAS, (2) requiring Audit Committees to pre-approve all APNAS, and (3) improving the disclosure of APNAS and audit fees, but in neither country has 'fee dependence' been defined in terms of quantitative parameters.

Agency/costly contracting problems explained

The two major professional accounting bodies in Australia, the Institute of Chartered Accountants in Australia (ICAA) and CPA Australia (CPAA), require their auditor members to ensure that in the conduct of their audits they maintain independence from their client both in appearance and in fact.[6] Why is auditor independence so important?

In brief, auditor independence helps ensure an efficient and effective capital market. According to 'agency theory' and 'costly contracting theory' (see Watts & Zimmerman 1986), principals (who are assumed to be rational, self-serving but not risk averse) and agents (who are also assumed to rational and self-serving but not risk-takers) are bound to have differing goals and objectives. This is because they have different time horizons, different attitudes to risk and different work ethics. And if we consider company owners as principals and their appointed managers as agents, then these differing goals and objectives imply that company managers may attempt to operate companies in ways that suit themselves rather than the owners. For various reasons, owners are concerned that managers may have incentives to misreport the financial performance and the financial position of the companies they manage. These reasons may include, for example, to boost their bonuses by inflating profits, or to obscure the effects of excessive perks enjoyed by managers, or to influence the market price of company shares so that their options are more likely to be 'in the money'.

Owners are not economically able to fully monitor the behaviour of managers, and hence owners will deduct from managers' negotiated remuneration the estimated costs to them of managers' incongruent behaviour. Rational managers realise this and therefore have incentives to prove to owners that they have nothing to hide and, *inter alia*, agree to engage the services of an independent person to attest to the fairness of the reported financial performance and position. These independent attestors are auditors. Their report to the shareholders, stating that management's representations in the financial statement are true and fair,

[6]Kemp and Knapp (2004), Statement B4, *Independence*, p. 1106.

adds credibility and reliability – and in doing so eliminates information asymmetry between company and investors, which helps maintain an efficient market.

The agency arguments outlined above apply to an investor or equity ownership setting. Agency arguments can similarly be applied to the debt-provider setting. Here the financiers or debt-providers can be considered the principals and the managers (on behalf of the companies) can be considered agents, in the sense that the financier makes funds available to a company which are expected to be managed responsibly until the funds are repaid at some future time. Again, because agents have differing goals and objectives from principals, there is a fear that agents might mismanage the funds, allowing a transfer of resources away from debt-providers to the company. *Ceteris paribus*, the cost of finance will be higher because of these likely losses to the debt-providers. Hence companies have incentives to keep interest rates down by, *inter alia*, agreeing to have their financial statements audited by a reputable independent auditor. There is some evidence that this is in fact the case (see, for example, Pittman & Fortin 2004). The audit report in this case will add credibility to management's representations that the company is exercising good stewardship over the financier's funds.

Similar costly contracting theory arguments have been put forward to explain why auditors' reports may help a company minimise the political costs to which it is exposed by virtue of its operations in the wider business and social community.

However, the degree of credibility and reliability that attaches to an audit report depends largely on two factors; the auditor's competence and the auditor's independence (DeAngelo 1981). For the audit function to have value, there needs to be a belief in the minds of all parties that misstatements in the financial statements prepared by management will, in the first place, be discovered by the auditors (an issue of competence), and in the second place, be unbiasedly reported to users of those financial statements in the auditor's report (an issue of independence).

There is a large body of research that explores the competence with which auditors undertake audit engagements and make judgments about the truth and fairness of financial statements based on the evidence they collect. However, the academic auditing literature reviewed here is not concerned with the quality aspects of auditors; it focuses more specifically on aspects of auditor independence.

A well-informed and transparent market for audit services requires that auditors should not only be independent in fact, but that they should also appear to be independent. There are many threats to auditor independence in fact and in

appearance. The ICAA/CPAA Joint Code of Professional Conduct identifies five such threats:[7]

1. *self-interest threats*: where the auditor could obtain a benefit, either financial or otherwise, from the audit client
2. *self-review threats*: where (a) the auditor in undertaking the audit engagement is required to form a judgment on other work (assurance or non-assurance) previously performed for the audit client, and/or (b) the auditor was previously associated with the audit client and is in a position to influence the outcome of the audit engagement
3. *advocacy threats*: where the auditor promotes an audit client's position or opinion to the point that objectivity may be – or may appear to be – compromised
4. *familiarity threats*: where the auditor becomes too familiar and sympathetic with the audit client
5. *intimidation threats*: where the auditor is deterred from acting objectively because of threats from the audit client.

Narrowing the focus again, this chapter considers the research about only the first of these, namely self-interest threats. These arise most commonly through fee dependence when an auditor, who receives materially large fees from a client, may be inclined not to unbiasedly report misstatements in the client's financial statements for fear of displeasing the client, and consequently being removed from the audit and thereby losing the future income stream attaching to the engagement.[8] This argument is only valid, of course, if management have the authority to hire and fire auditors or if auditors negotiate with management to receive fees that are contingent upon a certain type of audit report being issued. In Australia, contingent fees for audit services are banned[9], and auditors are appointed and removed on the vote of shareholders not at the discretion of management.[10] This being so, one might argue the opposite case – that auditors will be unlikely to side with managers against shareholder interests by not faithfully reporting financial misrepresentation to owners for fear of being found out by shareholders and consequently dismissed by them. However, there is anecdotal evidence that managers are highly influential in the appointment and removal of auditors. And because of information asymmetry between auditors and shareholders, there remains some doubt about the efficacy with which shareholders could, in the absence of company failure and/or subsequent litiga-

[7]Kemp and Knapp (2004), Statement F1, Appendix 1, para. 1.22 et seq.
[8]The ICAA/CPAA Joint Code of Professional Conduct, Statement F1, Appendix 2, discussed the threat of fee dependence (at para. 2.102 et seq.). The Code suggests that when audit fees from any one client reach 15% of the audit firm's total fees, auditors should have external parties conduct reviews and such reviews should be documented. Should the client's fees form 'an unduly large proportion' (not further defined) of total firm fees, then the auditor is required to refuse to perform, or withdraw from, the audit engagement.
[9]See Kemp and Knapp (2004), Statement F6.
[10]See the Australian *Corporations Act 2001* (at Part 2M.4).

tion, discover mendacious reporting by the auditor. Thus fee dependence continues to be perceived as a threat to auditor independence.

To the extent that shareholders have the power to appoint, instruct, remunerate and remove auditors, then auditors are agents of the shareholders. To the extent that management has the power to appoint, instruct, remunerate and remove auditors, then auditors are agents of management. It must be said that in Australia, listed company boards generally appoint an audit committee to oversee the company's arrangements with the auditor. Management may or may not be represented on the audit committee. Such a committee adds another layer in the principal-agent structure. It is a matter of some speculation whether auditors are agents of the shareholders, the audit committee or management.

Some have argued that auditors can never be truly independent simply because they are always subject to unconscious self-serving biases that arise in any number of ways, but including the effects of simply receiving a fee for service from their client companies (Bazerman, Morgan & Lowenstein 1997). Others have argued the impossibility of auditor independence because of the inevitable conflict that arises when auditors perform work for one party (shareholders) but are paid by another party (managers) (O'Connor 2002). Various alternate structural arrangements have been suggested for the market for audit services (for example, Coffee 2001; O'Connor 2002; Ronen 2002; Sunder 2003), but none has been considered seriously by company management and the accounting profession. Perhaps this is because the status quo suits both those parties too well.

