CHAPTER – III

ACCOUNTING, AUDITING AND NON-AUDIT SERVICES: AN OVERVIEW

INTRODUCTION

The issue of auditor independence is of serious concern to regulators, investors, creditors and the general public. The fact that clients pay auditors for their audit and non-audit services generates an inherent economic dependence of the auditor on its clients (Mautz and Sharaf, 1961; DeAngelo, 1981). Such economic dependence increases with the size of client firms because larger clients generate bigger fees. These increased fees raise the concern that auditors may compromise their independence in the audit of their larger, more influential clients. However, compromise of auditor independence does not necessarily result from increased economic dependence of auditors on their larger clients if other countervailing economic forces are at work (Reynolds and Francis, 2000; AICPA, 1997).

The joint supply of audit and non-audit services has been a strongly debated issue and one that is of considerable interest to some corporate regulators. Regulators claim that the joint supply of audit and non-audit services to the same client is likely to impair the auditor’s independence. They argue that fee dependence and conflicts of interest are unavoidable in these situations and can be damaging.

Positive accounting theories have provided support for regulators’ concerns through the argument that economic bonding between auditor and client is likely to be increased by the provision of NAS by an incumbent auditor, and hence lead to the possibility of impairment of auditor independence. However, in general, accounting researchers struggle to find consistent empirical evidence that shows joint provision of audit services and NAS impairs auditor independence.
AUDIT HISTORY

Proper knowledge about the history of the professional audit industry helps gain an understanding of the value of reputation to an auditor. Watts and Zimmerman (1983) demonstrate that professional auditing is not a product of government requirements but more a result of “changes in the market for auditing”. They argue that the potential agency problems cause management to submit to this act of monitoring in order to minimize opportunistic behavior. According to them, audit work existed as early as the 13th century and “evolved gradually into types of audit as required by the first English companies Act (1844)”. Prior to this Act, auditors were not required but a great number of companies voluntarily submitted to some type of monitoring and recognized the value of the audit.

In the beginning, audits were performed by directors or shareholders and did not involve outside independent accountants until the 1900’s. By the time the 1900 Companies Act was passed in the United Kingdom introducing compulsory audits, most firms were already using Chartered Accountants. In the Untied State, the 1933 Securities Act officially required the use of independent or Certified Public Accountants (CPA). According to Watts and Zimmerman (1986), 82 percent of NYSE companies had professional auditors by 1926. The authors argue that this was a result of market forces and that the switch from internal to external auditors was in response to the higher demand for auditors and lower cost of “certifying auditor competence and independence”.

Although Watts and Zimmerman (1983) demonstrated the importance of auditing, they built much of their argument on the research done by Jensen and Meckling (1976). They believed the external audit as another mechanism used to reduce agency conflicts between managers and shareholders. This reduction occurs because auditing enhances the credibility of financial statements (Dopuch and Simunic 1980). Feltham et al. (1991) contend that auditors who are more likely to resist client pressures to accept questionable accounting practices are of higher quality. The role of the auditor in ensuring that issued financial reports are
of high quality is emphasized by members of the BRC, who recommend that auditors and audit committees enter into significant discussions regarding the quality of financial reporting. Further, the Auditing Standards Board amendment to Auditing Standards No. 61, communications with Audit Committees, requires that external auditors discuss the clarity, consistency and completeness of the client’s accounting practices with audit committee members (Abbott and Parker 2001). Audits should be more effective in reducing information asymmetries, and in reducing earnings management, higher the quality of the audit (Becker et al., 1998). In the theory of the firm they note that “the price which they (perspective minority shareholders) will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager’s interest and theirs”. These authors show the value of the role of monitoring of the firm and that the outside shareholders will pay more for the stock as this monitoring role is increased in order to minimize this divergence. One of the main monitoring methods mentioned is auditing. If auditing does contribute to increasing the value of a firm then it would be expected to be present as far back as companies with outside interests.

NON-AUDIT SERVICES (NAS)

It is found that auditors believe that their work would be used as a guide for investment, valuation of companies and in predicting bankruptcy. Furthermore, the third party feels that there is strong relationship between the reliability of auditor’s work and the investment decision. Also the auditor’s work facilitates the process of economic development through the presentation of reliable information concerning the financial position of companies (Wahdan et al., 2005). Concerns regarding audits performed by firms also offering non-audit services (NAS) go back to Mautz and Sharaf (1961), who asserted that management advisory and tax services which auditors provide tend to reduce the appearance of audit independence. Globalization in accounting and assurance service has also created the multidisciplinary nature of large audit firms (Brierly and Gwilliam, 2003). These multidisciplinary firms offer audit and non-audit services to audit clients and these have become one of the major concerns regarding the potential auditor
independence dilemma (Quick and Rasmussen, 2005). Levitt (2000) described auditors who perform significant NAS for audit clients have an additional economic incentive to retain the client—possibly at the risk of deciding difficult issues in the client’s favor so as not to present a disagreement with management that might ultimately lead to dismissal.

The SEC believes that non-audit services impair auditor independence because of the significant revenues generated from these services, and the consulting nature of these services often lead the auditor to identify himself with the interests of the management rather than with those of the public (SEC, 2000). Although there are market-based incentives for auditors to remain independent, there are also forces that potentially threaten auditor independence. Specifically, regulators are concerned about two effects of NAS. One is a fear that non-audit service fees make auditors financially dependent on their clients, and hence less willing to stand up to management pressure for fear of losing their business. The other is that the consulting nature of many non-audit services puts auditors in the managerial role (Defond et al., 2002). Significant increases in consulting revenue generated by CPA firms led the SEC to believe that increased economic dependence on these services may potentially impair auditor independence. Hence, in 1978, the SEC adopted disclosure requirements (ASR 250) that required audited firms to disclose NAS fees (as a ratio based on the audit fees). And in September 1981, SEC repealed ASR No. 250 rational for the repeal include insignificant purchases of NAS by audit clients, artificial and detrimental curtailments of NAS because of the disclosures, and investors’ seemingly lack of interests on this information (Abbott et al. 2003). The concern on NAS negative impacts reemerges as consulting work grew explosively in the 1990s (Antle et al., 2002). In 2000, the SEC issued final rule of independence. The rule requires firms to disclose the purposes of all fees paid to the auditor and identifying whether the fee is for 1) audit 2) financial information system design and implementation services 3) others, On July 30 2002, President Bush signed the public accounting reform and investor list of various services that an audit firm is not allowed to provide to its audit clients. Most banned services are related to consulting or advisory services that might create conflict of interests for independent auditors.
(Banham, 2003). According to the Sarbanes-Oxley Act (2002) the following items are non audit services:

(1) Bookkeeping or other services related to the accounting records or financial statements of the audit client - The auditor is considered not independent when he/she provides bookkeeping services for audit client. It involves with an inherent conflicts of interest, since an auditor supposed examines accounting records or financial statements prepared by him/her for its appropriateness.

(2) Design and implementation of accounting information systems - This is another example of creating inherent conflict of interest, since an auditor is required to evaluate the effectiveness of accounting system that he/she designed or implemented. Installing a computerized accounting system for client was immensely popular consulting services in many big accounting firms.

(3) Appraisal and valuation services – Appraisal, valuation, or any services involving a fairness opinion of contribution-in-kind report for audit clients, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during audit.

(4) Actuarial services – Any actuarially oriented advisory services involving the determination of amounts recorded in the financial statements and related accounts, other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during audit.

(5) Internal audit outsourcing services – Under generally accepted auditing standards, the auditor is required to evaluate the effectiveness of internal control system over financial reporting, which creates another example of conflict of interest. For example, Arthur Anderson provided the internal
control function for Enron, before it was banned by the 2000 SEC rule, and was blamed for not improving Enron’s ineffective control system.

(6) Management functions – Acting, temporarily or permanently, as a director, officer, or employee of an audit client or performing any decision making, supervisory, or ongoing monitoring function for audit client.

(7) Human resources – Searching for or seeking out prospective candidates for managerial, executive, or director positions, undertaking reference checks of prospective candidates for executive or director position, and recommending or advising audit client to hire a specific candidate for a specific job.

(8) Broker-dealer, investment advisor, or investment banking services – Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of audit client.

(9) Legal services – Providing any service to audit client that could be provided only by someone licensed, admitted or otherwise qualified to practice law.

