A CRITICAL ANALYSIS OF AUDITOR INDEPENDENCE UNDER THE NEW AUDIT REGULATIONS IN THE EU

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ABSTRACT

The subject of this article is the need for total independence of the auditors of annual company accounts, so that the companies' investors and shareholders, actual and potential, can place informed and well-founded trust in its official financial statements. This study sets out the various incentives a hired firm of auditors may have for adopting a subjective and unduly favourable stance towards its employers and explains the nature of the risks thereby entailed to the company's investors and shareholders, and indeed to the wider general public. It analyses the various legislative safeguards already adopted and the formal recommendations or proposed directives, made by the EU and US legislatures in recent years, to minimise or eliminate such risks, and assesses whether these regulations could

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ensure auditor independence.

Keywords: *auditor, auditor independence, the role of auditors in corporate governance, audit regulations*

ÖZET

Şirketlerin mevcut pay sahiplerinin ve muhtemel yatırımcılarının, şirket finansal mali durum tablolarına bilinçli ve tam olarak güvenmelerine hizmet eden, 'şirketlerin yıllık hesap denetçilerinin tam bağımsızlığının gerekliliği' hususu bu makalenin konusunu oluşturmaktadır. Bu çalışma, şirketleri denetleyen denetim şirketlerinin sübjektif ve haksız bir şekilde şirketler lehine tutum almasına neden olan muhtelif saikleri ortaya koymakta ve dolayısıyla bu yanlı tutumun yatırımcılar ile pay sahipleri ve kamu bakımından teşkil ettiği risklerin niteliğini açıklamaktadır. Makale bu riskleri azaltmak için Amerika Birleşik Devletleri'nde ve Avrupa'da kabul edilmiş çeşitli yasal düzenlemeleri incelemekte ve bu düzenlemelerin şirket denetçilerinin bağımsızlığını sağlayıp sağlayamadığını değerlendirmektedir.

Anahtar Kelimeler: *Denetçi, denetçi bağımsızlığı, denetçilerin kurumsal yönetimdeki rolü, bağımsız denetim düzenlemeleri*

I- INTRODUCTION

Auditing and audit reports are essential tools for a functioning capital market and a corporate governance system.[1] An effective, strong audit system is essential to create market trust and confidence because it provides a fair and true picture of the companies, which are audited, and minimises the cost of capital for those commercial entities in a healthy financial position.[2] Audit reports provide a powerful tool for shareholders and other constituencies to monitor how a company is managed, and in this way they enhance the corporate governance system, and companies' businesses and affairs.[3]

The past audit failures[4] - Enron, WorldCom, Independent

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[1] EBKE, Werner, "Accounting, Auditing, and Global Capital Markets" **Corporations, Capital Markets and Business in the Law** Ed. BAUMS, Theodor/ HOPT, Klaus/ HORN, Norbert, Kluwer Law, 2000, p. 113; The High Level Group of Company Law Experts, "Report on a Modern Regulatory Framework for Company Law in Europe", 2002, p. 70.

[2] European Commission, *Green Paper: Audit Policy – Lessons from the Crisis* COM(2010) p. 3-6.

[3] EBKE, Werner, "Corporate Governance and Auditor Independence" **Reforming Company and Takeover Law in Europe,** Ed., FERRARINI, Guido, Oxford University Press, 2004, p. 508.

[4] See, COFFEE, John, "What Caused Enron? A Capsule Social and Economic History of the 1990's" **Cornell Law Review,** Vol. 89, Issue 4, pp. 269-284, 269-272; MELIS, Andrea "Corporate Governance Failures: To What Extent Is Parmalat

Insurance, Lernout &Hauspie, Vivendi and Parmalat in Italy - have demonstrated the need for legal reform to provide an effective audit system.[5] These collapses were usually associated with the lack of auditor independence.[6]

The independence of audit firms is a prerequisite for an objective, true and fair report as to a company's financial situation. Where there is an absence of impartiality, the audit firms provide biased reports and overlook significant errors or misrepresentations in a company's financial statements; consequently, the audit reports lose their reliability, which in turn creates an overall decline in confidence in the capital market. In that event, investors will be unable to analyse the financial situation of their company satisfactorily, and thus the cost of capital will increase.