While investigating the pricing of audit services, Simunic (1984) noted that the provision of APNAS would exacerbate the self-interest (fee dependence) faced by auditors. He reasoned that not only would the APNAS fee add to the level of fees derived from the audit client, but further, that the joint provision of audit and non-audit services might cause knowledge spillovers between the audit and the consultancy, enabling the auditor to perform either or both of these services more cheaply than a competitor supplier. These knowledge spillovers are sometimes referred to as 'economies of scope'.[11] To the extent that these 'efficiencies' are not passed on to the client by way of lower fees, they represent an economic rent (or a quasi-rent) to the auditor. If the APNAS services are recurring, the future stream of economic rents could be substantial.

The other worrisome aspect of APNAS is that it provides management with the opportunity to offer consultancy to the incumbent auditor (often referred to as

[11]There appears to be little published evidence as to the exact nature and incidence of these economies on audit costs. Antle and Demski (1991, p. 2) speculate:

> Some types of internal control deficiencies may generate high audit costs, but low costs for consulting to correct them. A client that generates high audit costs from a bad control environment due to improper attention from top management may be easier or harder to conduct an executive search for than an average client. The costs of conducting market surveys may be unrelated to audit costs.

'side payments') which, in contrast to audit fees, could be awarded on a contingency basis. In other words, management have the discretion to reward auditors with a stream of APNAS fees conditional upon the auditor concurring with management's representations in the financial statements. Such discretion is not subject to specific review and approbation by shareholders.

So herein lies the problem at the foundation of all APNAS fee research: does APNAS impair auditor independence through fee dependence? The question of whether APNAS causes the audit (and/or the consultancy) to be performed more efficiently and effectively is not as important as the independence issue because, notwithstanding an efficient and effective audit, shareholders are no better off – and likely worse off – if fee dependence is able to sufficiently influence auditors to bias their reports in favour of management.

In the remainder of this chapter, I review the extant empirical research literature that attempts to answer the specific question, does fee dependence occasioned by APNAS impair auditor independence?

Evidence from the archival literature – perception studies

APNAS and knowledge spillovers

It has been argued that the provision of APNAS by a company's incumbent auditor strengthens the economic bonding between auditor and client company and hence impairs the auditor's perceived independence. This is because the added economic benefits of the APNAS fees (being the quasi-rents associated with synergies/knowledge spillovers from or to the existing audit) strengthen the reluctance of the auditor to risk losing the audit through some disagreement with management (Simunic 1984).

Many studies have investigated this 'perceived lack of independence' by trying to determine if there is a measurable effect on audit fees in the presence of APNAS fees paid to incumbent auditors. Simunic (1984), Simon and Francis (1988), Abdel-khalik (1990), Turpen (1990), Butterworth and Houghton (1993), Ezzamel, Gwilliam and Holland (1996) and Houghton and Jubb (1998) collected public auditee data, while Palmrose (1986) and Ezzamel, Gwilliam and Holland (2002) surveyed public companies, and Davis, Ricchiute and Trompeter (1993) collected private audit firm production data to examine this relationship. Some used initial audit settings to incorporate 'low balling' effects into the picture.

It was generally thought that in a competitive market the benefit of knowledge spillovers (if they existed) would, in part at least, be passed on to the auditee and thus would operate in such a way as to hold audit fees *down* in the presence of APNAS fees purchased from incumbent auditors.

The results of the tests of this proposition were far from expected. The research generally supports the finding that there is a significant *and positive* relationship between APNAS fees paid to incumbent auditors and audit fees.[12] Simunic's (1984) conclusion was that auditors' cost functions for audit services and APNAS *were* significantly interdependent – the results consistent with knowledge spillovers flowing from audit to APNAS as well as the other way around, provided the demand for audit services is elastic.

The theoretical arguments supporting a positive relationship have not been well developed. Other explanations have been proposed to explain the positive relationship: for example, auditee financial difficulty causing higher levels of both APNAS and audit fees (Simunic 1984); APNAS fees related to major changes in auditee organisational structure (including changes in the accounting and internal control systems), which might require greater auditor effort (Palmrose 1986); and lack of competition in the market for APNAS (Solomon 1990).

Davis, Ricchiute and Trompeter (1993) in fact set out to test such alternative explanations for the incidence and level of APNAS fees and found APNAS and audit fees were related to increased audit effort – a result that was inconsistent with the view that performing both might provide the auditor with incentives to compromise 'objectivity' (p. 149). Ezzamel, Gwilliam and Holland (2002) surveyed UK companies in 1995, soliciting information not only about APNAS paid to incumbent auditors but also non-audit services purchased from other consultants, as well as information about the size of the companies' internal audit functions. They then used a number of models to evaluate the relationship between audit fees and various components of APNAS and non-audit services supplied by others.[13] They found audit fees were significantly positively associated with corporate finance advice and tax advice supplied by the auditor, but that audit fees were not associated with any of the non-incumbent supplied management consulting advice. They conclude (p. 13):

> We interpret these results as supporting explanations of the positive association between fees paid for non-audit services and audit fees in terms either of client specific differences, for example organisational complexity, or of events giving rise to the purchase of more audit and non-audit services rather than in terms of direct economic linkages between cost productions for audit and non-audit services. More tentatively, we speculate that the presence of another auditing firm at the client in a consulting capacity may exert competitive pressure on the fee for external audit.

[12]However, at least one of the US studies, Abdel-khalik (1990), failed to find any relationship.
[13]It seems to me a great opportunity missed that Ezzamel, Gwilliam and Holland (2002) didn't use their survey data to attempt to answer the question, what explains the level of APNAS fees out of a total level of non-audit services fees paid by a company to both incumbent auditor and other consultants?

However, few clear implications for auditor independence can be drawn from the above line of research.

Another, and potentially more fruitful, line of research has been proposed that attempts to model directly the level of APNAS fees paid to incumbent auditors with perceived notions of auditor independence. This research strives to determine the relationship between the demand and/or supply drivers of APNAS fees and the perceived lack of auditor objectivity (rather than investigating the level of APNAS fees as one of a number of components of audit fees). A summary of that research is set out below.

APNAS and surveys of market users' perceptions

There is a large body of research that has investigated whether the mere existence of APNAS causes different classes of external users of financial statements to infer a lack of independence between auditor and client, and whether – and if so, how – such a perceived lack of independence might cause those users to alter their attitudes towards, and contractual relationships with, the audited company. Some of this research looks at the appearance of independence threats arising from the *level* of APNAS (self-interest threats), while some addresses the appearance of independence threats from the *nature* of APNAS (self-review threats):[14] in this chapter, I review only the former.

Pany and Reckers (1988) allude to more than 20 years of surveys that indicated that users of financial statements were concerned about possible loss of auditor independence in cases where the incumbent provided audit and significant non-audit services concurrently. McKinley, Pany and Reckers (1985) argued that biased phrasing of some questions in some of these early survey instruments might have caused the severity of this so-called 'perception problem' to have been overstated. As an alternative to employing a survey instrument, McKinley, Pany and Reckers asked subjects whether they would approve or reject a loan application from a small company for which the level of APNAS was manipulated. Their results showed that users' perceptions of auditor independence and of financial statement reliability were unaffected by the level of APNAS. The McKinley, Pany and Reckers study was conducted on a relatively small scale and manipulated APNAS in just a binary fashion (0 or 30% of audit fees). Pany and Reckers (1988) sought to overcome these limitations by conducting a larger survey of bank loan officers and financial analysts, who were asked a series of questions about whether a loan to, or an investment in, a company was sound, given levels of APNAS that ranged between 0 and 90% of audit fees. Various other questions were asked about the perceived levels of auditor independence

[14] An early example of this sort of research is Shockley (1981). More recently, Lowe, Geiger and Pany (1999) elicit loan offer perceptions about auditor independence when the client company outsources internal audit work to the incumbent auditor.

and financial statement reliability. Bank loan officers were significantly more willing to provide loans when APNAS stood at the 25%-level, while at other levels there was no significant difference in perceptions (i.e., bank loan officers perceived independence risk no differently when APNAS was 90% to when it was set at 0%). Financial analysts were influenced (negatively) in their perceptions about the company's short-term riskiness only in the case where APNAS was 90%. The authors concluded that they were unable to find any real support that APNAS results in changed perceptions of auditor independence.

