AUDITOR INDEPENDENCE:

REGULATION AND MARKET COMPETITION ENHANCING TRANSPARENCY AND OBJECTIVITY IN INDEPENDENCE DECISIONS

by

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EXECUTIVE SUMMARY AND RECOMMENDATIONS

Financial reports provide value-relevant information on companies to equity, debt and other markets. Financial reports are the representations of the management of those companies. Audits of financial reports add value by providing a competent and independent attestation of the validity of these representations. This lowers the "information risk" for the users of this information. Audit firms operate in a highly competitive environment. There is significant evidence that they are active rivals in respect of audit pricing and competency for undertaking audits. There is little or no observable evidence that audit firms compete in respect of independence.

The issues that relate to audit independence are complex. One dimension of independence relates to the auditor's identification of the client. The client in many non-audit services engagements is company management. This is not the case with audit engagements, and some auditors mistake the person or persons who have the power to hire or fire the auditor (often company management) as being the client of the audit. The ultimate client of an audit is the stockholder or shareholder.

The second issue is that independence and threats to independence are frequently subtle and difficult to observe and measure. Hence controlling the decisions that relate to them cannot rely on crude definitions and imprecise measures. Formal legislative or regulatory processes for ensuring audit independence are unlikely to succeed in establishing the presence of a threat to independence other than when the threat is gross, extreme or easily measured.

The third issue is that independence is rarely tested with any degree of rigour. When it is tested, it is sometimes found to be lacking. Because independence is difficult to observe, the market tends to accept its existence as a matter of trust. When this trust is thought to be misplaced, the market can react in a swift and sometimes exaggerated way. Additionally, where the quality (both competence and independence) of an audit is tested (often in the circumstance of a corporate failure), auditors frequently have good defences

as to their competency but rarely do they have equally convincing defences for the objectivity of their decision making or the independence of their audit.

Threats to independence can include factors that are as easy to measure as the joint supply of audit and auditor provided non-audit services (APNAS). However, they may include circumstances that are more subtle, including the intertwining of several factors that in combination cause a threat to independence.

Research evidence based on real world market behavior shows conclusively that companies that have strong governance in the form of a significant proportion of external directors (i.e., clearly independent from company management) are rewarded with enhanced share price. That is to say, the capital market prefers companies where a separate group that is, at least partly, distinct from the executive of the company controls the ultimate policy decisions. It is argued that a process that parallels this corporate control mechanism would enhance the management of audit quality and, in particular, of auditor independence.

This report recognizes that enhancing auditor independence can involve a number of parties and makes recommendations as follows.

(1) The legislative and regulatory environment be adjusted to require that auditors of companies (in particular those that are traded on the stock exchange) have observable quality controls for independence.

(2) These controls involve the creation of a panel of expert persons who are not associated with the audit firm and who do not commercially benefit from any of the decisions made. This panel of experts is hereafter referred to as an "Independence Board".

(3) Each audit firm that has sufficient critical mass of audits of publicly traded companies be required to establish an Independence Board. This Board would be empowered with the authority to define, review and decide upon all threats and potential threats to independence. It would also have responsibility for the quality control and educational programs in respect of an audit firm's independence decision making. Each Independence Board would have accountability to the audit firm to which they relate, and, in terms of overall policy to the corporate regulator.

(4) The audit firms that do not have sufficient critical mass of audits but which nonetheless have some audits of publicly traded companies should have access to an Independence Board established under the auspices of a professional body of accountants. These Boards would, in general, operate as those described above.

(5) The content of audit opinions should be extended to include a description of the competencies of an auditor and the quality controls for independence. That is to

say, the ultimate client of the auditor should have observable information of both the competence and independence of the auditor.

(6) Each audit firm should be required to make publicly available, information in respect of its quality controls regarding independence threats. Specifically the persons appointed to the Independence Board and their credentials should be disclosed in some public forum (such as an audit firm's website). Where there is a resignation from an Independence Board, or a change in its membership that resignation or membership change and the reason for it should be disclosed publicly in a timely fashion.

The ultimate objectives of this model are to:

(1) enhance independence decisions within audit firms;

(2) make more transparent to the users of audit reports the characteristics and the audit process (both in terms or competence and independence), and

(3) remove independence decision-making from those who have a commercial or vested interest in the outcome of the independence decision;

The mechanics of the model require certain actions, specifically they are:

(1) the provision of a framework which recognizes that independence is as crucial to audit markets as competence; and

(2) the recognition (by capital market participants and boards of directors in particular) that the market for audit services will benefit from competition between audit firms in respect of independence as much as competence and price.

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1.0 INTRODUCTION

Over many decades the corporate community and regulators in many jurisdictions are seen to react forcefully after high profile company failures occur. Where these company failures are linked also to real or perceived audit failure, corporate regulators, politicians, the community and the accounting profession react frequently as well, suggesting and even demanding change in and over the audit profession. Some of the implemented changes over time have enhanced the quality of auditing but we continue to see unsignalled corporate failures occurring, prompting an ongoing perception that the audit process is not capable of delivering a product that is of value to the market. In past years this perception of lack of capability surrounding the audit product has been described as an "expectations gap", which arises in part because what is expected by participants in the market is not realistic. However, there remain instances where people who have a clear understanding of audit processes and realistic expectations of outcomes from an audit raise concerns about the quality of auditing. That is to say, there is not just an "expectations" problem but a real or rationally perceived problem with outcomes from audits. This perception is exemplified in the USA by the collapse of ENRON in late 2001 and in Australia by the failure of HIH Insurance early in 2001.