In the past, it had been argued that the reputational cost was a sufficient incentive for an auditor to carry out an independent and objective audit.[7] However, mere reputational constraint is no longer enough to ensure auditor independence. *John Coffee* put forward a

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a Particularly Italian Case?" **Corporate Governance: An International Review**, 2005, Vol. 13, pp 478-488.

[5] FLORES, Cláudio, "New Trends in Auditor Liability" **European Business Organization Law Review,** 2011, Vol 6, pp. 415-436, p. 416.

[6] DAVIES, Paul, and WORTHINGTON, Sarah, **Gower's Principles of Modern Company Law**, 8th edition, Sweet&Maxwell, 2009, p. 767; COFFEE, John, **Gatekeepers: the Professions and Corporate Governance,** Oxford University Press, 2006, ch 5.

[7] COFFEE, (n. 4) p. 279-280.

general deterrence theory, which is that the costs of compromising auditor independence and the benefits of acquiescence auditing must be in stable equilibrium.[8] He observed that the change in financial benefits obtained from the companies and the diminution in the costs of market deterrents impaired auditor independence. According to this theory, the role of audit regulation is to ensure that the incentives to maintain independence are not outweighed by the incentives to compromise. If the balance tilts towards compromise, audit firms are more likely to fail to provide a reliable and transparent report.

Following the Enron failure, the European Council issued a Directive[9] and the European Commission prepared a recommendation[10] to limit the liability of auditors to protect them from catastrophic losses, so as to retain a competitive audit market. The US responded to the Enron failure by enacting the Sarbanes-Oxley Act (SOX) in 2002.[11] The same pattern repeated itself after the 2007-8 financial crisis, in the wake of which it was wondered how these

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[8] COFFEE, (n. 4), p. 288-293.

[9] Council Directive (EC), 2006/43 concerning statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC [2006] OJL-157 (hereinafter referred to as the Directive of 2006).

[10] Commission Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms [2008] OJL 162/39 (hereinafter referred to as 'Recommendation').

[11] Public Company Accounting Reform and Investor Protection Act of 2002, Public Law 107–204, 116 Stat. 745.

financial institutions obtained clean audit reports just before they collapsed. The credibility of the auditors was challenged on account of these clean reports.[12] Subsequently, the EC engaged in a broad audit reform. First, it published a Green Paper[13] and later announced a proposal[14] on specific requirements regarding statutory audit of public-interest entities. These consultation papers finally resulted in the publication of the Directive[15] on statutory audits of annual accounts, and the EU Regulation[16] on specific requirements regarding statutory audit of public-interest entities. It is evident that the EU aims to enhance audit independence by adopting the Directive and the Regulation.

This paper aims to assess the current state of auditor independence under the new directive and regulation, with a reference to US audit regulation. It first defines the auditor's role; secondly it analyses the factors affecting the auditing system; and finally, it

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[12] SIKKA, Prem, "Financial Crisis and the Silence of the Auditors" **Accounting, Organisation and Society,** 2009, Vol. 34, pp. 868-873, 869; House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City' (Ninth Report of Session 2008-9) 5, 74.

[13] European Commission, *Audit Policy: Lessons from the Crisis* COM(2010) (hereinafter referred to as 'Green Paper').

[14] European Commission, Proposal for a Regulation on Specific Requirements regarding Statutory Audit of Public Interest Entities, COM(2011) 2011/0359 (hereinafter referred to as 'Proposed Directive').

[15] Council Directive 2014/56/EU Amending Directive 2006/43/EC on Statutory audits of Annual Accounts and Consolidated Accounts [2014] OJ L 158/196 (hereinafter referred to as 'the Directive of 2014').

[16] Council Regulation No 537/2014 on Specific Requirements Regarding Statutory Audit of Public- Interest Entities [2014] OJ L 158/1 (hereinafter referred to as 'the Regulation of 2014').

addresses the question of whether the regulatory steps are sufficient to guarantee the impartiality of auditors in the EU.