Some years later, Arthur Andersen won a battle with the SEC enabling its newly formed but legally separate consulting 'arm', Andersen Consulting, to undertake all manner of non-audit services for Andersen audit clients. Other Big Six accounting firms were not given the same opportunity and there was a renewed debate at the time into auditor independence. Lowe and Pany (1995) obtained the views of 401 loan officers as to whether, *inter alia*, the dollar amount of the consulting relationship (manipulated between subjects as either material or immaterial) affects perceptions of auditor independence. Interestingly, Lowe and Pany defined 'material' fees as being 12% of the audit firm's *office* total revenue. In addition, two levels relating to the recurrence of the APNAS were tested – in one case, the APNAS was treated as a one-off project, in the other as a 'continuous association' between client and auditor. Their survey results indicated strong support for the assertion that user perceptions of auditor independence are affected by the materiality of the APNAS, and weaker support for the proposition that user perceptions are affected by the continuity of the APNAS.

In 1996 a survey of company finance directors and audit partners was conducted in the United Kingdom to gauge perceptions about auditor independence and the effectiveness of recent UK regulatory changes to mitigate threats to auditor independence (Beattie, Brandt & Fearnley 1999). Questions about APNAS fee dependence (measured as the percentage of APNAS to audit fees) were included in the survey instrument and this threat to independence was ranked sixth in importance by finance directors and equal twelfth in importance by audit partners. Interestingly, Beattie, Brandt and Fearnley report that perceived economic dependence by audit partners on their audit clients was ranked very highly by both groups of respondents.

In a pre- and post-Enron study, Thornton, Reinstein and Miller (2004) surveyed bank executives and loan officers (representing well-informed financial statement users) and audit and non-audit CPA practitioners (representing financial statement preparers) to determine their attitudes about a number of issues associated with auditor independence and the provision of APNAS. By replicating some of the questions previously used by Reinstein and Lander (2001), they were able to test for changes in perceptions before and after the Enron scandal became

headline news in the United States. The results of the survey are interesting but not surprising:

- An equal amount of subjects (41%) thought APNAS would be likely to compromise auditor independence as those who thought it wouldn't, but auditors (and other CPAs, including those in industry) are significantly less concerned about a potential compromise than bankers.
- Public audit CPAs are significantly more likely than others surveyed to perceive that APNAS increases the client's power over the auditor and that APNAS improves the quality of the audit.
- However, public audit CPAs are less likely than other respondents to perceive that high APNAS implies a breach of independence in fact.
- Bankers and audit CPAs agreed more often than non-audit CPAs that litigation threats affected auditor credibility more than auditor independence.
- Significant differences pre- and post-Enron were observed. Generally, perceptions about the importance of auditor independence and client power afforded by APNAS over the auditor strengthened for all groups of respondents.

As an aside, the survey showed that respondents displayed little homogeneity about what types of APNAS were most serious in compromising independence, which indicates 'that regulators may not be able to satisfy all users' and preparers' desired level of auditor independence through a series of non-audit service proscriptions' (Thornton, Reinstein & Miller 2004, p. 19).

APNAS and market responses

Concern about APNAS fee dependence was confirmed in an Australian study by Gul and Tsui (1999), who investigated shareholder responses to varying levels of APNAS disclosed by 500 Australian publicly-listed companies in 1993 and 1994. Gul and Tsui obtained market evidence as to whether the returns accruing to a holder of a share were affected by the level of reported APNAS. They hypothesised an inverse relationship due to the expected reduced investor reliance on the integrity and objectivity occasioned by higher levels of APNAS. Using an OLS regression model, which included an interaction term (APNAS multiplied by earnings yield) as the variable of interest, they find a significant and negative relationship between returns and APNAS as hypothesised. However, after controlling for audit firm quality (using a Big Six dummy variable), they find that Big Six 'quality' auditors significantly moderate investors' negative association with APNAS. Gul and Tsui (p. 12) conclude: 'The results suggest that concerns regarding the adverse effects of [APNAS] on investor confidence are warranted only when [APNAS] is provided by non-Big 6 auditors'.

Another study (Brandon, Crabtree & Maher 2004) investigates the debt market's perceptions of independence impairment caused by APNAS. Using corporate disclosures about audit and non-audit service fees required in the United States under SEC Rule S7 (SEC 2000), the authors regress company bond ratings against APNAS fees and a number of control variables. The regression shows a significant and inverse relationship between the dependent variable and APNAS. The APNAS variable is operationalised three ways (APNAS as a percentage of audit fees, the total of APNAS plus audit fees, and APNAS and audit fees separately) and in all cases the regression coefficient is significantly negative. However, Brandon, Crabtree and Maher are unable to improve the prediction accuracy of a benchmark bond-ranking prediction model by including an APNAS variable.

APNAS and auditor reappointment

Raghunandan (2003) uses a novel setting in which to examine shareholder perceptions of auditor independence. He analyses shareholder voting in 172 *Fortune 1000* companies in the United States which elected to adopt shareholder ratification of management-nominated auditor re-appointments between February and April 2001. Raghunandan finds evidence to support the argument that one would be expected to observe less shareholder support for auditors who supplied large APNAS to their clients. However, the implications of these results need to be cautiously drawn because even in cases where APNAS was high, shareholder ratification of the re-appointment was, on average, still 97%.

APNAS and management's perceptions

Another body of empirical research has investigated management's perceptions about the relationship between the level of APNAS and agency costs. This research posits that companies with high agency costs (usually measured by ownership dispersion and managerial share ownership and leverage) will have incentives to signal to shareholders and financiers that their financial statements are credible and reliable. Given that managers have the discretion to issue APNAS consultancies, if managers perceive that APNAS will impair auditor independence (either in their own eyes or those of owners and debt-providers) then, *ceteris paribus*, high agency cost companies will be expected to report lower APNAS than low agency cost companies.

Parkash and Venable (1993) set out to test the above agency theory-inspired proposition. They argue further that recurrent APNAS represents an annuity and therefore is likely to be perceived as more of an impairment to auditor independence than non-recurrent APNAS. Using US information about APNAS made available under the old ASR 250 disclosure rules, Parkash and Venable combine data sets of approximately 250 listed companies for 1978, 1979 and 1980, and regress APNAS against agency cost variables. Both univariate and multivariate

analysis support the hypotheses that lower levels of recurrent APNAS are associated with lower levels of managerial/director ownership, lower levels of owner dispersion, and higher levels of leverage (as a surrogate for closeness to debt covenant limits). The results, however, revealed some temporal anomalies. The regression for 1978 reflects in substance the overall pooled results. However, the 1979 indicator variable is only significant for larger auditees, while the 1980 indicator variable is only significant for smaller auditees. Similarly, when recurrent APNAS fees are broken down into the categories of tax, pensions and personnel, and systems, the explanatory power of the agency variables is mixed. A major limitation of the study not specifically addressed by Parkash and Venable is the underlying assumption that the demand for APNAS is cross-sectionally and temporally homogeneous. This is unlikely to be the case in practice. The reason why an auditee purchased less APNAS from its auditor in a particular period may be because it had less of a *need* of non-audit services in that period – and *not* because of agency theory-related incentives for an independent auditor.

In a much more recent study, but using the same ASR 250 data as Parkash and Venable (1993), albeit with a much larger selection of companies, Hackenbrack (2003, p. 23) reports that the disclosure of APNAS during those years altered management's appetite for APNAS:

> The evidence reported in this study is consistent with the SEC's policy substantively changing behaviour. The percentage of companies jointly sourcing audit and [APNAS] dropped from 54% to 42% during the effective period of ASR 250, a time when consulting industry revenues were expanding at 20% annually. Investors' reactions to the mandated disclosure are positively related to managements' subsequent purchases at two levels: the likelihood a company chose to jointly source audit and [APNAS] and the overall (relative) purchase levels for the 14% of the sample that purchased high levels of [APNAS].