1.1 The Audit

An audit is a service provided by professional accountants. The demand for this service is, in many instances, compulsory due to legislative or other regulatory requirement, but sometimes it is voluntary and is the choice of either management or others (including stock or debt holders). Financial reports of a company are the representations of the

management and directors of that company. An audit is an attestation of these representations by management and assesses the truth and fairness (or in the minds of some, validity) 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 of those reports.

For the attestation to be of worth it must have two crucial requirements. First, the attestation needs to be competent. That is to say, it needs to be undertaken by experts in the field of auditing (this expertise may extend beyond auditing to industry specific, asset/liability or transaction expertise) and may involve the necessity of having competent audit technologies and processes to undertake the audit. Secondly, for an audit to be valuable it must be undertaken independent of management. That is to say the judgement exercised by the auditor needs to test the assertions made by management and not simply concur with them.

1.2 The Value Adding Capacities of Audit

Consider the following simplistic and hypothetical example that illustrates why audits have the potential to be highly valuable. Company A and Company B are two entities that operate in the same industry. They have the same risk profile, the same cash flow characteristics and assets and liabilities. For all intents and purposes they are economically identical with the same outlooks, the same competencies and qualities of management. In this simplistic example, a competent, independent auditor audits Company A. Company B is not audited. The question is, if both these companies were traded on a stock exchange, which company would have the higher stock price? The answer is Company A. This answer is unconditional. Company A has a higher share price because the information conveyed to the market has lower "information risk".

Remember that the financial reports produced (and used by stock markets and many other participants in a market economy) are simply assertions by management. These assertions are guided by Accounting Standards, Generally Accepted Accounting

Principles and by conventional business practices. They are also guided by the integrity and quality of company management and of the board of directors. However, the checks and balances that produce these financial reports do not extend to a critical professional independent review of these documents in the absence of audit. Such a review ought be undertaken by persons who are, (1) expert in the field and, (2) able to thoroughly investigate the company with a right of access unparalleled by anyone other than those who are internal to the management of the company. Only where this 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. Audits do, therefore, add value to a company and have the potential to affect stock price.

Extending the example to that of two identical companies: one company has an audit provided by an audit firm that has a reputation for high quality auditing and the other is audited by one that has a reputation for providing an adequate audit. The stock price difference between these two companies would not be as large as that existing for companies with a competent, independent audit and 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 at 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 and Taylor, 1995).

There is one further point to conclude from this example and that is despite the high level of regulation in many jurisdictions, the audit product is not homogenous in quality. We observe differences in the quality and indeed if one examines both the literature and the web sites of many accounting firms, one will see them competing strongly on the basis of quality differences in the audit in respect of audit competency. Many accounting firms claim industry specific expertise or other types of competency that quality differentiate them from other suppliers.[1]

2.0 TWO PILLARS OF AUDITING: COMPETENCE AND INDEPENDENCE

As argued above, the value of an audit comes about only if two quality components are present, competence and independence. An audit that is competently undertaken but not independent of management amounts to an audited financial report, which is nothing more than the mere representations of management. In this case the audit does not lower information risk and is not valued by the market for information, be it debt, equity or other markets which rely on financial information.

Where the audit is independent of management but not competent, then the attestation of the financial report is flawed due to the lack of competence. As such it still does not lower information risk and hence the assertions of management remain the substantive information to the market. The audit does not lower information risk in either case where it is independent of management but not competent or where it is competent but not independent of management. 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.

2.1 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 and Francis, 1999). That is to say it is a "good" that cannot be "test driven" or about which some clear observable evidence

cannot be gained until it is actually experienced. This makes auditor choice and indeed the decision about the acceptable price of the audit more difficult than in many other markets for goods.

Put another way, the qualities of an audit have to be experienced to be understood. Even after it has been experienced, it is not easy to observe all the qualities of an audit and indeed only those most intimately involved with the auditor may be able to observe key characteristics of the quality of an audit.

Those intimately involved with the audit (e.g. those involved in the finance function or with the audit committee of an auditee may each have some opportunity to observe the characteristics of an audit) will have some opportunities to observe aspects of competence. However, even in these circumstances it is possible that those closely involved with the audit may not be able 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. There is a presumption by auditees and those interested in the audit process that independence exists, but its existence is taken on trust rather than having any substantive underlying evidence for belief in it. If this trust disappears or is eroded in any way, the outcome is likely to involve scepticism and, as a consequence, the outcome in terms of depleted value attributed to audit will be more exaggerated than would otherwise be the case.

2.2 Competing on Competency

As can be observed in the brochures of many accounting firms, from their web sites and particularly in their tender documents, the audit firms compete vigourously in respect of competency. We observe that certain firms have specifically expert partners or that they have enhanced experience and competency in respect of a particular industry class or classes. They also compete on different types of audit technology, different data bases of industry or general economic information, particular information system flows or

research capability. They can also compete on access to world class expertise in other parts of the organization and the like. There is no doubt that the audit firms compete vigourously in respect of competency. This competition has led undoubtedly to the development of greater expertise and experience which adds to the production of higher audit quality. There is also no doubt that audit technologies have evolved and become better focused on higher risk issues within auditees. These are the benefits of a competitive process within the market for auditor services.

2.3 Competing on Independence

One of the difficulties is that although audit firms disclose information about firm-wide competency, there little or no observable information on the processes and outcomes in respect of independence. Auditors are exposed to potential threats to independence many times during and even before acceptance of audit engagements. These threats to independence find their way into an audit process 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, threats issued by an auditee to terminate an audit engagement or put out for tender an auditor 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 only occur 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. Indeed, it is also possible that auditees are not conscious of it. There are a significant number of such potential threats. Possibilities of these subtle threats include a 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

fees earned from each auditee may not represent a threat by itself; when linked together, they do potentially pose a significance fee dependence threat in combination.