II- THE INDEPENDENCE OF AUDITOR

1- The Role of Auditor

In the context of corporate law, one of the most important developments is the separation of ownership and control.[17] This concept means that the management of a company is independent from its shareholders, but the separation of ownership and control causes the agency problems according to the literature because managers could seek to maximise their own interests. Therefore, the interests of managers and shareholders might diverge. The costs arising from managers acting opportunistically, the costs of monitoring them and the costs of aligning the interests of managers and shareholders are called ‘agency costs’.[18]

Agency costs are the inevitable consequence where decision-

[17] See BERLE, Adolf and Means, Gardiner, **The Modern Corporation and Private Property,** Transaction Publishers, London, 1991.
[18] JENSEN, Michael and MECKLING, William, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" **Journal of Financial Economics**, 1976, Vol. 3, pp. 305-360, p. 308.

making is delegated to individuals who do not bear the financial outcome of their decisions. The primary reason for the monitoring cost is the information asymmetry between the principal and the agent; the principals do not have the same level of knowledge about the company as their agents.[19] These are often specifically referred to as 'vertical agency costs'. Agency problems might occur between majority and minority shareholders. This type of agency problems are called 'horizontal agency problems'.[20] They usually exist in closely-held companies and large companies with a controlling shareholder. Agency problems might arise even in a sole proprietorship between the shareholder and the creditor when the company decides to bring in additional capital in the form of debt.[21] The sole shareholder has incentive to take greater risks because the creditor is at risk in the case of the failure of the company. The creditor carries the risk of failure and suffers agency cost because of the decreased value of the loan. This last type of agency problem is based on the fact that corporate decisions primarily aim to maximise shareholders' value, even to the detriment of creditors.

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[19] ARMOUR, John/ HANSMANN, Henry/ KRAAKMAN, Reiner 'Agency Problems and Legal Strategies' **The Anatomy of Corporate Law: A Comparative and Functional Approach,** Eds, Reiner Kraakman et al., 3rd edition, OUP, 2017, p. 29.

[20] See, ROE, Mark 'The Institutions of Corporate Governance', **Handbook of New Institutional Economics,** eds, MÉNARD, Claude/ SHIRLEY, Mary, Springer, 2008 p. 371.

[21] COLBERT, Janet/JAHERA, John, "The Role Of The Audit And Agency Theory" **The Journal of Applied Business Research**, 1988, Vol. 4, pp 7-12, p. 8.

To mitigate agency problems, shareholders, creditors, future investors, and other related parties could look into the financial statements of the company to obtain more information regarding the real position and performance of the company, but the reliability of company accounts is only guaranteed if an independent person or firm controls the financial statements of the company.[22] Auditing enters into the picture as an independent check and control on the accuracy of the financial statements.

In essence, 'audit is a control mechanism to monitor conduct and performance, and to secure or enforce accountability'.[23] Auditors are natural gatekeepers who aim to detect fraudulent transactions in the market.[24] The classic definition of an auditor is that he is a reputational intermediary[25] who verifies the financial statements of a company to investors by lending its reputation[26] to the investor to make

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[22] QUICK, Reiner/ WARMING-RASMUSSEN, Bent, "Auditor Independence and the Provision of NASs Perception by German Investors" **International Journal of Auditing**, 2009, Vol. 13, pp. 141-162.

[23] David Flint, **Philosophy and Principles of Auditing,** Macmillan, 1988, p. 12.

[24] KRAAKMAN, Reiner, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy" **Journal of Law, Economics, and Organisation,** 1986, Vol. 2, pp. 53-104, p. 54.

[25] COFFEE (n 4) p. 280; In *Dileo v Ernst&Young*, 90I F.2d 624, 629 (7th Cir. 1990), Judge Frank Easterbrook concluded that '*…an accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work…*'.