Firth (1997) was the first to attempt to overcome the assumption of cross-sectional homogeneity of non-audit services. The incidence of APNAS must be predicated on the *ex ante* economic need for such consulting/management services. He hypothesised that such a demand is likely to be a function of:

- corporate restructuring
- the installation of a new information system
- the recruitment of a new CEO, within the current or previous two years, from outside the company
- high asset growth
- the financial performance of the company.

Firth regressed APNAS fees paid to incumbent auditors (deflated by the audit fee) against agency cost variables after controlling for the above economic need variables. He used data collected from the 500 largest UK *industrial* listed companies, which were required to disclose APNAS fees paid to incumbent auditors for the first time in 1993. His results indicated that, except for company performance, growth and new information system installation, all 'economic need' variables were significant. All of the agency theory independence variables were also significant and displayed the expected directional sign. This led Firth to conclude that his study 'finds evidence in support of agency variables influencing the relative use of auditor-provided consultancy services' (Firth 1997, p. 19).

In an Australian setting, Houghton and Ikin (2001) posit a three-factor model to explain the level of APNAS paid by Australian companies to their incumbent auditor. The first factor is an '*ex ante* need for consulting services' (operationalised similarly to Firth (1997), but including the error term from a parsimonious audit fee model to capture the jointness of audit and APNAS fees), the second factor is a requirement for the incumbent to be an APNAS industry specialist, and the third is a willingness by the auditee to appoint the auditor. This 'willingness to appoint' construct is argued to be determined by agency and political cost pressures, together with management's perceptions of the strength of the auditee's portfolio of corporate governance practices, of which the appointment of an independent auditor is one such. In other words, the authors argue that if a company employs a number of strong corporate governance practices, these might mitigate against any pejorative perceptions arising from a high level of APNAS and thus help restrain any increase in agency or political costs. Using OLS regression on data collected from a sample of 432 companies selected from among the largest 500 companies listed on the Australian Stock Exchange (ASX) in 1997, Houghton and Ikin find general support for their model. In particular, equity (but not debt) agency costs and political costs were significantly and negatively related to levels of APNAS, which is consistent with the notion that management perceives the loss of independence associated with high APNAS as impacting the cost of doing business with stakeholders, and manipulates the levels of APNAS downwards accordingly. Further, they find some evidence that other good corporate governance practices offset this effect – the number of non-executive directors on the audit committee and the activity of the board were both significantly and positively associated with levels of APNAS.

Summary

It seems clear that perceptions of impaired auditor independence are aroused in the minds of financial statement stakeholders (if not auditors) by the incidence of high levels of APNAS.

Evidence from the archival literature – more direct tests

This section reviews the extant academic literature that specifically examines the relationship between auditor independence and the provision of APNAS. The concerns expressed by the public and regulators – that the joint provision of audit services and APNAS appear to compromise auditor independence – have motivated all the research described below.

Dopuch and King (1991) conducted an experiment using two abstract markets that modelled the contracting offers and acceptances between auditors and clients. In one market auditors could offer to provide APNAS as well as audit services, in the other market they could not. Since the interactions between market participants were complex, the results are difficult to interpret and extrapolate into the real world.

Unlike the research studies noted in the previous section (and unlike Dopuch & King 1991), each of the following studies directly explores the relationship between the level of APNAS fees paid to incumbent auditors and various proxies of auditor independence *in fact*. The different measures of independence used include the length of auditor tenure, the frequency of qualified audit opinions, auditor changes ('switches') and various agency theory-related incentives for auditor independence.

APNAS and auditor tenure

Beck, Frecka and Solomon published their research into the relationship between APNAS and auditor independence in two papers. The first (1988a) proposed an analytical, supply-side model of the bonding that develops between auditor and auditee in the presence of APNAS fees.[15] Assuming a competitive market for non-audit services, they argued that incremental bonding will be greatest in the case of recurrent APNAS when there are effective barriers to entry into the market (i.e., when the APNAS start-up costs and APNAS switching costs are greater than audit cost savings through knowledge spillovers). In the case of non-recurrent APNAS, they predicted that incremental bonding will only occur when there are real knowledge spillovers between the audit and APNAS engagements because the incumbents will then have lower costs than their competitors. The researchers were faced with a major limitation – audit and APNAS start-up costs, and audit and APNAS switching costs and spillover benefits are not directly observable to external parties. So Beck, Frecka and Solomon needed to make one further assumption in order to test their model – that as bonding increases so too will audit tenure (i.e., the length of time the incumbent auditor remains incumbent). In fact, of course, without this data on costs and benefits, their

[15] In fact, they extended the DeAngelo model (1981) by including the market for APNAS fees.

model cannot really be tested. Nevertheless, despite the inability to test the precepts of the model, their research does permit the empirical testing of the effect APNAS fees has on audit tenure (as a proxy for bonding and, inversely, for independence) and hence is instructive for this study. In their second paper (1988b), Beck, Frecka and Solomon empirically tested the relationship between various levels of APNAS fees (by categories) and audit tenure on US listed companies in 1978 and 1979. They selected 50 companies in both years with high levels of different categories of APNAS and compared them with 50 companies with low levels of APNAS. Overall the results are mixed. Limited support was found for increased tenure (increased bonding – decreased independence) in the case of some of the recurrent APNAS categories (systems, and pension and personnel – but oddly not tax) in the 1978 sub-sample. This was not replicated in the 1979 sub-sample. The difference in the means of audit tenure in the high APNAS groups varied only slightly in absolute terms with the low APNAS groups (the differences were significant, however). No significant results were found in respect of the non-recurrent APNAS. Dopuch (1988) finds the results unconvincing, especially since their sub-samples were so highly skewed.

Dopuch noted the low level of auditor switches that were evident in the Beck, Frecka and Solomon (1988b) sample compared to other research. He suggests (at p. 90) that it might be 'useful to look at client auditor switches for each of the accounting firms in their samples to see whether the frequency of switches of an accounting firm's high [APNAS] clients differs from that of switches of its low [NAS] clients'. DeBerg, Kaplan and Pany (1991) report how they took up Dopuch's challenge. They tested the assertion that companies with higher levels of APNAS would switch their auditors less often than companies with lower levels of APNAS. Using a matched pair research design, they compared levels of APNAS for all listed US companies that changed auditors between September 1978 and February 1982 with levels of APNAS fees reported by similar companies that did not change auditors in that time period. Like Beck, Frecka and Solomon (1988b), they used the disclosure requirements of ASR 250 to obtain data about APNAS fees and used the same categories of recurrent and non-recurrent APNAS. Despite the good motivation of the research, they failed to find any significant differences in the levels of total APNAS, recurrent APNAS and non-recurrent APNAS between the two groups of 'treatment' and 'control' companies. The claim that higher levels of APNAS increased bonding between auditor and auditee was thus rejected, as also, by inference, was the claim that APNAS fees might impair auditor independence. In an extension to their prime research question, DeBerg, Kaplan and Pany (1991) investigated whether the decision to change auditors was related to changes in the purchase of APNAS. Levels of APNAS before and after the auditor switches were analysed. The results indicated that lower levels of total APNAS and recurring APNAS were purchased from

the successor auditor compared to the predecessor auditor and also to the non-change company group.[16]

APNAS and qualified opinions

The notion that a less independent auditor is less likely to issue qualified or modified audit opinions is appealing, and many studies have now been undertaken to examine the effect APNAS fees might have on the incidence of qualified audit opinions. Initially, most of these were Australian studies because for many years APNAS fees were required by legislation to be disclosed in company annual financial statements.