The presence of degree of subtly can not be over-emphasised. It can also mean that possible threats may not become actual ones. For example, even the joint supply of audit and APNAS is not *necessarily* a threat to independence but rather it is how that arrangement is used in the relationship between auditor and auditee that converts the potential to an actual compromise of the independence of the auditor. Creating observability and measurement of this actual threat is a major challenge.

2.4 Testing Auditor Competence and Independence

It is often said that audits are usually successful and auditors, in general, perform their function in a professional and diligent manner. It is my 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 my 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[2]. In the circumstances of corporate failure there are incentives for persons outside the organization to rigourously 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 that an auditor is (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 judgement 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.[3]

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 judgement 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 my 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 that can be identified to assert that judgements and decisions reached were made independent of auditee management. On the whole, judgements in respect of independence are entirely in-house[4]. Perhaps more disturbing is that: (1) recognition of threats to independence; (2) determination of alternative courses of action; and (3) final judgement relating to decisions involving independence, are routinely made by those persons within the audit firm who (directly or indirectly) have some commercial interest in the outcome of the decision.

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.

3.0 LEGISLATING OR REGULATING FOR AUDITOR COMPETENCE AND INDEPENDENCE

There are those who argue that the best way of going forward in relation to audit quality is to enhance the legislation and/or regulation of the market for audit services (e.g.

Ramsay Report, 2001). There is some merit in this argument. With regard to competency issues, there is merit in ensuring that there is a floor or base below which no individual may practise as company auditor. Generally, this is the model used in much of the developed world. The means by which these competencies are assessed varies between jurisdictions but usually it operates to ensure that those who have inadequate expertise and/or inappropriate experience are precluded from entering the supply side of this market.

Such legislation and/or regulation is effective in ensuring that there is a minimum standard applied to those who seek to supply this market. However, there is no legislation or regulation that precludes competency quality differences above this minimum. Eliminating the variations in the quality of competencies would be economically inefficient and anticompetitive. What we observe in most marketplaces are incentives to enhance the competency above that minimum. In some cases the competencies observed are at very high levels. Competency enhancements include (1) hiring and rewarding of particularly expert people, (2) development of technologies that enhance the audit process, (3) establishment of data sets that facilitate benchmarking, and (4) the use of global networks of research information, to mention but a few.

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 regulatory mandated base proficiencies.

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

3.1 Regulating Independence: Effectiveness – Timeliness

If there is to be regulation or legislation in respect of matters of independence or threats to independence, I predict that there will be significant costs and problems with inefficiencies.[5] I 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, independence requires contemporary decision making that is *ex ante* rather than *ex post*. The avoidance of independence threats is better than dealing with compromised independence in place (refer, for instance, International Federation of Accountants, Section 8, "Independence"). A 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 very subtle threats, which are not easily measured and therefore not susceptible to an effective legalistic or regulatory intervention.

If there is some outside board or tribunal external from the day to day operations of the audit that deals with independence threats, it is my belief that such a board would learn of independence threats only after the fact and then only where there has been a damaging outcome and the facts of the case are publicly, or at least semi-publicly, revealed. This does not aid the efficiency of the market nor build value for either auditee or auditor. It also does not enhance the value to stockholders and those that hold the debt of a particular auditee.

3.2 Regulating Independence: Effectiveness – Defining the Threat

As noted above, many independence threats are hard to identify and observe. From the example of joint supply of audit and NAS (below in Section 4.0), under what conditions does the joint supply become an independence threat? If by regulation or law a threat to independence is defined as existing when APNAS fees are, say, 50 percent of audit fees, then it is possible, even likely, one will observe many cases where joint supply will occur at levels of 49.9 percent. Such a situation will be legal but is it not a threat to independence? 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 little or no better off than the current situation in which no restriction is imposed externally.

3.3 Regulating Independence: Efficiency

As previously noted, independence is subtle, difficult to observe and often hard to measure. Thus, it can be difficult to efficiently regulate the presence of independence. Even if it can be effectively regulated, deciding on the threat, its measurement etc. can cause economic inefficiencies.

This is illustrated within the case of the joint supply of audit and non-audit services in Section 4.0.

3.4 Regulating Independence: Completeness

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 ago the joint supply of audit and non-audit services was not an independence threat but it is now. If legislation in respect of auditor independence had been put in place at that time the joint supply threat would most likely have not been identified as an independence threat. Thus that legislation would now be seen as incomplete.

Also, as many threats are not identified or easily measured, the likelihood of legislation 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 section that follows (Section 4.0) is a discussion of one of the current issues under debate (the joint supply of audit and APNAS). This issue is used to illustrate some of the costs of regulation and/or legislation and some of its benefits.

4.0 THE CASE OF JOINT SUPPLY OF AUDIT AND NON-AUDIT SERVICES

Over recent times we have seen a flood of reports and commentaries in respect of the ENRON crash and the subsequent heated debate on audit quality and in particular, auditor independence. As noted in the *Australian Financial Review* (6 February 2002), the current debate focuses in large part on joint supply of audit and auditor provided non-audit services (APNAS).

4.1 The Joint Supply of Audit and Other Services

Audit firms supply audit services. They also supply other consulting services, which can generally be described as non-audit services (NAS). The provision of NAS to clients that are not also audit clients is not seen as an issue in audit quality. The concerns arise with the joint supply of audit and *auditor provided* non-audit services (APNAS).

One possible legislative or regulatory outcome from the current debate is the banning of the joint supply of audit and APNAS. On balance it may be decided that in the interest of the public good, the preclusion of this joint supply is a necessary outcome and would help limit one of the important threats to independence. This may be so but this should be a decision taken only after considering both the costs and benefits of such an action. The costs include not only economic costs to the auditee but also inefficiencies in the market for audit services.