SARBANES-OXLEY ACT

During, 2001 the financial scandals of Enron and World Com were daily news. Arthur Anderson was on trial for obstruction of justice: the firm had authorized the shredding of work papers associated with the Enron scandal. The public were shocked and astonished. The twenty largest public companies saw their shares drop by more than 4300 million (Feldman 2005). A response was desperately needed. The credibility of public companies’ financial reporting had been sharply questioned after a series of financial reporting scandals in the late 2001. This series of corporate accounting scandals and failures pointed to a critical dawn in the regulatory environment’s ability to protect the investor. This flaw was so great; it threatened to materially undermine the world’s confidence in the American capital markets. Congressman Michael G. Oxley, a Republican from Ohio, was first to move. Swiftly he introduced a bill to fight back. It passed the Congressional House of Representatives till April 2002 with a vote of 334 to 90. Paul Sarbanes, a five-term Maryland Democrat, had also sponsored a separate bill
that passed the Senate with a 97 to 0 vote on July 15, 2002. The very next day, on July 16, 2002, World Com filed the largest bankruptcy in United States history. By week’s end, the Dow Jones industrial Average had plummeted 654 points (Feldman, 2005). Again the pressure for Congress to do something was tremendous. The legislators quickly merged into one bipartisan package the Sarbanes- Oxley bill. It was passed by Congress on 30, July 2002 with only three “no” votes. The SOX has brought about the most extensive reform of corporate financial reporting in nearly 70 years.

The Sarbanes- Oxley Act, an amendment to the 1934 SEC Act, created the Public Company Accounting Oversight Board (PCAOB) and granted that board the authority to set accounting standards. The Act made a number of changes in the relationship between independent auditors and the firms they audit that would dramatically affect the internal control environment, the “tone at the top:, which the Treadway report considers the foundation of effective internal controls. These changes include the following : (1) independent auditors must report to the audit committee of the board of directors of the audit client, (2) the lead auditor review partner must be rotated every five years, (3) a second audit partner must review and approve audit report, (4) it is a felony with penalties of up to 10 years in jail to willfully fail to maintain all audit and review work papers for at least five years, and (5) auditors are prohibited from offering certain information system and accounting services to their audit clients.

The Sarbanes Oxley Act does not contain a formal statement of purpose. However, based on a review of the pertinent sections, the Sarbanes Oxley Act clearly intends to achieve the following:

2. Increasing registrant’s required disclosures.
3. Making management more accountable
4. Improving the regulation of auditors.
5. Prohibiting conflicts of interest between management auditors and advisors.
The main sections of SOX that affected the auditing phase within public accounting firms are Section 101, which established the Public Company Accounting Oversight Board (PCAOB). The Act created a new oversight board. Its role is to oversee the audit of public companies that are subject to the securities laws, and related matters in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors (Sarbanes Oxley Act, 2002, p8).

This board has wide powers to register accounting firms, establish or modify standards, conduct investigations and discipline accounting firms, and execute any other necessary enforcement actions required by Act. Section 201 deals with auditor’s independence, which according to the AICPA standard AU 220 states that auditors must be independent in both fact and appearance “in all matters relating to the assignment” (AICPA Professional Standards). Section 201 which outlines a list of prohibited activities that can be done by auditors, the SOX also specifically addresses the scope of services question. According to the Act, it is unlawful for a registered accounting firm that provides an audit service to also provide any of the following non-audit services during the same time frame as the audit:

1. Book keeping or other services related to the accounting records or financial statement of the audit clients.
2. Financial information systems design and implementation.
3. Appraisal or valuation services, fair opinions or contribution-in-kind reports.
4. Actuarial services.
5. Internal audit outsourcing services.
6. Management functions or human resources.
7. Broker or dealer, investment adviser or investment banking services.
8. Legal services and expert services unrelated to the audit.
9. Any other service that the accounting Board determines, by regulation, is permissible.
Any other non-audit service can be performed by a registered accounting firm only if the service is pre-approved by the client’s audit committee.

Section 203, deals with the mandatory rotation of audit partners every 5 years, this standard was brought about to try and stop collusion between long relationships of audit partners and companies which results in reduced audit quality (Ariel, Brody, Pany). An audit partner is defined as “a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee” (George). Auditors must also remain off the audit for at least 5 years before they are able to return to the audit engagement. This collusion was made obvious with the crash of Enron and Arthur Anderson. Many people were unaware of which employees were Enron and which employees belong to Arthur Anderson, because of the lackadaisical attitude the Arthur Anderson employees took with them their clients. Also, many of the Enron employees were former Arthur Anderson auditors, which meant that Arthur Anderson was auditing and reviewing the work of their former associates which could have effected the auditors ability to be independent (Herrick, Barrionuevo).

Sec 206 of SOX deals with this problem and the problems resulting from conflicts of interest and states that “the Chief Executive Officer (CEO), Chief Finance Officer (CFO), Controller, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company’s audit firm during the 1-year preceding the audit”.

The Section 404 dealing with the management’s assessment of Internal Controls has caused the most controversy of the Sarbanes-Oxley Act. “This section requires each annual report of an issuer to contain an “internal control report” (SOX of 2002). This created two responsibilities when dealing with the audit of internal control; 1) State what management’s responsibilities are in maintaining internal controls, and 2) State whether the internal controls are effective. The main controversy with statement 404 has to do with the increase of
audit fees. The PCAOB issued “Auditing standard No. 2” which deals with both section 201 and section 404 and how an auditor should conduct their audit to achieve the highest amount of efficiency at the lowest cost to the companies. In a policy statement released by the PCAOB in May 2005, it stated “that auditors should integrate their audits, exercise judgments in their audit plans, use a top-down approach, use the work of others, and engage in direct conversations with audit clients”. The PCAOB realizes that in the first year of implementation of section 404 the costs have been too high. The PCAOB feels that is due to the initial start up costs that will not be present in following years, and the auditors not conducting an integrated audit. Auditors admitted not integrating the internal controls audit into the audit of the financial statements and instead conducted two separate audits (PCAOB statement). Audit standard No. 2, hopes to reduce future costs by designing the integrated audit model, “which combines the audit of internal control over financial reporting with the audit of the financial statements, such that the objectives of the two audits are achieved simultaneously through a single coordinated process” (PCAOB statement). With this an auditor will collect evidence and plan the audit with both audits in mind. It also states that auditors should use their own professional judgment and mend audit plans to their specific needs.

**SIZE OF AUDITING FIRM**

Recent accounting scandals raise serious concerns among financial markets regulators, operators, investors, and academic researchers, in credibility of financial reporting. It becomes necessary to access the extent of earnings management or identify what kinds of firms are engaging in earnings management. The firm size has positive impacts on earnings management because large firms usually have strong internal control systems and governance mechanisms, can access high quality services from large CPA firms, and care for its reputations. These factors may discourage earnings management. In contrast, however, the large firms may also face more pressure to report positive earnings or earnings increases have more bargaining power in negotiation with auditors, have
higher abilities to maneuver given wide range of accounting treatments available, and have stronger management power to make it easier to manipulate earnings.

Large firms have usually grown up with a long history during which they may have better appreciation of the market environment, better control over their operations and better understanding of their businesses relative to small firms. They may have established their credibility in the business community and social responsibility as well, including the credibility of financial information disclosed by these firms because large firms are more able to use best expertise and modern information, technology to generate reliable and timely information compared to small firms. Hence, the cost of engaging in earnings management will be higher for large firms than small firms. Therefore, their concern about reputations may prevent large firms from manipulating earnings.

Large audit firms have better financial resources and research facilities, superior technology and more talented employees to undertake large company audits than smaller audit firms. Their large client portfolios enable them to resist management pressures whereas small firms provide more personalized services due to limited client portfolios and are expected to succumb to management requirements (Lys and Watts, 1994). The focus on auditor size assumes that top auditors have more valuable reputations and, therefore, stronger incentives to perform high-quality audits (DeAngelo, 1981).

DeAngelo (1981) has theoretically analyzed the relation between audit quality and auditor’s size. She argued that large auditors will have more clients and their total fees will be allocated among those clients. Defining the auditor’s independence by the conditional probability that the auditor will disclose any misstatement in financial statements given that this misstatement was already discovered, DeAngelo (1981) argued that large auditors will be more independent and therefore, will provide higher quality of audit. DeAngelo (1981) who argues that large auditors have more incentives to be accurate because they have more client-specific rents to lose if their reports are not accurate. She analytically demonstrates that auditor size is positively related to audit quality. In her study,
auditor size is measured by number of clients. She argues that since auditors earn client-specific quasi-rents, auditors with more clients have more to lose by failing to report discovered misstatements in financial statements.

Following DeAngelo’s (1981) argument that size of audit firms is positively associated with audit quality, many studies use size (Big 8/6/5 vs. non-Big 8/6/5) as the audit quality proxy (Krishnan, 2003; Becker et al., 1998; Firth and Smith, 1992; Nichols and Smith, 1983).

Many audit quality studies indicate that, when accounting firm size is used as the indicator of audit quality, higher audit quality is associated with less information asymmetry and higher information quality. The results of studies that test the relationship between audit quality and audit firm size using other proxies for audit quality (e.g., Teoh and Wong, 1993; Palmrose, 1988) usually support the hypothesis that audit quality and audit firm size are positively associated. The results of some empirical papers have provided additional support for the use of auditor size as a proxy for audit quality. Davidson (1993) used an indirect method to support the argument that size is a good proxy for auditing quality. He argued that managers have incentives to manipulate the reported earnings to meet the analysts’ forecasts. Therefore, if large auditing firms provide higher-quality audits than small auditing firms, we may expect the forecast errors of big auditing firms’ clients to be larger. Using data for Canadian firms, his results support that expectation indicating that the auditor size is a good proxy for auditing quality.