Barkess and Simnett (1994) were concerned with two issues relating to APNAS – the pricing of APNAS as well as the association, if any, between APNAS and auditor independence as measured by audit report qualifications (and by auditor switches; see notes). They drew their sample from the top 500 listed companies in Australia for each of the five years 1986 to 1990. Data was not pooled.

A parsimonious OLS model was proposed that would identify any relationship between APNAS and predicted drivers of the level of APNAS – namely, audit fees, auditee size and auditor. To this was added an independent variable to identify qualified audit reports.

The results relating to auditor independence observed by Barkess and Simnett indicated that there was no support for the contention that auditors would be less likely to issue qualified audit reports when they are selling higher levels of APNAS to their clients. Univariate analysis failed to reveal any significant differences between the level of APNAS in companies receiving qualified and unqualified audit reports in each of the five years. This was confirmed in the regression analysis – the audit qualification indicator variable was insignificant in all years except 1989 (where it was significant and *positive*).

Wines (1994) stated that while many researches have investigated financial statement users' *perceptions* of auditor independence in the presence of APNAS fees, none had examined the connection between the output of the audit process – the audit report – and APNAS fees. He claimed that observations of variations in the nature of audit reports issued is likely to tell us more about real independence effects than users' perceptions of independence effects. Wines selected the 76 largest Australian listed companies that survived during the 10-year period 1980 to 1989, and analysed the pooled data by regressing APNAS fees as an independent variable against audit report qualifications as the dependent dummy

[16]In an Australian study, Barkess and Simnett (1994) also investigated the relationship between APNAS fees and auditor switches (although they claim to be testing auditor tenure). A summary of their research appears in the section 'APNAS and qualified opinions', but briefly their results indicated that there was no significant relationship between the two variables. In contrast to DeBerg, Kaplan and Pany (1991), they noted that the average level of APNAS fees increased sharply in the year after the auditor switch and concluded that companies 'may change auditors in order to gain access to higher levels of other services' (Barkess & Simnett 1994, p. 106).

variable. The probit model is very parsimonious, controlling only for auditee size and dummy variables for industry and auditor. Wines found a significant – and negative – relationship between audit qualifications and APNAS fees, as predicted.

Craswell (1999) was motivated by the desire to reconcile the conflicting results of Wines (1994) and Barkess and Simnett (1994). He regressed APNAS fees as an independent variable against audit report qualifications as the dependent dummy variable. Craswell included 'emphasis of the matter'-type comments in auditors' reports as qualifications, while Wines did not. (Craswell's dependent variable could more accurately be described as 'modified audit report' rather than 'qualified audit report'.) Craswell's logit model controlled more carefully for the (audit risk and complexity) factors that prior research had identified as being responsible for producing cross-sectional differences in qualified audit reports. These included size, profitability, leverage and asset composition. The model also included a dummy variable as a control for cases in which auditors had issued a qualified audit report in the prior year and another to indicate whether the auditor was a member of the Big Eight or not. The data sets of the three studies overlap in time – Craswell selected all listed Australian companies in 1984, 1987 and 1994, but analysed each year's data separately. Craswell (1999) failed to find any significant relationship between the incidence of modified audit reports in the presence of APNAS fees paid to incumbent auditors.

Craswell appears to be the more complete and robust research, however various limitations in all studies are evident. These include:

- the failure to adequately control for audit quality (a co-requisite with audit independence for an audit qualification)
- the inability to determine, from publicly available data, precisely those companies that experienced circumstances that would normally have given rise to a qualified audit opinion but did not receive one from the incumbent auditor
- the existence of alternative explanations for the results (the consequence of the APNAS consultancy might be to so improve accounting systems, for example, that an audit qualification becomes no longer appropriate).

In another Australian study, Houghton and Jubb (1999), while not investigating auditor independence *per se*, found that audit qualifications were costly both in terms of audit fees (particularly in the year following the qualification) and also APNAS fees (in the year of the qualification).

Craswell, Stokes and Laughton (2002) conduct an investigation of the effects of audit fee dependence on an auditor's propensity to issue qualified audit opinions. Again set in Australia, the authors use qualified opinions only as their dependent regression variable, on the basis that modified opinions do not constitute the

exercise of 'serious' independent judgments by auditors. As an extension of prior research, Craswell, Stokes and Laughton consider an auditor's audit fee dependence at a local office level as well as at a national level. Variables are included in the regression to control for other company characteristics generally associated with the issuance of a qualified opinion and for the impact of the level of APNAS fees. Listed Australian company data for two years (1994 & 1996) are collected and analysed separately (i.e., the data are not pooled). The results of the study indicate that 'the fee dependence variables do not have a statistically detectable impact on the exercise of independent judgement in the formulation of the audit opinion' (Craswell, Stokes & Laughton 2002, p. 271). The authors note that any observed incidence of a qualified audit report must have arisen as a coincidence of two factors – viz, an *ex ante* error in the financial statements and an auditor sufficiently unbiased as to qualify the audit report – and that the first factor should be controlled for in studies such as these. Unfortunately, *ex ante* errors in financial statements are not observable, but some have argued (for example, Whittred 1980) that delays in issuing audit reports are evidence of client-auditor negotiations over financial statement misstatement and might serve as a useful proxy. Craswell, Stokes and Laughton analyse whether late reporters are systematically different from the rest of their companies and conclude in the negative.[17]

Since 1992, UK companies have been required to disclose levels of APNAS in addition to levels of audit fees. Firth (2002) extends his prior research into the effect of agency costs on levels of reported APNAS (Firth 1997, see above) by investigating (1) whether levels of audit fees and APNAS fees are driven by common events and characteristics that create a demand for APNAS as well as an increase in the amount of audit effort, and (2) whether, after controlling for cross-sectional differences in an auditee's need for consulting services, higher levels of APNAS lead to a higher incidence of unqualified audit opinions. It is the second question that is of interest here. Audit report qualifications are modelled as a function of the size of client, its financial performance, leverage, asset composition, risk characteristics, Big Six status of the auditor and various fee dependence measures including the ratio of APNAS to total assets, the ratio of audit fees to total assets, and the ratio of audit and APNAS fees to the total fee income of the audit firm. 1112 listed UK companies are selected using 1996 data. The probit regression results show that the coefficient of the variable of interest, APNAS/total assets, is significantly negative, indicating that the higher the APNAS, the more likely it is that the audit report will be 'clean'. The fee

[17]Knechel and Payne (2001) use proprietary information obtained from an international public accounting firm to examine the causes of lags in audit reports. They find that, in addition to incremental work effort, the existence of contentious tax issues and the level of staff experience, one factor that helps explain audit report lag is APNAS – which works to *decrease* the lag. They conclude that this indicates the synergistic relationship between APNAS and audit effort. However, such a finding is also consistent with the notion that APNAS increases independence threats.

dependence argument is reinforced by the moderately significant and negatively signed variable APNAS/total APNAS + audit fee.[18] This result confirms Wines (1994), but is at odds with other similar research. Note that there is, of course, an alternative explanation for any observed negative relationship between APNAS and qualified opinions – namely, that high APNAS might have so improved the auditee's accounting systems and internal controls and/or operations that the reasons for qualified opinions are substantially reduced.

A couple of US studies fail to replicate Firth's (2002) results. DeFond, Raghunandan and Subramanyam (2002) test the proposition that going concern qualifications are negatively associated with levels of fee dependence. Fee dependence is measured both in terms of APNAS and total fees (i.e., APNAS + audit fees). They choose going concern qualifications specifically because of the serious consequences for both client and auditor of misreporting when financial failure might be imminent. Their sample of 4105 companies lodging proxy statements with the SEC between February and October 2001 included 160 with going concern qualifications. Their analysis is rigorous, and after controlling for cross-sectional variation in the demand for audit and consulting services to derive unexpected fees[19], they report (p. 1250):

> Our results provide no support for either hypothesis. That is, we find no evidence of a significant association between the auditor's propensity to issue a going concern opinion and any of our fee measures. This finding is robust to replacing all fee variables with their respective unexpected components, and after controlling for the simultaneity bias induced by endogeneity among non-audit fees, audit fees and going concern opinions.