The joint supply of audit and APNAS brings with it certain benefits. These benefits can be seen at both a theoretical and practical level. From a theoretical perspective, joint supply is said to produce efficiencies for the auditee. This can be argued since a service provider that understands well the operations of the company via its appointment as an auditor can also efficiently and effectively deal with other non-audit issues without a significant lead time spent getting to know the organization, its people and its processes. The research literature refers to this synergy as "knowledge spillover" (e.g. Beck, Freck and Solomon, 1988). Because of the knowledge gained in the audit, consulting activities

can be undertaken quickly and efficiently. The threat to independence however is potentially considerable. The threat lies not only in the heightened fee dependence of the auditor, but also in the fact that the auditor may learn something about the organization from the consulting activity which should feed back into the audit process. However, there may be reluctance to do so since it may highlight deficiencies in the auditor which could pose a threat to the integrity and independence of the audit. To counter this threat to independence, it is common for auditors to appoint different persons to undertake consulting activities as opposed to audit work. Where there is a separation of duties in this way, it in fact undermines the efficiency of joint supply since the knowledge spillover is systematically removed by the use of what is referred to in the auditing profession as "Chinese walls".

On a more pragmatic level, the management of the auditee frequently seeks to use the auditor as the consultant of first choice because of favourable interpersonal relationships built up between management and auditor. This preference for the use of a particular audit firm may be due to the firm's familiarity with the client and also because management values the firm's pre-existing knowledge of operations since this generates shorter engagement times and therefore lowers costs.

Consequently, for both theoretical and practical reasons, an auditor might be seen as the preferred supplier of consulting services. The cost to the auditee (and perhaps the auditor), however, is potentially substantial. If an auditor is, or is seen to be, non-independent then the value of the audit is reduced or negated. The cost of not having an independent audit is not borne by the management of the auditee directly but by the stockholders and others that directly use the audit opinion to add a level of integrity to the representations of management in the financial report. Indirectly the management may suffer because the market may regard the financial information produced as encompassing high information risk and consequently share prices will be traded down and the premium for risk will rise in debt markets and the like. Given that there are instances where joint supply does not pose an independence threat (so therefore there is no cost to joint supply) and there are efficiencies in knowledge spillover or in lead time,

the preclusion of joint supply may represent a cost to the economy and not a benefit. Alternatively, if joint supply represents, on average, a threat to independence and there are no knowledge spillovers or other efficiencies in the joint supply, the banning of joint supply would provide a net benefit to the economy.

Legislators and those who regulate the market for audit services will need to make a balanced decision. The balance is between the potential efficiencies of permitting joint supply and the potential costs in independence or threats to independence (real or perceived). Legislative or regulatory prohibition of joint supply would of course not be a resolution that would give rise to decisions on a case-by-case basis. Hence, there would be certain circumstances where the preclusion of joint supply would be an inefficiency and a cost to the economy, and other occasions where it would be the optimal result and positive for the economy.

The point here is that a legislative decision covers all circumstances and is not case specific, so some instances will occur where the legislative route is economically inefficient. It is therefore reasonable to say that legislative or regulatory decision making in this area is crude and may hold potential inefficiencies in some cases. However, the issues surrounding joint supply of audit and APNAS are even more complex than has been canvassed so far.

One further cost inefficiency that exists with the joint supply of audit and APNAS, at least in theory, is that if an auditor senses the auditee chooses the auditor as NAS supplier because of an audit context association, an auditor has a monopoly position and can price accordingly.

The extent of joint supply will vary between auditees because of the existence of differential incentives in each individual case (Parkash and Venable, 1993). For example, it has been demonstrated that those organizations which operate in highly sensitive industries (e.g. the mining industry which has significant taxation concessions) may well have much lower levels of APNAS so as to not draw attention to questions of

the quality of both governance and the financial information provided by them. In addition, some auditees that have many stakeholders or are sensitive to issues of the integrity of the financial information (e.g. deposit-taking institutions in the finance industry) may also choose to have very low levels of APNAS compared to the audit fee. These actions are economically rational as companies in these situations seek to have and be seen to have highly independent auditors. So it is natural that there will be variation between individual auditees and auditees within a particular industry, reflecting their different economic and commercial circumstances.

4.2 Potential Economy Effects of the Preclusion of Joint Supply of Audit & APNAS

Prohibiting the joint supply of audit and APNAS can have three potential substantial commercially adverse consequences. The first of these possible consequences is that should joint supply be banned, accounting firms may choose to withdraw from the market for audit services and allow others who have reputations for lower quality audits to become the only suppliers in the market. If this were to occur the immediate effect would be, on average, to lower the quality of audits as the enhanced expertise and audit technologies would no longer be available. In the longer term, one would expect market equilibrium to return and premium suppliers, whether from the original smaller group of such organizations or from a new group of niche audit suppliers, to emerge. However, if there were a demand for a premium audit product, one would expect that there would be market response that would ensure the supply of it. Nevertheless, in the shorter term there may be an absence of premium suppliers, which would cause substantial economic and commercial cost. Therefore, if the banning of joint supply were to happen, this would need to be managed very carefully over a period of several years.

An additional cost of the banning of joint supply may relate to the availability of expertise. Imagine if an audit firm had as its client a major insurance organization. A substantial part of the audit involves having expertise that is of an actuarial nature. Let us assume that for the purpose of the audit, the audit firm must use these actuarial services for a period of 1,500 hours or approximately three-quarters of a one-person year. If that expertise resides within the accounting firm then some other productive activity must be

found for the actuarial expertise for the other one-quarter person year. If this expertise could not be available to be a consultant or adviser to audit clients, it may effectively mean the expertise moves to some other area of the insurance industry and is not available to the audit firm. Put another way, if actuarial expertise exists within the accounting firm and if one bans joint supply, then that actuarial expertise is potentially available only to a smaller (non-audit client) proportion of the insurance company market. Put even more simply, if an actuary works for an audit firm and that firm is successful in the market for auditing insurance companies and holds 50% of the market, then that actuary will have only limited consulting opportunities in the insurance market – the 50% that are not audit clients. This constraint may be so limiting as to result in the actuary leaving the audit firm – thus his or her expertise is lost to the audit process. Alternatively, it may mean that the actuarial expertise is not used optimally for a portion of the year, resulting in higher charge-out rates if the expertise is retained within the audit firm.