Pearson (1985) found the level of auditor independence to be positively associated with size of the audit firm. Large audit firms did not rely on revenue from a single client because the impact on their financial position was not material, as compared to smaller audit firms. Pearson (1980) reported that smaller firms would experience more difficulty in resisting client pressures in situations of conflict. On the issue of the association between size of audit firm and users’ perception of the reliability and therefore confidence in the information content of financial statements, Goldman and Barlev (1974) argued that companies tend to switch from small to large audit firms during
initial public offerings (IPO) due to the high reliance of banks and financial analysts on the reports certified by large audit firms. Consistent with this argument, McKinley et al. (1985) discovered that the type and size of the audit firm were positively associated with auditor independence. The respondents indicated that financial statements audited by Big Eight audit firm would be less likely to contain undetected fraud (proxy to measure financial statements reliability) as compared to those audited by smaller firms.

IMPORTANCE OF AUDIT QUALITY

The literature on auditor characteristics suggests that auditors provide two valuable roles to capital market participants: an information role and an insurance role. Auditors provide independent verification of manager prepared financial statements and can discover and report breaches in a client’s accounting system (Watts and Zimmerman (1981), DeAngelo (1981)). In all markets, the established practice of fairness and transparency is an essential element in the issuing and trading of securities. Wallace (1980) claimed that investors demand audited financial statements because these statements provide information that is useful for their investment decisions. This implies that the audit process adds some value to accounting information and is valued as a means of improving the quality of the financial information.

The auditing process is supposed to serve as a monitoring device (Wallace 1980) that will reduce managers’ incentives to manipulate reported earnings. Therefore, it is hypothesized that higher the auditing quality, lower the earnings management activities by managers, ceteris paribus. The potential conflicts of interests among owners, managers, and other security holders create an environment in which an outside auditor may contribute significant value to investors. In fact, recent high profile misstatements and fraud by large corporations have brought increased scrutiny of the role that public firm auditors play in financial markets. 'The demand for auditing arises from the auditor’s monitoring role in the principal agent relationship. According to agency theory, an agency relationship is a contract under which one or more principals engage an
agent to perform some service on the principals’ behalf and delegate the decision-making authority to the agent (Jenson and Meckling, 1976). The financial statement audit is a monitoring mechanism which helps reduce information asymmetry and protects the interests of the principals, specifically, stockholders and potential stockholders, by providing reasonable assurance that the management’s financial statements are free from material misstatements (Watts and Zimmerman, 1986).

Jacobides and Croson (2001) define monitoring as collection of any information by the principal in the agency relationship. An audit is one monitoring mechanism. It helps stockholders to collect reliable information. Auditing serves to reduce information asymmetry and the reduction in information asymmetry is an indicator of the level of audit quality. Auditors reduce information asymmetry between managers and stakeholders by providing reasonable assurance that the financial statements are free of material misstatements (Becker, et al., 1998).

On the other hand, the concern about the quality of accounting numbers and its relation with the quality of the auditing process is increasing over time, following the periodical clusters of business failures, frauds, and litigation (Chambers 1999). 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.

The existence of both, competency and independence are necessary conditions for the audit to be a value adding one and cannot be a substitute for the other. Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement (Mautz and Sharaf, 1961). 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.

While the primary responsibility for the quality of financial statements is with the management of the company producing those statements, external auditors provide independent assurance about that quality. That audit results will be relied on and recommended for audit quality improvements will be seriously considered and implemented. The organization’s reputation for consistent high-quality work helps ensure that decision makers will more readily and more surely accept findings and implement recommendations. 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. 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 skepticism and, as a consequence, the outcome in terms of depleted value attributed to audit will be more exaggerated than would otherwise be the case.

**DEFINITION OF AUDIT QUALITY**

Audit quality refers to the auditor conducting the audit in accordance with Generally Accepted Auditing Standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with GAAP, and (2) are not materially misstated, whether due to error or fraud.
This definition assumes that reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with GAAP and that, within the requirements of GAAP, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor’s opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company’s auditor of record and reporting the reason for the resignation to the Securities Exchange Commission (SEC).

Audit quality describes how well an audit detects and reports material misstatements of financial statements, reduces information asymmetry between management and stockholders and therefore helps protect the interests of stockholders. High audit quality should be associated with high information quality of financial statements because financial statements audited by high quality auditors should be less likely to contain material misstatements. Audit quality contributes to the credibility of financial disclosure, and to the extent contracting with the firm is made less costly, it reduces the cost of capital (Jensen and Meckling (1976), Watts and Zimmerman (1986), Ball (2001)). In addition, because investors often use audited financial statements as the basis for asset-allocation decisions, securities laws provide recourse for the investor against the auditor. In this way, auditors provide investors with a means to indemnify losses. (Kellogg (1984), Wallace (1988), Stice (1991), Dye (1993)).

DeAngelo (1981) defines audit quality as the market-assessed joint probability that a given auditor will both detect material misstatements in the client’s financial statements and report the material misstatements. This is a definition of perceived audit quality since DeAngelo (1981) emphasizes the role of the market in assessing audit quality. The willingness to report discovered material misstatements is defined by DeAngelo (1981) as auditor independence. Therefore, according to DeAngelo’s (1981) definition, audit quality is a function of the auditor’s ability to detect material misstatements (auditor competence) and auditor
independence. DeAngelo (1981a) has argued that audit quality depends on the joint probability of an auditor discovering and disclosing a problem in an accounting system. Given that a problem has been discovered, the probability that an auditor discloses the problem depends on the degree of independence. DeAngelo (1981a) and Watts and Zimmerman (1981, 1986) define audit quality as the probability that an auditor will both discover and truthfully report a discovered breach, and suggest that the probability of reporting is a function of independence. Since high-quality, independent auditors are more likely to detect and object to the client firm use of aggressive and questionable accounting practices, earnings management is expected to decrease as audit quality improves.

Palmrose (1988) defines audit quality in terms of level of assurance. Since the purpose of an audit is to provide assurance on financial statements, audit quality is the probability that financial statements contain no material misstatements.

Davidson and Neu (1993) provide an audit quality definition that is based on the auditor’s ability to detect and eliminate material misstatements and manipulations in reported net income. Lam and Chang (1994) suggest that audit quality should be defined on an engagement-by-engagement basis rather than on a firm basis. Elliott and Jacobson (1998) refer to a two-pronged requirement for audit quality- objectivity and competence. They believe that objectivity can result from perfect integrity, perfect independence, or some adequate combination of the two.

Most empirical audit quality research defines audit quality relative to audit risk which is the risk that an auditor may fail to modify the opinion on financial statement that are materially misstated (AICPA, 1994). The theoretical relationship between non-audit services and audit quality is ambiguous. On the one hand, non-audit services may increase auditors’ client knowledge and therefore increase the probability that problems are discovered. Therefore, for a given level of independence, non-audit services may increase audit quality. On the other hand, non-audit services may increase or reduce auditor
independence. If non-audit services provide auditors with client specific rents, companies may be able to obtain more favorable reports by threatening to switch auditor – in this case, non-audit services may reduce independence (DeAngelo, 1981a; Antle, 1984; Simunic, 1984). However, non-audit services may increase a client’s dependence on its auditor, thereby reducing the credibility of the switch threat (Goldman and Barlev, 1974).

**IMPORTANCE OF INDEPENDENCE**

The issue of auditor independence, its nature and its determinants, in particular, has been the subject of investigation and pronouncements by policy makers and the accountancy profession for several decades. For example, the U.S. Senate, (1976 and 1985, Metcalf and Dingall committees) American Institute Certified Public Accountants (AICPA) the Cohen (1978), and the Treadway Commission (1987) Public Oversight Board (1986) in the U.S., Canadian Institute of Chartered Accountants (1978). Statement of auditing practice AUP (AARF 1992) in Australia and the auditing practices board (APB 1992, 1994) in the UK. Auditor independence is the core of the auditing industry. The Independence Standards Board (ISB 2000 p. 11) state the goal of auditor independence is to support user reliance on the financial reporting process and to enhance the capital market. Elliott and Jacobson (1998 p. 1) say that “the purpose of audit independence is to improve the cost-effectiveness of the capital markets by reducing the likelihood of material bias by auditors that can undermine the quality of the audit and also the objective of audit independence is to improve the reliability of the financial statements. This information risk is reflected in the cost of capital, both of the particular firm and the market in general.

Kinney (1999) agrees that independent standards along with accounting and auditing standards are essential to the value that our capital market system provides for investor protection, corporate governance, and facilitation of capital formation. He explains both a constraint view and a core value view of independence. According to the constraint view, independence is achieved by externally constraining auditors through rules issued by SEC or the AICPA. According to the core value view auditors themselves will maintain independence.
to preserve their market value. Arthur Levitt states that “one generation of accountants passes on the light of independence to the next. That light sustains the profession’s life through a culture of integrity, a mission of objectivity and an ethic of responsibility.” The auditors are handed a precious legacy, what they do with it will determine the future of this profession. It is a heavy burden but an overwhelming privilege.