DeFond, Raghunandan and Subramanyam's results are supported by Geiger and Rama (2003), who investigated the effect that different levels of fees paid to auditors had on the incidence of going concern qualifications for stressed manufacturing companies. The selection of a smaller sample than DeFond, Raghunandan and Subramanyam – they examined only 66 companies – enabled them to test a richer model. In particular, Geiger and Rama collected data relating to a company's default status, management plans and audit committee composition, all of which have been shown to be associated with US audit opinions. Their regression showed a significant and positive association between the auditor's propensity to issue going concern opinions and audit fees, but no such association with APNAS. Similar to DeFond, Raghunandan and Subramanyam, their results are unchanged after controlling for the endogeneity of audit opinions, audit fees

[18]Interestingly, Firth (2002) found no observed association between audit fees and audit qualifications. The reason might be as explained by Houghton and Jubb (1999), who observed a lagged effect between the two.

[19]The authors here draw on prior research by Craswell, Francis and Taylor (1995) and Whisenart, Sankaraguruswami and Raghunandan (2003) for variables explaining audit fees, and Parkash and Venable (1993), Firth (1997), Whisenart, Sankaraguruswami and Raghunandan (2002; see References), and Frankel, Johnson and Nelson (2002) for variables explaining APNAS.

and APNAS. In other words, they found no evidence of APNAS having any significant adverse effect on auditor reporting judgments in their sample of stressed companies.

The results of both DeFond, Raghunandan and Subramanyam (2002) and Geiger and Rama (2003) are compatible with the findings of Reynolds and Francis (2001). They also use the incidence of going concern audit reports to determine whether large audit clients (i.e., large in terms of audit fees at an audit firm office level) affect the propensity for auditors to issue biased audit reports. They cannot find any evidence that economic dependence causes auditors to report more favourably for larger clients. On the contrary, they conclude that auditors generally report more conservatively (i.e., with less concern for self-serving bias) for larger clients, attributing this to greater litigation and reputation risk associated with misreporting for those larger clients where fee dependence is high.

In another interesting Australian study, Barkess, Simnett and Urquhart (2002) take a different perspective on the debate. They set out to determine if audit firms which receive material fees from clients are less likely to issue qualified opinions by examining audit fee data on a firm-by-firm basis. They collected client fee data on Australia's largest 25 audit firms over the years 1988 to 1992. A number of tests were performed:

- comparing the rate of audit qualifications of those clients that contributed more than 0.5% of total firm revenues with the rate of qualifications across all companies
- using an audit opinion prediction model first propounded by Monroe and Teh (1993), comparing actual opinions with predicted opinions for those 77 companies that contributed more than 0.5% of audit firm revenues in 1991 and 1992
- including a fee dependence ratio in the audit opinion prediction model to determine if that improved the specification (i.e., the accuracy of prediction) of the model.

Barkess, Simnett and Urquhart (2002) found no support in any of their tests for the proposition that audit firms allowed their reporting judgments to be biased in favour of high fee paying clients.

APNAS and earnings management

Much attention was given to the work of Frankel, Johnson and Nelson (2002) when it was published. It was the first to publish results using the audit and APNAS fee data that was required to be disclosed in all US company proxy statements lodged after April 2000. It seems a number of researchers had thought of using earnings management as a measure of earnings quality, and then testing the notion that economic bonding between auditor and client through fee de-

pendence might be associated with lower earnings quality and therefore higher earnings management. Frankel, Johnson and Nelson used three measures of earnings management (meeting or just beating earnings forecasts, absolute discretionary accruals, and the share price reaction to disclosed audit and APNAS fees) and two measures of fee dependence (ratio of APNAS fees to the total of audit and APNAS fees, and the rank of the magnitude of APNAS for the auditor across clients in the sample). Their sample comprised 3074 US companies disclosing APNAS and audit fee data in proxy statements filed with the SEC between February and June 2001. After controlling for various auditor and company characteristics affecting earnings management, they find a significant and positive relationship between APNAS and small earnings surprises and the size of discretionary accruals. This finding supported the UK results of Gore, Pope and Singh (2001).

Kinney and Libby (2002) raised some conceptual and model specification concerns in the Frankel, Johnson and Nelson (2002) study which have been addressed to some extent by other researchers. For example, Ashbaugh, LaFond and Mayhew (2003) used a modified discretionary accruals model that controlled for company performance (and could not find any association between their APNAS ratio and earnings management for those companies reporting positive discretionary accruals).[20] Ashbaugh, LaFond and Mayhew also respecified the regression modelling 'benchmark beating' (and could not replicate the Frankel, Johnson & Nelson finding). In summary, they state: 'Overall, our study indicates that [Frankel, Johnson & Nelson 2002]'s results are sensitive to research design choices, and we find no systematic evidence supporting their claim that auditors violate their independence as a result of clients purchasing relatively more nonaudit services' (p. 611).

Similarly, Antle et al. (2002) address the endogeneity issue concerning the joint determination of audit fees, APNAS fees and to some extent earnings management. Contrary to the findings of Frankel, Johnson and Nelson (2002), the evidence provided by their 1994-2000 UK company data indicates that increased discretionary accruals are associated with a *decrease* in APNAS. Antle et al. claim that their results are robust to preliminary tests on US data.

Francis and Ke (2003), who focus only on beating earnings forecasts as a proxy for earnings management and hence poor quality reporting, make three improvements to the Frankel, Johnson and Nelson study. First, they respecify the model to exclude companies with large negative earnings surprises, second they consider quarterly earnings benchmarks rather than annual benchmarks, and third they measure 'fee dependence' by using three additional metrics. They find no sys-

[20]This is a significant finding because there is evidence that companies engage in earnings management in a hierarchical order; the first objective is to report positive earnings, next to report a positive change in earnings, and then, given the first two objectives are achieved, to meet or just beat analysts' forecasts (Degeorge, Patel & Zeckhauser 1999).

tematic evidence that companies paying high fees (APNAS or audit or both) are more likely to manage earnings to meet analysts' forecasts.

Another study to investigate this question was Larcher and Richardson (2003). Initially replicating the research design used by Frankel, Johnson and Nelson (2002), they find a positive association between the absolute value of discretionary accruals and APNAS paid to auditors. However, after applying 'latent class mixture models', using additional measures of fee dependence (including *unexpected* fees), and including some corporate governance control variables, they report that this positive association is driven by a small cluster of companies (only 8.5% of companies in their large sample) that have a relatively small market capitalisation, lower book-to-market ratio, lower institutional shareholding and higher managerial ownership. Further, these companies concurrently show symptoms of weakness in corporate governance mechanisms. The overall results show a *negative* association between auditor independence (as proxied by four alternate fee measures) and earnings quality (as proxied by discretionary accruals).

Chung and Kallapur (2003) strengthened the case for no independence impairment. They failed to find an association between earnings management and APNAS fees (measured in terms of relative importance to the audit firm at both a national and office level) after controlling for industry and geographical segments, auditor industry expertise, audit tenure and some additional company corporate governance characteristics.

The latest US study follows the trend. Reynolds, Deis and Francis (2004) expand the Frankel, Johnson and Nelson model to include control variables for auditor litigation risk and reputation protection, company industry membership and IPOs. Their highly explanatory model (R^2 of approximately 75%) shows that neither of their fee dependence measures (ratio of APNAS to total fees paid to the auditor and the natural log of total fees) is significantly related to discretionary accruals and hence not to earnings management.