If the actuarial expertise is not in-house but outsourced from consulting actuarial firms, then there is the possibility that a major insurer may in fact have contracts with all available consulting actuarial firms. If this were to occur a conflict of interest position between any consulting actuarial firm and the audit firm would arise. Again appropriate expertise may not be available to conduct the audit.

5.0 AUDIT REPORT COMMUNICATIONS

While underlying expertise and audit technology is subject to considerable competition between the audit firms, the actual output of an audit that is observable by the market (as opposed to internal communications with management and/or the board of directors of a company) is generally highly standardised. The formal audit opinion issued to the markets is usually limited to a small number of homogenous and standardised sets of wordings. Preliminary research suggests that the strength or “potency” of qualified opinions is high and received with interest by the markets while the potency of

unqualified or clean opinions is not seen as particularly substantive. Put another way, clean audit opinions bring little new information to the market.

There has been much debate about the wording of audit opinions and during the past several years some changes in the wording in some jurisdictions has occurred. Generally audit reports are homogenised and fall into one of a small number of categories but are uninformative in respect of many of the processes and underlying judgements and decisions that go towards the final product. They are completely devoid of any representations of either the competency or independence of the auditor; the two pillars upon which auditing is based. By and large, they generally describe the processes and framework within which the audit is conducted.

Given that auditing is based on competency and independence, I recommend that the audit opinion should not be silent on what are the competencies and level of independence of an auditor. It is recognised that auditors vary in both competency and independence (given a minimum floor level). Therefore, those who seek to rely on the audit output (the opinion), should be provided with a visible sign of these attributes so that if and when necessary, the auditor can be seen to be accountable for those qualities (competency and independence).

In the absence of detailed information about the competencies and independence of the auditor, audit markets are forced to rely on a generalised market reputation of the auditor. This provides advantages for those auditors already possessing market reputations. The difficulty is that the market is not fully and **contemporaneously** informed about changes to the reputation of an auditor or an audit firm or of the fact that this average reputation does not apply to each and every audit case. Different audit partners and audit offices etc., even within the same firm, give rise to differences in the competency or independence of a particular audit. Given that audit firms compete for audit contracts, the representations made *ex ante* to win a specific audit contract should be made available to the public *ex post.* This will mean that the auditor can be held accountable for the

delivery or non-delivery of these competencies and independence protections to those who rely on the audit opinion in each case.

5.1 Disclosures made by the Auditor

At present the audit opinion discusses the scope of the audit examination and the conclusions reached in respect of that audit. Where the audit opinion is unqualified (and is without an emphasis of matter) the descriptions contained in the audit opinion are typically a small number of paragraphs comprising less than a page of discussion. Where there is some form of qualification or emphasis of matter, somewhat more detail is contained and in some circumstances readers are referred to other parts of the financial report. This description does not, however, raise any of the detail in respect of the competency or independence of the auditor, the two pillars upon which auditing is based. A further component to the conventional audit opinion (or an attachment to the opinion) should specify details of the competency and independence of the auditors to undertake a particular audit. More specifically such a disclosure could cover: (1) the quality control procedures used to ensure independence from the management of the auditee, and (2) an indication of any threats to independence that have occurred in respect of the audit. In this way the reader would be informed of any threats to independence and, one would expect, the means by which these threats were dealt with. It might be argued these disclosures would become "motherhood" statements that differ little between firms. However, the provision of a "benchmark" statement to which auditors could be held accountable would, it is argued, create an incentive for adherence and even competition in striving for workable but commercially viable solutions to minimising or dealing with independence threats.

Care ought to be exercised in respect of these disclosure requirements such that commercial in-confidence material is not divulged unnecessarily or in a way that is damaging to the auditee or its stockholders. However, this is unlikely to be the case if the quality control procedures described in the first point are effective. In addition, it may be useful for the readers of financial reports to understand the procedures by which the auditor was appointed to the task and for how long both the audit firm and the

engagement partner (and review partner if one exists) have been in place within the audit. For example, if the appointment of the auditor were by way of full tender where both the qualities and cost of the audit were considered, this would be added information assisting the reader of the financial report to understand the quality of the auditor. If, however, the auditor were to be appointed by way of personal recommendation from a member of the management or the board of directors, then this would also be useful information to readers. Perhaps on each occasion an auditor is appointed or reappointed, the criteria used for the appointment could also be disclosed in the annual report, possibly as part of the director's report or perhaps as an attachment to the audit report. This disclosure is envisaged to be primarily the responsibility of the audit firm but it needs to be reviewed for consistency by the audit committee and/or the board of directors of the auditee. Several of the foregoing suggestions provide ideas for a model of auditor independence.

6.0 A MODEL FOR CONTROLLING AUDITOR INDEPENDENCE: A BALANCE OF REGULATION AND MARKET COMPETITION

Typically in advanced economies one observes boards of directors that have policy control of auditees. Conventionally these boards comprise both "internal" directors (those holding various executive positions within the auditee) and "external" or independent directors (often made up of former CEOs from other organizations, external lawyers, others expert in the industry or in related industries, even former audit partners and the like). Some of these individuals are truly independent directors, others have been described as "grey" (that is to say they are somewhere between being part of management or have commercial dealings with the company and those who are truly independent of the management of the organization). Capital market research has shown that companies with strong corporate governance in the form of a significant proportion of their boards comprising truly independent directors have been rewarded in the form of increased share price. That is to say, the market for information (including the capital market) rewards organizations that have good quality control processes that are independent of the internal management of the organization.