**DEFINITION OF AUDITOR INDEPENDENCE**

Auditor independence is an important element of the assurance that an audit report provides to its readers with increasing globalization of business and the expansion of the large audit firms into truly multinational enterprises. Also, “the concept of independence has proved, however, to be difficult to be defined precisely” (Antle, 1984). Thus the concept of auditor independence has been argued from many perspectives amongst the professional authorities. Important definitions and views have been presented below:

(1) The SEC (2000) defines independence as “a mental state of objectivity and lack of bias”. (2) The AICPA describes auditor independence as an absence of interests that create an unacceptable risk of bias with respect to the quality or context of information that is the subject of an audit engagement (AICPA, 1997). (3) Arns et al. (1999) defined independence in auditing as taking an unbiased view point in performance of audit tests, the evaluation of the result and issuance of the audit report. Independence includes the qualities of integrity, objectivity and impartiality.

John Carey (1946) explained independence as an abstract concept and it is difficult to define either generally or in its peculiar application to the public accountant. Essentially, it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course. Independence may be a state of mind or a behavior. According to AUP 32, independence requires freedom from bias,
personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure.

Mautz et al. (1961) defined independence as an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily representations by management. If the accountants were not independent of the management of his clients, his opinion would add nothing.

Independence Standard Board (ISB, 2000) goes freedom from these pressures and other factors that compromise or can reasonably be expected to compromise an auditor’s ability to make unbiased audit decisions. These representative definitions all reflect the importance of objectivity (ability to suppress biases) and integrity (willingness to express an opinion that truthfully reflects the evaluation of what has been discovered during the audit) as the two key aspects of auditor independence (Dunmore and Folk 2001, p. 8)

- ‘the conditional probability of reporting a discovered breach’ (DeAngelo, 1981a, p.186);
- ‘the ability to resist client pressure’ (Knapp, 1985);
- ‘an attitude/state of mind’ (AICPA, 1992; Moizer, 1994, p.19; Schuetze, 1994, p.69);
- An absence of interests that create an unacceptable risk of bias – the AICPA White Paper definition (AICPA, 1997); and
- Freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor’s ability to make unbiased audit decisions’ (ISB, 2000).

The Public Accountants and Auditors Board (PAAB) define independence as follows in their Code of Professional Conduct: “Independence is a quality, concomitant with integrity and objectivity, which enables a member to apply unbiased judgment and objective considerations to establish facts in arriving at an opinion or decision.”
THE ELEMENTS OF INDEPENDENCE

There is widespread agreement between regulators, accounting practitioners and auditing academics that auditor independence enhances auditor credibility. Historically, the SEC, the ISB and AICPA have partitioned independence into two dimensions: independence in appearance (IIA) and independence in fact (IIF).

The majority of empirical studies on the IIA focused upon identifying the factors which potentially influence independence and assessing their impact upon perceived independence since independence, in fact is unobservable. It is important for an auditor to maintain an unbiased viewpoint in his actions regarding the audit and it is equally important for the auditor to be perceived as independent by the users of financial statements. These two viewpoints are referred to as independence in fact and appearance. There are two aspects to independence: independence in fact and independence in appearance. Independence in fact refers to the ‘actual’ independence of the auditor. It is concerned with the state of mind of the auditor and how the auditor acts in a specific situation. It is difficult, and in many cases not possible, to determine whether an auditor has acted independently, because it involves knowing what has gone on in the mind of the auditor. The other aspect of independence is independence in appearance. This is how other people might view the independence of the auditor. It is necessary for auditors to not only act independently, but be seen to be independent because independence in appearance reduces the opportunity for an auditor to act otherwise than independently. Auditor independence as it relates to independence in appearance may be addressed in statutory law, professional standards and audit firm policy.

**Independence in appearance (IIA)**

IIA refers to the public or others perceptions of the auditor’s independence. Since IIA relies on the perceptions of users of financial statements, thus it is an empirical concept (Dykxheer and Sinning, 1981). This notion of independence (IIA) is one of the cornerstones of auditing theory and the sine qua non of auditing
practice. The importance of IIA comes from its effects on the value of the firm. Simunic (1984) stated that one would expect firm value to be affected by the perceived reliability of financial reports and so the quality of auditing. A loss in value may occur because rational purchasers of the firm’s securities will require compensation for any perceived risk of non-truthful reporting.

Academic research has examined independence in appearance by examining financial statement users’ perceptions of auditor independence where various conditions or services are provided by the auditor. Most of the literature on auditor independence suggests that the credibility of financial statements depends on the perceived independence of the external auditor by the users of financial statements (Levin, 2000). Thus auditor independence perceptions do appear to have economic consequences. Firth (1980) argues that if the auditor is not seen to be independent, users will have less confidence in the financial statements, and the auditor’s opinion on the company’s financial statements will be of value. From a regulatory point of view, one violation of IIA occurs when auditors provide material amounts of certain kinds of NAS to audit clients (Pitt and Birenbaum, 1997). Hence IIA of activities, relationships and other circumstances which would lead to well informed investors and other users reasonably to conclude that in an unacceptably high risk situation an auditor lacks independence of mind.

**Independence in fact (IIF)**

IIF relates to the notion that the auditors possess an independent mindset when planning and executing audit and that the resulting audit report is unbiased. Dykakouorn and Sinning defined IIF as the auditors’ state of mind of his or her ability to make objective and unbiased audit decision (1982). It basically refers to the mental attitude of the auditor in terms of professional objectivity (Gul and Tsui, 1991). Thus IIF is concerned with auditor objectivity (objectivity is defined, in the context of an audit, as the ability to make unbiased audit decision (ISB, 2000). IIF means that decisions should be made objectively without influence from other parties or factors. The second type of independence is that the auditor
is perceived to be independent (Stamp and Moonitz, 1978) debated IIF deals with intellectual honesty, providing its existence is difficult. Although IIF is at the core of independence requirement, it is not observable in a timely manner, making it difficult to regulate (Schuetz, 1994). In general, prior academic research has examined IIF by examining auditor judgment and decision making variation in the presence or absence of conditions hypothesized to induce auditor bias.

**THREATS TO AUDITOR INDEPENDENCE**

Threats to auditor independence are sources of potential bias that may compromise, or may reasonably be expected to compromise, an auditor’s ability to make unbiased audit decisions. Because threats may, or may reasonably be expected to, compromise an auditor’s ability to make unbiased audit decisions, independence decisions makers should identify and analyze the effects of threats that are sources of potential bias. Threats are posed by various types of activities, relationships, and other circumstances. Identifying the types of threats posed by specific activities, relationships, or other circumstances should help independence decision makers understand the nature of those threats and their potential impact on auditor independence.

Independence risk is defined as “the risk that is threats to auditor independence to the extent they are not mitigated by safeguards, compromise or can reasonably by expected to compromise. And auditor’s ability to make unbiased decisions” (ISB, 2000). Threats to auditor independence represent pressures or other factors impairing auditor’s objectivity. To be independent, an auditor must be able to overcome the threats that compromise objectivity. Identifying sources of threats help to illuminate their nature and impact on auditor’s independence. Threats to auditor independence are sources of potential bias that may compromise or may reasonably be expected to compromise an auditor’s ability to make unbiased audit decision. Significance of threat to auditor independence is the extent to which threat increases independence risk. Schulte Jr (1966) pointed out that this attitude could evoke auditor empathy for management, which could compromise independence. The significance of a specific threat depends on many factors including nature of activity, business relationship,
financial interests, employment with audit client, managerial or supervisory, personal relationships, provision of NAS and other circumstances creating the threat. Standards of auditor independence should establish a framework of principles supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures. Theorists generally hypothesize that concurrent provision of NAS to audit clients pose a threat to auditor independence. These arguments are based broadly on notions of economic dependency and mutuality of interest (Wines, 1994). Relationships that could have an effect on an auditor’s independence include personal relationships (such as between family members) financial involvement with the entity (such as by way of investment) provision of other services to the entity (such as undertaking valuations) and dependency on fees from one source. These threats can be generally classified (ISB 2000 (b) paragraph 12) as: (a) Self-interest (b) Self-view threat (c) Advocacy threat (d) Familiarity (or trust) threat and (e) Intimidation threat.

a) Self-interest threat

A self-interest threat exists when the auditor has financial or other interests which might cause the auditor to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit. In relation to non-audit services, the main self-interest threat concerns fees and economic dependence and these are addressed in Auditing Practices Board (APB) Ethical Standard. Self interest threat arises from auditors acting in their own interests. It includes auditor’s emotional, financial or other personal interests. Auditors may favor consciously or subconsciously these self-interests over their interests in performing a quality audit. For example, auditors’ relationships with auditees create a financial self-interest because auditees pay the auditors’ fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor’s spouse and an auditee. To mitigate or to eliminate this threat one can use safeguard prohibitions against certain financial interests and family relationships between auditors and auditees’ restrictions on the percentage of the total firm fees, earned from one auditor and
auditing firm disclosures to the audit committee of all services provided to the auditor.