However, the latest UK study (Fergusson, Seow & Young 2004) does find a positive association between earnings management and APNAS purchases between 1996 and 1998. Three measures of earnings management were used, including a measure of the likelihood that the auditee's accounting policies were publicly criticised or subject to investigation by regulators. Three measures of APNAS fee dependence were also employed; (1) the ratio of APNAS fee to total auditor fees, (2) the log of APNAS fees, and (3) the decile rank of the auditee's APNAS fees in the auditor practice office. The authors note that the UK environment during the period of the study was one of stable economic growth, few corporate collapses and low auditor litigation.

One Australian study adopts a different measure of earnings management. Ruddock, Taylor and Taylor (2003) posit that auditors who are fee dependent may have incentives to monitor client reporting less thoroughly and that this may lead to a noticeable reduction in reporting conservatism (the notion of anticipating losses but not profits). They use three measures of reporting conservatism (one as reflected in share returns, another as reflected in the time series of earnings, and the last in the time series of the relation between cash flows and accruals) proposed by previous researchers (Basu 1997; Ball & Shivakumar 2002) and various measures of APNAS and client importance to audit firms. Ruddock, Taylor and Taylor summarise their results in the following way (p. 5):

> With only one exception, we are unable to identify any statistically significant incremental decrease in earnings conservatism associated with relatively larger amounts of [APNAS]. … However, further analysis indicates that this [exception] is driven by client year observations drawn solely from one of the Big Six audit firms. Additional tests indicate our results are robust to alternative measures of [APNAS] (and client) significance, as well as attempts to control for the potentially endogenous relation between the demand for [APNAS] and earnings conservatism. We therefore interpret our results as being inconsistent with the claim that relatively larger amounts of [APNAS] results in reduced auditor independence in fact, but consistent with the view that market forces such as litigation risk, the more general loss of reputation and alternative governance mechanisms serve to discipline auditors from reducing their independence in order to gain increasing [APNAS] fees.

The overriding impression from the above body of research is that as models become better specified, the prospects of finding positive associations between APNAS and the quality of reporting become more remote. However, few would disagree that our current ability to accurately model 'earnings management' or indeed 'earnings conservatism' is not able to be improved upon. At present they remain at best noisy proxies for aggressive reporting. Perhaps a stronger measure of earnings quality (or the lack of it) is the degree to which companies restate the numbers in their financial statements to correct past errors.

APNAS and profit restatements

The *Economist* magazine recently reported a study by two Cornell University professors (Eisenberg & Macey 2004) investigating whether the failed Arthur Andersen was very different from its peers, in terms of clients who restated earnings as a result of errors subsequently discovered in prior year financial statement which had received clean audit opinions. The study indicates that Arthur Andersen's record of having large clients which subsequently restated earnings was no worse than the other Big Five auditing firms. Over a five-year

period ending 2002, there was no significant difference between the restatement rates for all audit firms (Deloitte & Touche had the highest rate at 5.6%, while Arthur Andersen had the second lowest rate at 2.8%). And, interestingly, restatement rates increased over the period and as client size increased.

Like qualified auditor reports, restatements of profits provide an *ex post* indication of auditor quality and auditor independence. This has prompted a number of studies into the association between the coincidence of APNAS and subsequent earnings restatements by their audit clients.

Raghunandan, Read and Whisenant (2003) test the relationship between the incidence of restatements and three measures of fees paid to auditors; APNAS fees themselves, the ratio of APNAS to the sum of audit and APNAS fees, as well as total fees as a single amount. They calculated what they called the 'unexpected' levels of all three measures. The motivation for this was to control for economic factors and firm characteristics that might have caused APNAS to vary between companies (after Firth 1997, Houghton & Ikin 2001, and DeFond, Raghunandan & Subramanyam 2002, as previously discussed).[21] Comparisons were made between 110 US companies that restated earnings in 2000 and 2001, with some 3500 'control' companies. They report (p. 232):

> The results, based on a comparison of the distribution of unexpected values, indicate no statistically significant differences across the two groups for any of the three measures. Thus, these findings are not consistent with concerns that non-audit fees or total fees paid to the auditor inappropriately influence the audit such that the financial statements are subsequently adjusted.

Earnings restatements and corporate governance mechanisms were the focus of a study by Agrawal and Chadha (2003). However, they used the ratio of APNAS to total fees paid to incumbent auditors as a proxy for potential auditor conflicts. A total of 159 US companies that reported restatements in 2000 and 2001 were matched on size and industry with the same number of control companies that did not restate. Agrawal and Chadha find that several key corporate governance mechanisms (such as the independence of the board and the independence of the audit committee) are unrelated to the probability of earnings restatements. However, interesting for our purposes is the finding that APNAS is found to have no association with low-quality reporting inferred by the restatement of earnings.

Another study, by Kinney, Palmrose and Scholz (2004), sought to determine if certain types of APNAS were related to the restatement of earnings for previous financial statement misstatements (caused by serious 'core' errors rather than

[21]Noting Whisenant, Sankaraguruswami and Raghunandan (2003), they also control for the jointness of APNAS and audit fees.

'technical' errors). Kinney, Palmrose and Scholz surveyed the seven largest US public accounting firms to collect a breakdown of audit and APNAS fees paid by their audit clients between the years of 1995 and 2000. Their sample consisted of 374 'fee-years' (187 that restated earnings and 187 matching observations that didn't). If restatements represent poor quality reporting then they would expect to find higher levels of APNAS among the restatement group than the control group. However, for only one category of APNAS fees, 'other consulting and all other services', which represented about 23% of all APNAS fees paid, was there evidence of such an association. Other categories were either negatively correlated with restatements ('tax' 33%) or not significantly correlated at all ('financial information systems design and implementation' 8%, 'internal audit' 1%, and 'audit related' 35%).

APNAS and *ex post* litigation

In addition to earnings restatements, subsequent litigation against auditors of listed companies for biased reporting represents another potential setting to ascertain whether auditors have been independent *in fact*. In Australia, most claims against auditors for breach of contract or for negligence seem to be settled out of court – the number of such cases going to full trial are very small. One would expect greater scope to be open to researchers in other countries with larger capital markets. However, I can find little evidence of active research in this area. Antle et al. (1997, p. 23) report:

> In Minet's risk management database of 610 claims against auditors, there are only 24 claims in which the claim mentions that the auditor also supplied consulting services. In 19 of those cases it does not appear that independence was an issue. In two of the remaining five cases, there were allegations of lack of independence, but the allegations were not directed at the supply of consulting services. This leaves us with only three out of 610 cases in which there were allegations that independence was somehow impaired by the supply of consulting services.

They further report that they supplemented the Minet data with their own evidence gathered from informal questions to lawyers who could be expected to be well-informed about such claims against the Big Six and they failed to uncover any additional cases.

Similarly, Palmrose (1999) reported that her auditor litigation database, compiled since 1969, contained less than 1% of instances of lawsuits against auditors that alleged non-audit services impaired independence (cited in Kinney 1999).

Summary

The overall conclusion that is apparent from this line of research is that there is no persistent evidence that the level of APNAS fees impacts auditor independence *in fact*. This conclusion is robust across various measures of auditor independence – namely, audit tenure, propensity to issue qualified audit opinions, the level of client earnings management, the degree of earnings conservatism, client *ex post* profit restatements and *ex post* litigation against auditors.

Evidence from the archival literature – auditor focus

Because audit firms are not regulated to disclose business information in annual reports as listed companies are required to do, much important data about audit firms – e.g., their internal financial results and arrangements at an office, state, national and global level, their activity in different business sectors, their financial arrangements with consulting divisions and associated entities, and partner remuneration and review, etc. – are not publicly observable. This has meant that survey and experiment have been the main avenues by which researchers have endeavoured to explain audit judgments in different settings.