My primary recommendation for auditor independence decision making is that each of the larger audit firms (i.e. those that have sufficient critical mass in auditing within any particular jurisdiction) establish an auditor Independence Board within the partnership. Such a Board should not consist of just one individual but should comprise a minimum of three persons and preferably an effective maximum number of either five or seven . Such a Board should consist of individuals not drawn from current or former partners nor other employees of the organization or similar organizations but should be experts in one or other of several fields (auditing, commercial law, professional services, accounting or auditing standard setting andaccounting policy making). This Board in whole or part (where part would comprise at least three members) would for every audit consider each threat to independence that exists within the organization in a contemporaneous and confidential fashion. The outcomes of their deliberations would be a decision either to proceed or not with an audit engagement or to put in place certain controls and procedures that would ensure an adequate level of independence is attained for each audit engagement.

It would be important that this audit firm Independence Board be chaired by a person who is both expert in the area of auditing and independent of the day-to-day operations of the organization. It is also important that each member of the Board not benefit commercially, either directly or indirectly, from any single decision made in respect of independence. Put bluntly, independence decisions should be removed from those who may benefit commercially from those decisions i.e. the partners of the audit practice. The Board would have in effect power of veto over independence issues and ultimate control of acceptance and retention of audit engagements.

The reasons why an Independence Board with internal access to an audit firm would be more effective than an arrangement imposed externally are as follows:

1. Independence issues, threats and potential threats can be dealt with swiftly and contemporaneously with the audit. A decision *ex ante* in any critical matter can be made and enforced by the Board.

2. The Board can deal with commercially sensitive issues without those issues becoming public or accessible by competitors.

3. The quality control processes of the board can be observed by the market which gives rise to the possibility that accounting firms would 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. Reward structures within audit firms could take account of decisions made by the board in achieving equity across partners responsible for practice growth.

Such a Board would be different from an externally imposed board where I suspect only extreme, crude or easily measured independence issues would come before it and then probably only *ex post* after some crisis has occurred or independence had been compromised. The existence of such a Board can (and should in the minds of many) be supported, protected and monitored by the appropriate corporate regulatory agency.

6.1 Firms Without the Critical Mass to Establish an Independence Board

There will be instances, possibly many cases, where smaller audit firms will not have sufficient critical mass to establish an Independence Board comprising at least three expert external persons. It is also possible that the number of expert persons available in the market, at least in the short term, would be limited and that organizations would not be able to compete for the appropriate quality people to establish such Boards internally. Either because of the paucity of expert persons or because of the absence of critical mass, it is necessary to put in place an alternative procedure for these audit firms.

It is suggested that the professional accounting bodies could sponsor the establishment of a Board or Boards, which such auditing firms could utilise. In substance, these Boards would act as internal Boards. The facts of any case would remain entirely confidential and the Boards would act swiftly and contemporaneously to deal with any potential threat to independence when it appears. It is important there is no suggestion of a substantial commercial cost being incurred by declaring a threat to independence and that in fact there is a positive outcome from it. There is, however, an issue that such Boards may be inundated by requests to adjudicate. Remembering that these Boards (created by the professional body) are unlikely to have a detailed knowledge of the firms they are dealing with, their knowledge of the people, structures and control procedures will also be more limited. This means that these Independence Boards need to operate with considerable care if they are to be effective. The details of the issues involved here are outside the scope of the current document but are the topic of further inquiry by the present writer.

6.2 Assuring Those Sceptical of Auditor Independence

One of the advantages of boards of directors within corporations is that they change the incentives of internal management to be more considerate of stakeholders. Having an Independence Board within an audit firm divorced from short-term revenue gathering activities and focused on the longer term survival of the firm and the profession may achieve a similar level of consciousness of all stakeholders to the audit process. If audit firms compete in respect of the quality control of their independence, then they will focus on long-term gains to their firm and the profession and ultimately the auditees and their stockholders, rather than short-term revenue gains for the audit firm from a particular audit or non-audit engagement.

Even those sceptical of the auditing profession would at least be partially satisfied with the incentives shift from the short-term to the long-term.

6.3 The Independence Boards: Some Mechanisms

As indicated above, each of the professional bodies in different jurisdictions together with each of the major firms that have sufficient critical mass, should establish

Independence Boards. These Boards should be able to deal with contemporaneous threats or perceived threats to independence in a highly confidential yet timely fashion. Their decisions should be seen as authoritative and conclusive. Rewards to this Board should not be linked to the profitability of the firm and indeed structures may well be set up to ensure that there is some distance between the audit firm and the payment of the fixed fee income to the members. One option is that each of the accounting firms set up a trust fund with an appropriate amount of capital and Board members are remunerated from interest or other revenue generated within that trust fund. As indicated earlier, there should be a panel of not less than three persons to remove any possibility of individual bias. Decisions should be made by a simple majority vote. In the case of a three-member panel, it would be two persons. Importantly, the names and qualifications of those persons who become members of the Board should be made publicly available. For example, each of the firms should publish the names and credentials of its members on their web site and information about those members should be available for each audit tender and audit engagement. Where a member of the panel is appointed, any previous associations with that firm or other firms should be disclosed. Where an audit Independence Board member resigns or the term is not renewed and a change in personnel takes place, the reason for that resignation or non-renewal should also be made public. Audit Independence Board members should sit for a maximum of (say) five years in any one firm and that period should be rotated such that no more than one-third of a panel retires in any one year. This ensures ongoing understanding of the processes and allows a sense of "corporate history" in decision making. Persons should not be permitted to move from one Board to another for some stipulated time to ensure commercial confidentiality of the prior audit firm is not breached. In addition considerable care will need to be given to understanding the legal liability of these Board members. In particular the extent to which they can and will be held liable for subsequent evidence of absence of independent judgements within the audit firm.