b) Self-review threat

A threat that arises from auditors reviews their own work or the work done by others in their firms. It may be more difficult to evaluate without bias one’s work or that of one’s firms than the work of someone else or of some other firms. Therefore, a self-review threat may arise when auditors review judgments and decisions they or others in their firm have made. To mitigate or eliminate this threat, it can use safeguards concurring partner and peer reviews and prohibitions against auditors acting in the capacity of auditor management.

c) Advocacy threat

These are threats that arise from auditors or others in their firm, promoting or advocating for or against an auditee’s position or opinion rather than serving as unbiased attesters of the of the auditee’s financial information. Such threats may be present, for example, if an auditor or others in the auditor’s firm promotes an auditee’s securities or acting as an advocate for an audit clients’ position in dealings with their parties, to mitigate or eliminate, by among other safeguards, mandatory rotation of engagement partners and restrictions on certain employment relationships between auditors’ family members and auditees.

d) Familiarity (or trust) threat

A threat that arises from auditors can be influenced by a close relationship with an auditor. Such a threat is present if auditors are not sufficiently skeptical of an auditee’s serrations and as a result, too readily accept an auditee’s viewpoint because of their familiarity with or trust in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long standing personal or professional relationship with an auditee.
e) Intimidation threat

A threat that arises from auditors being or believing that they are being overtly or covertly coerced by auditees by other interested parties. Such a threat may arise if an auditor or auditing firm is threatened with replacement over a disagreement with an auditee’s application of an accounting principle. Intimidation threats may be mitigated or eliminated by among other safeguards concurring partner reviews, internal consultation requirements and an appropriate “tone at the top” in both auditing firms and auditees.

COMPETENCE

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 judgment exercised by the auditor needs to test the assertions made by management and not simply concur with them. Competency enhancements, includes (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. In respect of
regulating or legislating for independence, the challenges can be seen as 1) efficiency, (2) effectiveness, and (3) completeness.

AUDIT COMMITTEE

According to the agency theory, owners and agents have incentives to invest in various information systems and control devices to reduce agency costs associated with information asymmetry (Jensen and Meckling, 1976). In this context, management may use various means to indicate to others the quality of the information they are providing. Demands for monitoring may lead to external audits (Chow, 1982), the use of outside directors (Anderson et al., 1993) and audit committees (Menon and Williams, 1994). The use of audit committees can be considered an important part of the decision control system for internal monitoring by boards of directors (Fama, 1980). In other words, the board of directors delegates some of its oversight responsibilities to the audit committee.

One main component of corporate governance arrangements relates to the appointment of an audit committee within the organization. Section 205 of the Sarbanes-Oxley Act defines an audit committee as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”

The IIA has its own definition of the audit committee in Practice Advisory 2060-2, which runs as follows: “The term ‘audit committee,’ as used in this document, refers to the governance body that is charged with oversight of the organization’s audit and control functions.

The SEC suggests that: “the audit committee serves as an important body, serving the interests of investors, to help ensure that the registrant and its accountants fulfill their responsibilities under the securities laws.

The purpose of the committee shall be to assist the board in its oversight of the integrity of the financial statements of the company, of the company’s
compliance with legal and regulatory requirements, of the independence and qualifications of the independent auditor, and of the performance of the company’s internal audit function and independent auditors. Members of the committee shall be appointed by the board of directors upon the recommendation of the nominating and corporate governance committee and may be removed by the board of directors in its discretion. All members of the committee shall be independent directors under the standard proposed by the New York Stock Exchange, and shall also satisfy the New York Stock Exchange’s more rigorous independence requirement for members of the audit committee. All members shall have sufficient financial experience and ability to enable them to discharge their responsibilities and at least one member shall be a financial expert.

Audit Committee Financial Expert Disclosures—Section 407—at least one member of every corporate audit committee must be identified as a “financial expert.” The SEC has released guidance for these specific SOA financial expert rules. To qualify, the audit committee financial expert should have had experience as a public accountant, internal auditor, or principal financial officer. With that experience, the financial expert should have:

1. An understanding of generally accepted accounting principles and financial statements.
2. Experience in the preparation or auditing of financial statements of comparable organizations with an emphasis on accounting for estimates, accruals, and reserve
3. Experience with internal accounting controls
4. An understanding of audit committee functions

AUDIT COMMITTEE RESPONSIBILITIES SHOULD ENCOMPASS

1. Reviewing and approving audit strategies, policies, programs, and organizational structure, including selection/termination of external auditors or outsourced internal audit vendors.
2. Establishing schedules and agendas for regular meetings with internal and external auditors. The committee should meet at least four times a year.

3. Supervising the audit function directly to ensure that internal and external auditors are independent and objective in their findings.

4. Working with internal and external auditors to ensure that the bank has comprehensive audit coverage to meet the risks and demands posed by its current and planned activities.

5. Significant input into hiring senior internal audit personnel, setting compensation, reviewing annual audit plans/schedules, and evaluating the internal audit manager’s performance.

6. Monitoring, tracking, and, where necessary, providing discipline to ensure effective and timely response by management to correct control weaknesses and violations of law or regulation noted in internal or external audit reports or in examination reports.

7. The Audit Committee should consider the reputation of their management to avoid management’s opinions influencing auditors for being objective, independent and ethical. An Audit Committee member who is not independent of firms can reasonably be expected to demonstrate that they are from management or the external auditors should disclose this are have adequate policies and procedures in place to ensure fact and may refrain from voting on the issue.

8. Audit committee must approve all audit and non audit services in advance. While audit committees have or should have been doing this all along, that approval often was little more than a formality prior to SOA. In addition, when an audit committee approves any material of non audit services, they must be disclosed to investors through the annual proxy statement.

9. Receive reports from the external auditor concerning the use of material GAAPs and alternative policies, the management letter, and other correspondence such as the independence and engagement letters.
BACKGROUND OF ENRON

Enron, the multinational energy trading company, bought and sold gas. With deregulation of the energy business in the 1980s, and new suppliers on the deregulated market, energy prices became less stable. Enron began in 1985, due to a merger between Houston Natural Gas and Netter North of Omaha, Nebraska and was designed to create the first nationwide natural gas pipeline system. Enron took the opportunity to make profit in the new deregulated future market. Buyers and sellers use futures markets to get a better deal on commodities than they would do ordinarily in the open market. Enron’s role in the new market was to act as middleman and buy and sell gas for potential customers in the futures market at a fixed price. So, for instance, Enron would buy tomorrow’s energy and sell it at a fixed price today. Enron’s strategy worked to keep prices relatively stable and minimize fluctuations in the market. Meanwhile, Enron was able to make money from these transactions, as the company was able to charge for its role in this process. At one stage, Enron controlled almost a quarter of all gas in the U.S. market. The company also moved into other areas, such as offering companies the opportunity to hedge against the risk of price increases in other commodities like coal and steel, as well as external factors such as weather risk. In 2000, Enron was one of the world’s leading energy, commodities, and services companies. Revenues were $101 billion dollars and profits were $979 million dollars, and Enron listed as the number seven company on the Fortune 500 listing (Behr, 2001).

By the year 2000, Enron planned to move into broadband Internet networks to reflect the success of the dot.com economy. The company’s share price grew as it began internet trading and offering investors a free service, resulting in increased customers.

Accounting practices to maintain the impression that the company was making money, Enron used complicated accounting methods to keep its share price high. These techniques included removing losses from its books and legally passing them on to an independent partnership as “assets.” Another accounting ploy was to treat as profits investment money linked to particular business
enterprises coming into the company, although those projects had not yet started. Also they used to hide millions of dollars of debt while allowing the executives and directors to make substantial profits. All of these partnerships were approved by Enron’s board of directors and reviewed by Arthur Andersen, the firm’s external auditor.

The crisis of Enron’s share price in Summer 2000 was $90, but there was also speculation that the company had profited by reselling gas it had purchased in the futures market at a much higher cost to the consumer. The company denied this was the case, and its 2000 annual report showed income had increased by some 40 percent in three years. In August 2001, Enron’s chief executive resigned. These unnerved investors, who sold millions of shares, which cut $4 off the share price by the end of that week. In October of 2001, Enron reported a $1 billion write-off of investment losses and restructuring charges from unsuccessful technology ventures and other operations (McLean and Elkind, 2004). The write-off left Enron with a $618 million loss in the third quarter or 84 cents a share (Behr, 2001). Enron was unable to recover its losses, while the share price continued to fall, because it had hedged against its own stock. The Securities and Exchange Commission requested that Enron voluntarily provide information regarding certain related party transactions (McLean and Elkind, 2004). According to Behr (2001) the article in the Wall Street Journal indicated that Enron’s Chief Financial Officer had set up several investment partnerships with the approval of Enron’s board. On November 8, 2001, Enron decided to restate its profits for the previous four years.