[26] They are repeat players in the market who police the players in order to protect their reputations, see KRAAKMAN (n 24) p. 94.

it trust the company's disclosures.[27] In the context of corporate governance, auditors carry out this role by checking the financial statements of companies and monitoring the activities and performance of management for the benefit of shareholders, creditors, and other related parties. As a result of audit, shareholders and other parties are more confident that company accounts represent the true and fair view of the financial condition and performance of the company.

The US-American Center for Audit Quality defines the role of auditors in corporate governance, as follows:

> 'An independent financial statement audit is conducted by a registered public accounting firm. It includes examining, on a test basis, evidence supporting the amounts and disclosures in the company's financial statements, an assessment of the accounting principles used, and significant estimates made by management, as well as evaluating the overall financial statement presentation to form an opinion on whether the financial statements taken as a whole are free from material misstatement'.[28]

[27] CUNNINGHAM, Lawrence, "Beyond Liability: Rewarding Effective Gatekeepers" **Minnesota Law Review,** 2008, Vol. 92, pp. 323-386, p. 328.

[28] Center For Audit Quality, 'In-Depth Guide to Public Company Auditing', (2011) 3 available at http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf accessed 07.08.2013.

Auditors provide reasonable assurance to the capital market.[29] In this regard, this additional assurance provides a disincentive to management to follow their own interests and gives more confidence to shareholders and the future investors, thereby increasing the liquidity of the markets.

As audit reports provide transparency in the capital market by enabling stakeholders to perceive the condition of the company, the auditor also carries out a 'public watchdog function'. Likewise, the American Institute of Certified Public Accountants (AICPA) stated that independent auditors carry out a public trust role. If the public do not trust audit firms, it will not rely on the audit reports and will be less likely to invest in that company, which in turn will cause an increase of the capital. The public trust role of auditors is described in *United States v. Arthur Young & Co* as follows:

> 'By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the

[29] MOORE Don/ TETLOCK, Philip/ TANLU Lloyd/ BAZERMAN Max, "Conflicts of Interest and The Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling" **Academy of Management Review,** 2006, Vol. 31, pp. 10-29, p. 13.

> corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust'.

A similar approach is acknowledged in the Directive of 2006: 'the public-interest function of statutory auditors means that a broader community of people and institutions rely on the quality of a statutory auditor's work. Good quality contributes to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements.[30]

As a result, auditors are part of checks and balances of corporate governance. They exist to address agency problems in corporate governance and to monitor activities of management, and in some cases the majority shareholders in the company, and to attest to company's performance for the benefit of shareholders, creditors, and other related parties. The role of auditors is to provide some assurance that managers or dominant shareholders are not seeking to maximise their own interests to the detriment of other constituencies. By ensuring that the annual reports of the company demonstrate a true and fair view of the company's financial position and performance, it also carries out a public watchdog role in the capital market.[31]

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[30] Paragraph 8 of the Directive of 2006.

[31] KRAAKMAN (n 24) 54; see DOPUCHA, Nicholas/ KINGA, Ronald/ SCHWARTZ Rachel, "Contingent Rents and Auditors' Independence: Appearance

2- The Independence of Auditors

The role of auditors is easy to state, but it is very difficult to achieve. On the one hand the role of auditors in corporate governance requires auditors to be challenging, independent and sceptical regarding the management of the company. On the other hand, the management of the company has strong incentives to present the company's position in the best light, even if the real position of the company is not close to what has been presented in the audit report. Hence, both EU and US law require both public interest entities (PIEs)[32] and listed companies to be checked by an independent auditor or audit firm at the said entities'/companies' expense.[33] From the point of view of shareholders, creditors and other related parties, audit reports are only valuable and reliable when they are appropriately prepared by independent auditors. Otherwise, there would be no reason to require a company to be audited by an external auditor.[34] If the public no longer trust the audit report, then the costs of capital might increase

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vs Fact" **Asia-Pacific Journal of Accounting & Economics,** 2004, Vol. 11, pp. 47-70.

[32] Article 2/13 of the Directive of 2006.

[33] EBKE, Werner, 'In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities' **Northwestern University Law Review,** 1984, Vol. 79, p. 665, p. 672.