6.4 Long Term Sustainability of the Model

One of the advantages of a model such as this, which relies on the internal dynamics within the market for audit services rather than a regulated or legislated means of

proceeding forward, is that this market-based model is self-adjusting as time passes. For example, if a new independence threat occurs it could be observed within the market place and dealt with contemporaneously as it develops. For an example of this one need only look at the history of the joint supply of audit and APNAS. We can do this, as Australia is one of the few jurisdictions in the world where audit and APNAS fees have been disclosed for many years. In Australia, the total level of APNAS for the top 1,000 listed companies was a little over 100 million Australian dollars in 1990. By the end of that decade it had more than doubled. This is in the face of audit fees changing almost not at all over the same period (Houghton and Ikin, 2002). Therefore, the apparent threat of the joint supply of audit and APNAS, which was perhaps marginal in 1990, becomes a significant issue by the end of the 1990s. Threats to independence vary as markets change. A market-based model could respond to these changes as quickly as the market itself changes whereas legislated requirements are slow to change and tend to be subject to vested interest lobbying.

6.5 The Effect of Independence Boards on the Audit Process

The creation of an Independence Board is a necessary but not sufficient condition for the effective quality control of independence in an audit process. The Board needs to infiltrate and subsume all the processes in the audit firm and to affect the culture and ethos of the audit processes. The culture needs to be affected by the Independence Board and ensure that threats are identified, considered and dealt with. Perhaps more effectively, 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.

6.6 Existing Incentive Structures Within Accounting Firms Require Change

Evidence exists that one or more of the larger accounting firms (and possibly others) have in place (or have recently had in place) incentive structures which result in those involved in the audit benefiting from referrals from an audit client purchasing consulting activities from the accounting firm. On some occasions this consulting work was undertaken within a separate division of the accounting firm and in some cases it may have been

undertaken within the audit division of the firm. Irrespective of where the work is performed, the use of an audit engagement to generate fee revenue for non-audit work, particularly if audit personnel remuneration is influenced by this work, immediately gives rise to a potential threat to the independence of the audit process. This is a situation not adequately recognised as a threat in the recent IFAC Section 8 “Independence” revision nor in the re-exposure of Statement F1 by the accounting bodies.

Put bluntly, use of the audit process to lever additional revenue is seen by some as a potentially questionable practice and throws open substantial questions with regard to the integrity and independence of the audit. There is a fine line, however, between using the audit process to generate revenue and identify issues that the client may then choose to deal with by outsourcing consultancy. At the very least, however, Independence Boards set up within firms would need to review the incentive structures within each of the firms and make decisions as to whether these incentive structures require adjustment to remove any possibility of perceived threats to independence in the audit process.

6.7 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 avoided. 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.

It is recommended that an education program be set up which includes not only the principles underlying ethical dilemmas relating to auditor independence, but also practical case studies drawn from real world experiences (but made anonymous to protect

real world parties) and practice in applying ethical reasoning models. Such an education process may be compulsory in respect of those holding practicing certificates of either The Institute of Chartered Accountants or CPA Australia. Although such cases are now included in current CA and CPA programs, many existing professional accountants have not had the benefit of exposure to such case-based training materials.

Such cases could include examples of particularly assertive behavior by management of auditees, personal association between auditees and auditors, and the like. There needs to be a shift in culture where recognition of the long term benefits of independence are foremost in the minds of those involved rather than short-term fee or revenue targets being the dominant or even significant focus.

For example, I have been told on several occasions by a number of partners from several different audit firms that an important part of the audit engagement is the "recognition of the client". One distinguished senior partner of one of the major audit firms described to me a case where "knowing the client" was important to his engagement. In the case described to me, the auditee originally had a highly dispersed stockholder base. Change occurred and a significant block of shares was taken up by a single corporate entity (not a client of the audit firm). That partner then recognised that the "client" was not just the executive of the auditee company, but in fact that significant corporate shareholder.

This is an example of where the auditor has mistaken the "client" for the person(s) who holds the power to remove the incumbent auditor and replace that firm with another. This might be thought of as the "auditor eject button". The person who holds his or her hand over the "auditor eject button" is not necessarily the client. Certainly that person has the power to continue or terminate the audit engagement, and that is an important commercial consideration for the auditor, but the person is frequently not the client. If one goes to the roots of auditing, the client is the stockholders or shareholders of the company. There are other important stakeholders – the executive management of the auditee, major and minor debtors, employees and others, including but certainly not limited to the person or persons who could dominate or significantly influence the auditor

choice decision. This confusion between those that in a practical or logistical sense make the auditor choice decision and those that are the client is to my mind, endemic in the auditing profession. This confusion may be an underlying cause of the issues now confronting the auditing profession. It is my belief this issue is not, in the vast majority of instances, a conscious confusion of the identification of the underlying client, rather it is an unconscious one. For many years the culture of the audit firms has changed and moved away from its roots (of being an audit firm) to becoming a full-service business consultant practice. An unforseen effect of this is a change in the culture on independence. The trend to providing assurance on subject matters other than financial reports (e.g. corporate governance statements, internal controls etc) is likely to exacerbate this trend.