In effect, Enron admitted to inflating profits by concealing the extent of its debt through complicated accounting methods that is, removing losses from its books and legally passing them on to an independent partnership as “assets.”

TENURE

Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to an audited financial statement (Mautz and Sharaf, 1961). The
literature has long been concerned that the duration of the relationship between the auditor and the client potentially affects audit quality, but contains conflicting arguments (e.g., Mautz and Sharaf, 1961; Shockley 1981; Lyer and Rama, 2004). The general concern is that as this relationship gets longer, auditors are more likely to accede to their client’s accounting and reporting choices in order to retain the client. Regulators have pushed for mandatory auditor rotation. However, recent accounting scandals, involving corporations such as Enron in the US and HIH Insurance in Australia, have cast doubt over the independence of auditors and overall value of auditing. In particular, the economic dependence resulting from the provision of non-audit services, the familiarity developed from lengthy auditor tenure, and personal relationships built through alumni employees have been alleged to contribute to this erosion of auditor independence. In order to restore public confidence, policies such as mandatory audit partner rotation, prohibition/disclosure of certain NAS have been initiated by regulators and accounting bodies in the US, Australia and elsewhere (Sarbanes Oxley Act, 2002; SEC 2000, and). We define audit-firm tenure as the number of consecutive years in which the audit-firm client (audit-partner client) relationship exists. Since, at certain times one audit partner resigns and the other remains. According to Section 207 of the Sarbanes-Oxley Act, mandatory rotation refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer. Previous studies which empirically examined the association between audit tenure and abnormal accruals (e.g. Johnson et al. 2002; Myers et al. 2003), defined audit tenure as the number of years that a client has retained its “audit firm” rather than the lead or the coordinating “audit partner” which is stated in the SOX Act.

Auditor tenure has two aspects: the tenure of the audit firm and the tenure of individuals engaged in the audit, particularly the engagement partner. Although both have been tested in the literature, the emphasis has been on audit firm tenure due to difficulties in identifying the engagement partner, in most countries. The linkage between auditor tenure and audit quality is not clear. Some argue that longer tenure improves audit quality through learning, while others argue that longer tenure decreases audit quality because of independent concerns. The
The auditor independence hypothesis posits that audit quality is compromised as auditor tenure increases, while the auditor expertise hypothesis contends that audit quality increases with auditor tenure.

The auditor independence hypothesis incorporates three different arguments as to why audit quality might decrease as auditor tenure increases. First, over time, the auditor’s incentives shift towards maintaining and profiting from the client and the audit. The prospect of “client-specific rents” that the auditor can extract only over time may create an economic dependency on the client concerned, which impairs auditor independence (DeAngelo 1981a, 1981b; Magee and Tseng 1990). Second, as the auditor-client relationship lengthens, auditors may develop a “learned confidence” in the client (described in the IFAC Code of Ethics as a familiarity threat), which may result in the auditor not testing financial report assertions, anticipating results instead of being alert to anomalies, using less rigorous audit procedures or using static audit programs (Hoyle, 1978; Shockley, 1981; AICPA, 1992; Arrunada and Paz-Ares, 1997; Johnson et al., 2002; GAO, 2003). Third, a long relationship between a client and its auditor may lead to the development of personal relationships to the extent of developing bonds of loyalty, trust or emotive relationships (psychological dependence) so that truly independent auditor behavior becomes difficult (AICPA, 1992; Ariel et al., 2005). The consequences of diminished independence with long auditor tenure include the increased likelihood of the auditor acceding to client pressure in relation to their choice and application of accounting policies and, at the extreme, the possibility that excessive familiarity results in collusion between the auditor and the client (McLaren, 1958).

The auditor expertise hypothesis is based on information asymmetry between the client and the auditor, which reduces over time as auditors acquire client-specific knowledge. Because increased client-specific knowledge provides a comparative advantage in detecting material misstatements in financial reports, the lack of this knowledge in the early years of an audit engagement may result in a lower quality audit (Beck et al., 1988; Hoyle, 1978; Knapp, 1991; Solomon et al., 1999).
Additionally, low-balling theory also implies that it is important for auditors to keep their clients, in the early years of engagements, to recoup the initial investment in the clients. Thus, these assertions predict that audit quality improves with auditor tenure. Additionally, if the assimilation of client-specific knowledge and development of learning experience is very important for auditors to conduct high quality audits, then mandatory rotation that disturbs the accumulation on client-specific expertise will hurt audit quality.

The Sarbanes-Oxley Act of 2002 requires that the lead audit partner and audit review partner be rotated every five years on public company engagements. Proponents of the SOX Act suggest that rotation could significantly improve the overall quality of an audit and enhance the quality of the financial reporting process.

Geiger and Raghunandan (2003) used knowledge and independence arguments when questioning whether the length of auditor–client relationship was related to the issuance of going concern opinions for bankrupt companies. Their results indicated that the likelihood of a company receiving a going concern opinion prior to bankruptcy was lower when auditors were in the initial years of the engagement.

Farmer et al. (1987) pointed out that auditors could be inadequately influenced if they perceive a risk of losing the client when they do not agree with managers’ financial reporting preferences.

Dopuch et al. (2001) find that mandatory rotation reduces the auditor’s willingness to issue biased reports. Dopuch et al. conclude that mandatory rotation, with or without mandatory retention requirement, can increase auditor independence. Also, using a model to analyze the cost and benefit of mandating the rotation of auditors, Gietzman and Sen (2002) conclude that in certain well-defined circumstances, mandatory rotation of auditors is a desirable policy. In audit markets, with relatively few new client opportunities, removing the ability of management to influence the auditor reappointment decision can improve the incentives for auditors to maintain independence.
Davis et al. (2003) show a positive relation between discretionary accruals and auditor tenure and conclude that audit quality decreases with longer auditor tenure. Similarly, Casterella et al. (2002) find that audit failures are more likely when auditor tenure is long, supporting the view that longer the tenure, the lower audit quality.

Johnson et al. (2002) find that the absolute value of unexpected accruals is higher in the early years of audit firm tenure. Myers et al. (2003) report a negative relation between audit firm’s tenure and earnings quality measured by discretionary accruals and special items. Myers et al. (2003) indicate that the quality of reported earnings (as peroxide by earnings management through operating accruals) improves with audit firm tenure.

Brody and Moscove (1998) asserted that auditor rotation enhances greater independence through a reduction of clients’ inadequate influence on auditors.

Farmer et al. (1987) pointed out that auditors could be inadequately influenced if they perceive a risk of losing the client when they do not agree with managers’ financial reporting preferences. Mansi et al. (2004) document an inverse relation between firms’ cost of public debt and auditor tenure. Ghosh and Moon (2005) show that the impact of reported earnings on (1) stock returns, (2) stock rankings, and (3) analysts’ one-year-ahead earnings forecast is directly related to the length of the auditor–client relationship.

REPUTATION

A longstanding view in accounting literature holds that the demand for audit quality is driven by information asymmetry and conflicts of interest between managers and investors (Dopuch and Simunic, 1980; Watts and Zimmerman, 1983, 1986; Healy and Palepu, 2001). Managers can enhance the credibility of their firms’ financial reports by subjecting them to an independent audit. The higher audit quality, presumably stronger the assurance to investors, that the financial reports are free from material misstatements. Investors do not observe directly the quality of an audit though, but instead tend to rely on the auditor’s
reputation or brand name as an indicator of financial reporting credibility. Not surprising then, the manager’s point to reputation as a key factor in their choice of auditor (GAO, 2003). The primary role of financial reporting is to provide current and potential investors with information useful in making rational investment decisions (FASB, 1978, 34). Financial reporting mitigates information and agency problems between managers and investors (Watts and Zimmerman, 1986; Healy and Palepu, 2001).

An auditor with a tarnished reputation would not provide investors with sufficient assurance that managers are reporting in accordance with generally accepted accounting principles (GAAP) and complying with contractual requirements. Information problems arise when managers have incentives to overstate their firm’s prospects to attract investors, whereas agency problems arise when managers have incentives to misallocate or expropriate investors’ funds. An independent audit can weaken these incentives by assuring investors that managers are reporting in accordance with GAAP and complying with contractual requirements (Dopuch and Simunic, 1980; Watts and Zimmerman, 1983, 1986; Healy and Palepu, 2001).

Investors’ perceptions about reputation are influenced by multiple sources, including corporate financial reports, analyst reports, and press coverage (Fombrun and Shanley, 1990). Because financial reports play a crucial role in investor decision-making, a strong reputation for credible reporting enhance investors’ confidence that managers will actually report truthfully and fulfill their contractual duties, thus reducing the cost of capital (e.g., Beatty and Ritter, 1986; Milgrom and Roberts, 1986). A reputation for credible reporting is built over a long period based on consistent behavior; it may be lost quickly through an action that investors deem unacceptable (Fombrun and Shanley, 1990; Podolny, 1994). Reputations are most valuable in highly uncertain environments (Kreps and Wilson, 1982; Shapir, 1983; Weigelt and Camerer, 1988).