[34] Moore et al (n 29) 13.

and the market collapse might follow.[35] From the collapse of the City of Glasgow in 1878 to the Enron failure in 2001 and the 2007-8 financial crisis, these failures were partially associated with audit failures and subsequent reform attempts intended to enhance the auditor independence.[36]

The concept of independence comprises the concepts of "auditor in mind" and "auditor in appearance".[37] The first refers to 'the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism'. The latter means that 'the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that the integrity, objectivity or professional scepticism of a firm or a member of the audit team has been compromised'.[38] An auditor must satisfy both requirements in order to be deemed independent.

Until the Enron crisis, the field of auditor independence had

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[35] Max Planck Institute "Working Group on Auditor Independence - Comments on the European Commission Green Paper: Audit Policy – Lessons from the Crisis" **Max Planck Private Law Research Paper No. 10/24**, 2011, p. 4.

[36] MENNICKEN, Andrea/ POWER, Michael, 'Auditing and Corporate Governance' **The Oxford Handbook of Corporate Governance,** Ed. WRIGHT, Mike/ SIEGEL, Donald/ KEASEY, Kevin/ FILATOTCHEV, Igor Oxford University Press, 2013, p. 313.

[37] International Federation of Accountants (IFAC) Code of Ethics s 290.6.

[38] IFAC Code of Ethics s 290.6.

not been regulated by legislatures on both sides of the Atlantic. However, following the Enron crisis, the EU and US initiated a reform process and imposed requirements on auditors to enhance their independence. According to *Coffee*, the role of audit regulation is to provide that the incentives to maintain independence overwhelm the incentive to acquiesce. This theory focuses on the costs and benefits to auditors when they compromise their independence by **acquiescing** to the management's demands as to the financial statements.

The task of auditor regulation is complicated by the structural feature of auditing market.[39] While audit regulation requires auditor independence and objectivity, auditing market causes the auditors to have conflicts of interests which bind them to the company rather than shareholders, creditors, and other constituencies.[40]

Firstly, the major primary challenge to the independence of the auditor lies in the structure of the auditing system whereby an auditor is appointed and dismissed by the companies it audits.[41] The

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[39] See O'CONNER, Sean 'The Inevitability of Enron And Impossibility of Auditor Independence Under Current Audit System' **Working Paper** <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181> accessed 12 July 2012.

[40] KERSHAW David, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation', **Journal of Law and Society,** 2006, Vol. 33, pp. 388-420, p. 390-1.

[41] DAVIES, Paul, 'Enron and Corporate Governance Reform in the UK and the EC' **After Enron Improving Corporate Law and Modernising Securities Regulation in Europe and the US,** Ed., ARMOUR, John/ MCCAHERY, Joseph, Hart Publishing, 2006 p. 430.

auditor is naturally concerned with continuing its relationship with its clients. The financial dependence of the auditor on its client creates a conflict of interest between the role of auditor and the interests of the auditing firm. Secondly, the revenue from consulting services constituted more than two-thirds of the total revenue of the audit firms by 2000.[42] The audit firms may compromise with their client's demands in order to sell more non-audit services (NASs). Thirdly, the long term contracts may inherently impair the independence of auditors because the auditor could become too sympathetic and too accepting of the client's work.

As a result, a number of factors can be said to have a crucial impact on auditor independence. Even a pro-independence equilibrium setting could not ensure an independence-compromising decision or vice versa, depending on auditors' organisational culture, confidence, or even how they feel on a particular day.[43] The important point is that this array of considerations makes a considerable contribution to understanding accounting decisions and to assess whether the new EU audit regulation could achieve auditor independence.

III- The EU Regulation on Auditor Independence

The primary role of auditor independence regulation is to limit the

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[42] BYRNES, Nanette 'Where Have all the Accountants Gone?' *Businessweek* (Newyork 27 March 2000) http://www.businessweek.com/2000/00_13/b3674173.htm accessed 16 July 2012.