7.0 THE ROLES FOR VARIOUS STAKEHOLDERS

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

7.1 The Role of Regulators and Legislatures

While the basis of the model is that auditor independence is essential an economic problem, it is clear from current evidence that existing largely free-market approach in many jurisdictions in the world has resulted in less that optimal outcomes. These have had significant negative economic and social effects. While the proposed model relies on competitive market processes, it is crucial that the appropriate strong legislative and regulatory framework exist. Without this framework it seems likely that the model would potentially revert to the style of market presently in place. The essential framework requires as a minimum the existence of compulsion for all auditors of listed (publicly traded) corporations to access an Independence Board. This might also be extended to other companies as well. That is to say, one further component for qualifying to undertake company audits is the ability to access a recognized and regulator registered Independence Board. This compulsion is a parrell to the requirement on the part of the

audited corporation in many jurisdictions to establish an audit committee of the board of directors of a company.

The second regulatory or legislative requirement is a form of approval for and/or registration of Independence Boards. Ideally such Boards should be registered with a corporate regulator and should possess certain minimum standards in respect of membership, procedures and authority. Ensuring that the decisions of the Board are enforceable and enforced is part of this framework.

7.2 The Role of the Audit Firms

Each of the large audit firms that have a critical mass of audit clients would establish Independence Boards. The guidelines under which these Boards are established, the credentials of their members, the mechanism by which determinations are arrived at, and the means by which an appropriate culture is created within the firm are all necessary components of the proposed model. They are still subject to substantial further detailed discussion. However, the general principles outlined above need to be embedded within these newly created Boards.

In addition to the creation of Independence Boards, firms need to make transparent the processes of these Boards, their membership and quality control procedures. There are many ways in which this information can be disseminated to the market. Firms need to be competitive in respect of the independence control processes, and not just competitive in respect of competence and price.

7.3 The Professional Bodies

In each jurisdiction in many parts of the world there are one or more professional bodies representing the interests of the accounting profession. It is recommended that within each jurisdiction, at least one of these professional associations establish an Independence Board. This Board would act as an adjudicator in respect of independence decisions for smaller audit firms that do not have the necessary critical mass to establish their own internal Boards. Again, the professional body or bodies would need to

carefully consider the guidelines of the establishment of these Boards, the membership and credentials of the members, the mechanisms by which determinations are made, the means by which information is obtained and the means by which those in the profession access this style of Independence Board. Of particular concern in respect of these Boards is the need to ensure confidentiality of information provided to the Board, and sensitivities of both auditor and auditees.

7.4 The Auditees

The proposed model does not call for auditees to establish their own quality control procedures in respect of independence of their auditor. However it is inevitable with new disclosures and new information available to auditees that 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 an assessment (ongoing in nature) of the independence of the auditor. Additionally, especially if suggestions such as those presented here are not universally accepted, audit committees should evaluate as far as possible the procedures in place within the audit firm to make independence related decisions.

8.0 SUMMARY OF RECOMMENDATIONS

The thrust of this model includes the following characteristics:

1. The requisite regulatory framework impose a general requirement that auditors be independent of the management of auditees and that auditor decision-making be independent of that of auditee management.

2. The regulatory framework changes do not involve directly and in detail defining auditor independence. Nor should it describe or limit certain behavior of audit firms in respect of real or perceived audit independence threats.

3. The regulatory framework be changed to require auditors entitled to undertake company (and related) audits (in the Australian context, those with the designation “Registered Company Auditor”) to not only demonstrate certain levels of competence, but also to have access to a registered Independence Board.

4. That the appropriate corporate regulator be empowered to approve and register Independence Boards for use by company auditors and disapprove and de-register them as appropriate.

5. That each audit firm with sufficient critical mass establish an Independence Board.

6. That appropriate professional accounting bodies establish an Independence Board or Boards for those audit firms that do not have sufficient critical mass to establish such a Board themselves.

7. That the Independence Boards established be capable of accessing the internal information within auditing firms and processes to rule on threats and perceived threats to independence in a timely fashion and within strictly confidential circumstances.

8. That the audit firms compete with each other in respect of their independence quality control processes just as they presently do in respect of price and competency.

9. That the quality control processes for independence be observable by a wide section of the market and stakeholders in the market for audit services

10. That disclosures in company annual reports relating to auditors be extended providing an explanation as to why the audit firm holds the appointment. These

disclosures will include information on particular aspects of auditor competence and quality controls for independence decisions.

9.0 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 competence and yet this mechanism is presently not observable in respect of independence. The model proposes a market-based solution that will ensure competition on competence and independence as well as competition in respect of price. This market-based model requires the existence of a strong regulatory framework.

In addition to focusing on competing over independence, this model suggests that communication in respect of the audit needs to be more detailed. This is so that those stakeholders in the market for information relating to the audit can be fully informed of audit quality in respect of both competence and independence.

The operation of this market 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 regulatory framework that oversees strong competitive 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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ENDNOTES

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1 Recent examinations of the web sites of several of the larger accounting firms do not show any evidence that they quality differentiate in respect of independence.

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

3 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.

4 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).

5 This matter is discussed below in respect of the special case of the joint supply of audit and auditor provided non-audit services noted in Section 4.0.

BIOGRAPHICAL DETAILS

Keith A. Houghton is a Fellow of the Institute of Chartered Accountants of Australia (with practicing certificate) and a Fellow of the CPA Australia. He holds degrees from the University of Western Australia, the University of Melbourne and the London School of Economics and Political Science in the University of London. He is presently Fitzgerald Professor of Accounting at the University of Melbourne, Australia; a position he has held for the past twelve years. He recently completed a period as Visiting Professor of Accounting in the PhD program at the University of Texas at Austin. Prior appointments include positions in academe and the business community. He is and has been a consultant and adviser to a number of accounting firms, commercial organizations and public sector entities including public sector audit authorities. Much of this work has related to audit quality and financial information and has involved the provision of expert evidence (both for the plaintiff and defence) in litigation and commercial arbitration.

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