The impact of a service provider’s reputation on its clients has been a topic of great interest in financial literature. However, the impact of reputation losses of
service providers has not received as much attention. Since brand name is one of the most visible, low cost and easily available information regarding an incumbent auditor, it should be included in any experimental study on the perceptions of auditor independence and audit quality because these assessments cannot be complete if the auditor’s brand name is excluded or unknown. The brand name variable was operation aliased at two levels, Big Six and non-Big six auditors. In fact, a firm’s ability to repeatedly deliver goods and/or services of high quality is the cornerstone of the reputation building process (Klein and Leffler, 1981; Shapiro, 1983). Specifically, in auditing theory, there are two competing forces that influence auditors’ reporting strategy when they discover a breach from a given client: economic dependence and reputation protection (Reynolds and Francis, 2001).

According to the economic dependence, auditors would compromise their independence and report favorably in order to earn future quasi-rents by retaining clients. Alternatively, the reputation protection incentive leads the auditor to refrain from compromising independence to avoid lower audit fees from potential new clients (Davis and Simon, 1992) or being fired by some of their existing clients (DeAngelo, 1981b). If the important client is the auditor’s “core asset”, i.e., the negative effect of loss of reputation is extremely severe, then there is a tradeoff between economic dependence and reputation protection on the important client.

Slovin, Sushka and Hudson (1990) find that the stock price reaction to the announcement of a seasoned equity offering is a positive function of the quantity of bank debt, the quality of the firm’s investment banker, and the quality of the auditing firm. The result indicates that the deteriorating reputation of Arthur Andersen might exacerbate the negative announcement effects of their client’s firms.

Carter and Manaster (1990) find a negative relation between initial public offering (IPO) under pricing and underwriter reputation. More importantly, Carter and Manaster (1990) provide evidence that low dispersion issuers signal their low risk characteristics by engaging prestigious underwriters who, in order to preserve
their high reputation, market only IPOs of low dispersion firms. The rationale for this standard is that larger audit firms supply higher quality because they have more to lose than smaller firms with respect to reputation. In the light of recent events, a particularly interesting study by Reynolds (2000) finds that economic dependence (within a particular office) does not cause Big Five auditors to report more favorably. In fact, Reynolds’ findings support the notion that reputation dominates auditor behavior.

Based on Shockley’s (1981) results, it is expected that Big Six auditors’ perceptions of auditor independence will be influenced by audit brand name reputation while the non-Big six auditors’ perceptions will not be affected. Big Six auditors will rate auditors in their same brand name class as more independent, i.e., they are more likely to report a discovered misstatement and that there will be no difference in perceived independence between the two types of auditors for non-Big Six auditors.

In 2001, Andersen and the other Big 5 public accounting firms audited about 76 percent of U.S. publicly traded firms, representing 98% of public company sales. The Big 5 also controlled the global market for audit services. Because of their sheer size, these auditors were viewed as having the scale, technical expertise, and reputation incentives to uncover and expose most financial reporting irregularities.

Healy and Lys (1986) regard the auditor’s investment in reputation capital as a bond, which guarantees audit clients that they will receive the audit quality that was contracted for and the brand name of the auditor signals to financial statement users the quality of the audit firm. High reputation auditors maintain a high level of audit quality by diligently detecting misstatements and disclosing them in the audit report. DeAngelo (1981b) argues that audits conducted by Big Eight firms were more likely to discover the presence of material errors in financial statements compared to smaller firms as they possess technological advantages over their competitors. We can say Auditors’ assessment of audit quality as higher when the audit is conducted by a Big Four auditor compared to
when the audit is conducted by a non-Big four auditor. Also we can say auditors’ assess the auditor to be more independent when the audit is conducted by a Big four auditor compared to when the audit is conducted by a non-Big four auditor. Auditors’ assess the auditor to be more likely to discover the material misstatement when the audit is conducted by a Big four auditor compared to when the audit is conducted by a non-Big four auditor.

**INTERNAL CONTROL**

The importance of internal control and need for effective internal controls in helping to ensure that an entity’s operational and financial goals are met are longstanding (e.g., Kinney, 2001; Maher and Wright, 1990). In the past, internal audit was seen as a mechanism to double-check the many thousands of financial transactions that were posted to the accounts each week. In the 1950s and 60s, it pretty much consisted of basic tests of the accounts with a view to isolating errors and irregularities. Huge standardized audit work programs would be prepared that determined the steps that had to be taken to verify figures in the main accounting ledger and feeder systems. In contrast, today’s internal auditor facilitates the development of suitable controls as part of a wider risk strategy as well as providing assurances on the reliability of these controls. The move from detailed low-level checks of huge volumes of mainly financial transactions, to high-level input into corporate risk strategies, has been tremendous.

Internal auditors can add value to the entity by providing assurance that its risk exposures are properly understood and managed (Walker et al., 2003). Internal audit should play a key role in monitoring a company’s risk profile and identifying areas to improve risk management processes (Lindow and Race, 2002). As Walker et al. (2003) assert, internal audit can “help organizations identify and evaluate risks, moving the profession into the front line of risk management”. Internal controls are the structures and procedures adopted by the management of an entity to provide reasonable assurance that the goals and objectives of the entity are achieved (Colbert, 2002).
The Institute of Internal Auditors (IIA) defines internal auditing as: “...an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes” (IIA, 1999).

Also IIA define any action taken by the management, the board, and other parties to enhance risk management and increase the likelihood that established objectives and goals will achieve. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) and Office of Management and Budget (OMB) define internal controls as: A process, effective by an entity’s board of directors, management and other personal, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations (COSO, 1992, p.13; OMB, 2003).

External auditing standards (e.g. ISA 400 and AUS 402) recognize that an effective internal audit function can significantly strengthen the control environment by (i) reviewing the internal control structure and (ii) monitoring the operations of the information system and control procedures on behalf of the management (AUS 402 19(d)).

COSO (1992) specifies five interrelated components of internal controls that work to establish the foundation for sound internal controls within the organizations. These components include:
(1) Control environment: The core of any business is its people— their individual attributes including integrity, ethical values and competence—and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests (p16).

(2) Risk management: The entity must be aware of and deal with the risks it faces. It must set objectives, integrated with the sales, production, marking, financial and other activities so that the organization is operating in concert. It also must establish mechanisms to identify, analyze and manage the related risk (p16).

(3) Control activities: Control policies and procedures must be established and executed to help ensure that actions identified by management as necessary to address risks to achievements of the entity’s objectives are effectively carried out (p.18).

(4) Information and communication: Surrounding these activities are information and communication systems. These enable the entity’s people to capture and exchange the information needed to conduct, manage and control its operations (p18).

(5) Monitoring: The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant (p.18).

The Treadway Commission also recommends that all public companies should include reports covering internal control, written by management, in their annual report (COSO, 1992).

Weaknesses in internal controls have been causing many problems, including fraudulent activities, errors, and noncompliance with laws and regulations (Deloitte and Touche, 2005). In example of Enron, the lack of internal controls was a major cause of its troubles, (Verschoor et al., 2002, p.31). After the Enron and WorldCom accounting scandals, Congress passed the landmark SOX Act in 2002 to restore investor confidence. Section 404 is one of the most significant provisions of the Act. It requires managers to assess and report on their companies’ ICOFR, and requires external auditors to attest and report on the assessments made by client managers, as well as providing their own reports on
the ICOFR. The main purpose of Section 404 is to satisfy the need of investors to have confidence not only in the financial reports issued by a company, but also in the underlying processes and controls that are an integral part of producing those reports. SOX Section 404 compliance requires companies to undertake a considerable amount of preparation. Under SOX Section 404, public companies need to design, document, analyze and test their ICOFR. In effect, they must create elaborate internal control procedure manuals, and update them whenever processes change (Calabro, 2004). Not all companies initially have been up to the task. For instance, many companies admitted in their 2004 SOX 404 self assessments, that a variety of internal control areas are in need of remediation, such as financial processes, computer controls, internal audit effectiveness, audit committee oversight, anti-fraud programs, etc. (Taub, 2004). Section 404 directed the SEC to prescribe rules that require each annual report that a company files pursuant to section 13 (a) or 15 (d) of the Securities Exchange Act of 1934 to contain an internal control report: (1) stating managements’ responsibilities for establishing and maintaining an adequate internal control structure and procedures for financing reporting, and (2) contain an assessment, as of the end of the company’s most recent fiscal year, of the effectiveness of the company’s internal control structure and procedures for financial reporting (SEC, 2003a; SEC, 2006).

Sox section 302 requires a company’s signing officers to be responsible for establishing and maintaining internal controls, to evaluate the effectiveness of their internal controls, to present a conclusion of the evaluation, and to report any significant changes in internal controls, including any corrective actions related to significant deficiencies and material weaknesses (SEC).