The issue here is whether – and if so, to what extent – auditors take into consideration the level of APNAS fees (current and/or proposed) when making client acceptance and continuance decisions. How do firms, and partners within firms, weigh the benefits, such as the firm's enhanced profitability and reputation, and individual partners' enhanced remuneration and career prospects, against the potential costs, such as the potential compromise of reputation and independence in appearance, the potential loss of independence in fact, and the associated increase in business risk including litigation risk? Similar questions arise when auditors make judgments about the truth and fairness of contents and disclosures in clients' financial statements.

Early work in this area (Pany & Reckers 1980; Shockley 1981; Knapp 1985) suggested that total fees and/or APNAS fees are an important factor in auditors' judgment processes and decision behaviours. Lord (1992) introduced various 'contextural' variables into his investigation into how pressure affects auditors' decisions about reporting judgments. Two of these manipulated variables related to fee dependence; one was client revenue contribution (significant/moderate), the other APNAS fees (consistent/seldom). Significant interaction action effects were noted between pressure, client revenue contribution, APNAS and client financial condition, and the auditor's likelihood of issuing an unqualified opinion when faced with a reporting dilemma. Results are somewhat difficult to interpret, but one conclusion seems to be that 'pressured' auditors of smaller, financially healthier clients are more likely to accept management's suggested accounting treatment if APNAS is increased.

Chang and Hwang (2003) provide further experimental evidence supporting the proposition that audit judgments about clients' aggressive reporting would be influenced by the levels of professional fees paid to the auditor by the client. Chang and Hwang surveyed practitioners about how they would react to a reporting dilemma, while at the same time manipulating the degree of client business risk and client retention incentives. They operationalised retention incentives three ways; audit and APNAS fees, auditor competition (as a measure of dismissal threats), and individual partner career prospects being tied to client outcomes. Chang and Hwang found that when client risk is high, auditor judgments do not appear to be compromised by high retention incentives, but when client risk is low, it appears they might be. Unfortunately, individual components of retention risk were not themselves manipulated, so the results could just as well have been driven by either or both of the other components as by fee dependence.

Another 'angle' was investigated by O'Keefe, Simunic and Stein (1994). The positive association between audit fees and APNAS fees is only a threat to auditor independence if the extra fees charged for the audit work are not accompanied by extra audit effort. In other words, the impairment of independence might be observed if auditors exploited their existing fee relationship with the client by charging an audit fee premium over and above the level of audit work performed. Obtaining actual audit cost production data (audit hours by staff classification), O'Keefe, Simunic and Stein find no increase in audit effort (in any of the four staff categories) when APNAS is increased. They also find no premium for APNAS. In contrast, Hackenbrack and Knechel (1997) find some evidence of increased audit effort across audit activities (especially planning) and in labour mix (especially among partners and managers).

Johnstone and Bedard (2001) re-examine this issue in an initial engagement setting. They obtained proprietary data from one audit firm's initial engagement tender documents and analysed how planned audit effort and tender pricing varied with various levels of client business risk and the provision of APNAS. They report (p. 201):

> Our results also show that the firm plans more for clients purchasing additional services, and proposes a small but significant fee premium after controlling for the incremental effort. Supplementary analysis reveals no evidence that additional services clients have problems that might lead the firm to plan more effort or seek a higher fee. However, we do find more frequent use of industry experts, which may imply assignment of engagement personnel who can better integrate the multiple services provided. When we analyse the accepted bid group separately, no fee premium remains. This suggests that while the firm may try to charge a premium, the implied promise of cross-service

> synergy does not induce clients to pay a higher fee. In sum, the results of our analysis of accepted vs. rejected bids imply that fee premia charged for additional services are bid away in the market, while risk premia remain.

There is some experimental evidence that threats of formal sanctions (e.g., litigation risk and peer review risk) have a deterring influence on an auditor's propensity to suborn unbiased judgments about aggressive client reporting. In one study (Shafer, Morris & Ketchand 1999), while fees were not explicitly stated as the basis of the audit judgment dilemma, the case materials described the auditee as 'a valued client', and the potential to lose the client should the auditor not accept management's representations in the financial statements was clearly implied. Formal sanctions (with the exception of disciplinary action by professional bodies) were found to reduce the likelihood of auditors concurring with clients on the treatment in the financial statement of an aggressive asset valuation adjustment.[22]

Most research treats the engagement partner and audit firm as one. Promising research could be conducted into the intra-firm dynamics of partner and firm. For example, if engagement audit partners' remuneration and career prospects are tied in some way to the fees derived from their clients, and if audit partners have private information about the client that is not available to other partners in the audit firm (which seems likely to be the case), then engagement partners may have incentives to issue mendacious audit reports even in the absence of any contingent APNAS fees being offered by management.

Summary

This is an underdeveloped research area. We do not know very much at all from auditors themselves about whether they take into consideration the level of APNAS fees (current and/or proposed) when making judgments on (1) client acceptance and continuance, or (2) management's aggressive reporting practices. The little evidence that we do have is contradictory and inconclusive.

Conclusions

After reviewing the above literature, I summarise the conclusions as follows:

- There is evidence that financial statement users *perceive* that APNAS fees impair auditor independence. However, auditors do not necessarily hold the same view.
- There is mounting, robust evidence that the level of APNAS fees does not impair independence *in fact*, whether this is measured by audit tenure,

[22]The survey respondents were fairly mature AICPAs with auditing experience. Interestingly, they estimated that a majority of auditors would issue a clean audit opinion even if the amount of the misstatement was 40% of profits after tax. I doubt if auditors would now hold similar views in this post-Enron world.

propensity to issues-qualified audit opinions, the level of client earnings management, the degree of earnings conservatism, client *ex post* profit restatements, or *ex post* litigation against auditors.

- Evidence from auditors themselves about the impact that present and prospective levels of APNAS have on their day-to-day professional judgments is sparse and inconclusive.

While the accounting profession and regulators can take some comfort from the evidence about auditor independence *in fact*, the evidence about auditor independence *in appearance* is worrisome. It is of concern, too, because, for an efficient capital market to exist, it is just as important for the investing public to price the reliability of financial information into their transactions by a belief in auditor independence as it is for there to be independence in fact. It should be noted that this finding relates only to the level of APNAS fees – the nature of those APNAS services (that might compromise independence through the threat of self-review) are another matter altogether.

It appears that there is an 'expectation gap' between auditors and financial statement users as to the costs and benefits of APNAS. Recent company accounting scandals have probably exacerbated this gap. In addition to an education program such as the one mounted to address the audit expectation gap in Australia 15 years ago, one solution to this perception problem might be for the profession and/or regulators to establish some dollar-value limit to the level of APNAS fees above which auditor independence might be assumed to be compromised.

Any investigations that improve our knowledge about the following matters would be useful avenues for future research:

1. the effectiveness of different monitoring mechanisms (e.g., audit committees, audit firm reputation, auditor integrity and legal sanctions) in moderating the pejorative effect APNAS has on auditor independence
2. the internal mechanics of audit firms. In particular, the structure of audit partner remuneration packages and how these might influence incentives to breach independence, and whether this is exacerbated in the presence of APNAS
3. refining tests on stakeholder perceptions to determine limits to acceptable levels of APNAS
4. improving proxies for auditor independence in fact (e.g., actual data on the waiving of auditor-proposed year end adjustments, in the vein of Nelson, Elliott & Tarpley 2002)
5. increasing the period over which observations about auditor independence are collected. Australia and the United Kingdom have an immediate advantage here

6. identifying and investigating companies that have powerful characteristics and settings (as in Larcher & Richardson 2003).

The first three lend themselves well to an experimental and/or survey design, while the last three are best tested in an archival setting. Access to 'market-disciplined' data will remain a challenge.

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