FRAUD

We know that some firms commit accounting frauds and that these frauds distort financial statements and move price away from the fundamental value of the firm if market participants are misled. Consistent with this pattern of events, there is evidence that stock prices decrease when accounting frauds are revealed (Dechow et al., 1996; Feroz et al., 1991). Empirical evidence indicates that weak
Corporate governance is associated with financial reporting fraud (e.g. Dechow et al., 1996 hereafter DSS; Beasley, 1996), but little is known about the actions that fraud firms take to improve their weak governance after fraud detection and, perhaps more importantly, how effectively these actions restore investor trust. Given the importance of the relation between the quality of governance mechanisms and the credibility of the financial reporting system, it is surprising that we know so little about the nature and extent of this relation.

Generally, frauds are difficult to find and are hidden by individuals who perpetrate them, auditors attempt to identify risk factors that are associated with the occurrence of fraud. These fraud risk factors are commonly categorized along three dimensions of the fraud triangle: incentives, opportunities, and means of rationalization (AICPA, 2002).

- Incentives are present when employees feel pressure to commit fraud. Pressures from personal financial obligations or expectations regarding the entity’s profitability may all create incentives for employees to commit fraud.
- Opportunities arise when circumstances within entities are such that an employee can commit fraud. Employees may have opportunities to commit fraud when there are deficient internal controls or weak corporate governance.
- Some employees rationalize engaging in fraudulent behavior because they have attitudes or character traits which allow them to commit a dishonest act. Auditors synthesize their understanding of the fraud risk factors with other information to prepare their fraud risk assessments (AICPA, 2002).

Auditing standards state that “the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud” (AICPA, 1978).
Companies subject to Sarbanes-Oxley must now implement “antifraud programs and controls” that are evaluated annually during the integrated audit. Although most of these companies have already implemented components of an antifraud program such as codes of ethics and conduct, they may need to enhance their programs to meet the requirements of the new law and to avoid an auditor’s finding of a “significant deficiency” or “material weakness” in internal controls.

**Definition of fraud**

The word “fraud” has various meanings, and encompasses a wide range of activities. Fraud may involve a single, relatively minor act by alone employee, such as salesman falsifying an expense item on an expense report; or it may involve a massive, multi dimensional, and multi party scheme, such as members of top management misstating revenues on financial statements. Fraud is defined in the Merriam Webster Dictionary as “intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right” (Merriam-Webster, 2006). The Encyclopedia Britannica describes fraud as “the deliberate misrepresentation of fact for the purpose of depriving someone of valuable possession” (Britannica, 2006).

The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud is defined by the IIA as: Any illegal act characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threats of violence or physical force.

Frauds are perpetrated by individuals, and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage. Fraud is a deception deliberately or intentionally practiced. Fraud is often done in order to secure unfair or unlawful gain. The victim rarely suspects fraud and there is often a relationship of trust between the victim and the
perpetrator of the fraud. Moreover, fraud frequently involves the pressure or incentive to commit fraud and a perceived opportunity to do so.

The Statement on Auditing Standards (SAS), 82 defines fraudulent financial reporting as intentional misstatements or omissions of amounts or disclosure in financial statements, which is usually committed by management to deceive financial statement users.

Fraud, as it is currently defined in accounting standards, refers to “an intentional acts that results in a material misstatement in financial statements that is the subject of an audit” (AICPA, 2002: 106).

Fraud occurs when a misstatement is made and there is both the knowledge of its facility and the intent to deceive (Arens and Loebbecke, 1997).

**Distinguishing Between Error and Fraud**

The term “error” refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as the following:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

SAS No. 99 (AICPA, 2002) distinguishes fraud from error on the basis of whether the underlying action that results in a misstatement is intentional or unintentional. While fraud is a broad legal concept, the external auditor’s concern with fraud specifically relates to fraudulent acts that cause material misstatement of the financial statements.
An issue that complicates the problem of fraud assessment and detection is that, regarding any particular financial statement misstatement, intent is often difficult to determine. It is therefore often difficult to establish if a particular misstatement is due to error, or its more serious incarnation, fraud (AICPA, 1997). This is certainly true in the high volume and reutilized transaction cycles, such as the revenue cycle. For instance, a cutoff problem resulting in the inclusion of 2005 sales in the 2006 financial statements might be the result of a processing mistake (error), or the falsification or alteration of documents in order to purposely misstate revenue (fraud). Furthermore, auditing standards indicate that distinguishing between error and fraud is particularly difficult in those areas of the accounting and reporting function that are very judgmental or complex (AICPA, 1997). These areas tend to be low volume (e.g., one or at most a few transactions per accounting period) and non-reutilized, such as estimates for contingencies or other accruals. It is, for instance, difficult to determine whether the misapplication of a certain accounting principle regarding a judgment or estimate was intentional or unintentional (AICPA). Judgments regarding the risk of fraud made at the planning stage of the audit are made therefore in the context of significant uncertainty, and are expected to be sensitive to number of influences. These include the presence of risk factors and the perceived similarity of the current situation to previous experiences with fraud risk assessment.

Types of Audit Fraud

Levy (1985) states that fraud is commonly divided into two categories: management fraud and employee fraud. Management fraud originates from “above” and therefore, undermines the integrity of management and it usually escapes detection until the enterprise has suffered significant damage, employee fraud usually involves the circumvention of internal controls.
SAS 99 consider three following frauds as accounting frauds

(1) Fraudulent financial reporting

International misstatements of omissions of amounts or disclosures in financial statements designed to deceive financial statement users, in all material reports, in conformity with GAAP constitutes fraudulent financial reporting. Such frauds are practiced through a number of methods, usually falsified documents, and the omission of significant events or the intentional misapplication of GAAP. An example of an intentional misapplication of GAAP was alleged with World Com, where it capitalized lease expenses. Normally, fraudulent financial reporting involves (1) intentional omission of significant information from financial statements, (2) intentional misapplication of accounting principles, and (3) improper allocation of revenue and expenses recognition, fiction revenues and assets, over or undervalued expenses and liabilities, improper disclosure, and related party transactions (Loebbecke et al., 1989).

According to SAS 82, misstatement due to fraud may arise from fraudulent financial reporting, or may arise from misappropriation of assets. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. There are three categories of fraudulent financial reporting factors:

(1) Management characteristics and influence over the control of environment: management’s abilities, pressures, style and attitude relating to internal control in the financial reporting process. Fraudulent financial reporting can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on
performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some other entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

(2) Industry conditions: economic and regulatory environment in which the entity operates

(3) Operating characteristics and financial stability: nature and complexity of the entity and its transactions, its financial condition and its profitability.

(2) Misappropriation of assets

A misappropriation of assets, as the name suggests, refers to the theft of company assets that may result in the company’s financial statements being materially misstated (AICPA, 2003). Specific examples include embezzling receipts, stealing assets (e.g. cash, merchandise, etc.), or getting customers to pay for goods and services not yet received. There are two categories of risk factors related to misappropriation of assets. Misappropriation of assets involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment);
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity’s
purchasing agents in return for inflating prices, payments to fictitious employees); and
• Using an entity’s assets for personal use (for example, using the entity’s assets collateral for a personal loan or a loan to a related party).

(3) Management frauds

Another type of fraud that has perpetuated in the corporate sector is the management fraud. Management fraud can be said to be basically a zero-sum game. The gains made by the managers are equivalent to the losses of the others involved in it. The most common variety of fraud committed in public companies is generally strongly linked with conflict of interest. According to the IIA, fraud encompasses an array of irregularities and illegal acts characterized by intentional deceptions. Fraud may be committed against an organization, in which case the perpetrator is the sole gainer, or it may be committed in its favor, to the determent of the stakeholders. In the latter kind of frauds, generally, the proprietor too, has a share, in the gains; fraud of the first variety includes internal misappropriation or occupation and embezzling of fraud through credit card of fraud, etc. fraudulent financial reporting fits into the second variety. Fraud in favor of the organization goes along with corruption and bribery in doing deals that favor the organization. It is management fraud that causes the most damage to society. According to a study conducted by the Association of Certified Fraud Examiners (ACFR) (2003), the average loss from management fraud is eight times the loss from other types of fraud committed by employees. Fraud committed by management is termed “rational”, as it involves relationships with other parties and often middlemen rather than “transactional”. Often management frauds may be driven by the need to satisfy the ego or to build personal business empires. Another characteristic feature of such frauds is that there are individuals who help the person at the top in the organization, without themselves gaining anything and later on becoming whistle-blowers, bringing the scam to the world’s notice.
SUMMARY

Recent corporate scandals, such as Enron and World Com have focused the world’s attention on whether audit firms are supplying audits of sufficient high quality. The concern about the quality of accounting numbers and its relation with the quality of the auditing process is increasing over time following the periodical clusters of business failures, frauds, and litigation. Wallace (1980) claimed that investors demand audited financial statements because these statements provide information that is useful in their investment decisions. This implies that the audit process adds some value to accounting information and is valued as a means of improving the quality of the financial information. 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 judgment exercised by the auditor needs to test the assertions made by management and not simply concur with them.

The existence of both competency and independence are necessary conditions for the audit to be a value adding well, one cannot be a substitute for the other.