[43] KERSHAW (n 40) p. 393.

possibility that auditors will succumb to the pressure from the company for an acquiescent audit. Acquiescent incentives are primarily related to the audit revenue and the threat of losing audit and consultancy contracts. In addition, behavioural psychology has showed us that actors can depart from objective rational assessments, and cognitive biases could cause auditors to make an acquiescent audit.[44] The expected legal liability from the acquiescent audit and lost revenue from reputational damage constitute the primary deterrent to auditor acquiescence. Hence, audit regulation should establish a balance between acquiescent incentives and acquiescent deterrents by taking into consideration the realm of audit market. This section briefly discusses whether the major regulatory innovations in the EU relating to auditors could ensure auditor independence without damaging the dynamics of the audit market.

1- Regulating Non-Auditing Services and Audit Fees

Audit firms are appointed and paid by the client companies which they audit. Many authorities believe that the bargaining power of the client often outweighs the duties of the auditor because the management of the company is aware of its bargaining power. The management have an incentive to employ that bargaining power to

[44] SUNSTEIN, Cass, 'Behavioural Analysis of Law' **University of Chicago Law Review,** 1997, Vol. 64, p. 1175.

manipulate the audit reports in order to make the company look healthier than it is in reality for the purpose of maximising its own short-term interest. Therefore, there is an inherent conflict of interests between the role of auditors and the interests of auditor.

This conflict of interest is complicated by the features and types of the income of audit firms. The revenue streams of an audit firm consist of the audit fee and fees from non-audit services (NASs). The NASs include tax planning, corporate finance, information technology, and human resources. In the past, the audit firms experienced a rapid increase in the revenue from their consulting services departments in the 1980s and 1990s while that from the audit section was stagnating.[45] In the 1990s the revenue of big auditing firms from consulting services increased from 12 per cent to 50 per cent of the total revenue of the auditing firms[46], and in 2000 the income from the auditing service constituted less than one-third of the total revenue of the auditing firms.[47]

The cross-selling of consulting service threatened the independence of the auditor[48] because the auditors would lose the significant amount of consulting revenue if they were to terminate their relationship with their client, and the auditor would thus be

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[45] BYRNES, Nanette, 'Where Have all the Accountants Gone?' *Businessweek* (Newyork 27 March 2000) http://www.businessweek.com/2000/00_13/b3674173.htm accessed 16 July 2012.
[46] EBKE (n 3) 520-522.
[47] See BYRNES (n 45).
[48] COFFEE (n 4) 291-302; CUNNINGHAM (n 27) 344.

motivated to continue this relationship as long as possible. Because of the increased income from the provision of NASs, the consulting divisions of the auditing firms became more important and powerful.[49] They were able to exert pressure on the statutory audit team to please their clients. In order to sell more consulting services, the audit firms developed a marketing strategy that sells auditing service below cost ('low-balling').[50] The idea behind the strategy is that the auditing service is a kind of investment for lucrative consulting services. In other words, the auditing services became a portal to lucrative consulting services for the auditor.[51] This causes a situation in which the audit firm is dependent to its client due to the 'low-balling' strategy.

There is also a concern that the provision of NASs to the same company creates a conflict of interest which inherently reduces the scepticism of auditor because of the self-interest threat and financial

[49] PARTNOY, Frank, 'Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime' **Washington University Law Review**, 2001, Vol. 79, pp. 491-548; TROMPETER, Greg, 'The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Audit Partner Judgment' **Auditing: Journal of Practice and Theory**, 1994, Vol. 13, pp. 56-76 p 63.
[50] Coffee (n 4) 291.
[51] LAI, Kam/ YIM, Andrew, 'NASs and Big 5 Auditor Independence: Evidence from Audit Pricing and Audit Opinion of Initial Engagament' http://papers.ssrn.com/sol3/papers.cfm?abstract_id=340000 accessed 21 July 2012 p. 5.

dependence on the client,[52] because the audit firms might be willing to please their clients in order to provide lucrative NASs. It is likely that the management of company which is aware of its bargaining power may put pressure on audit firm for an overlooked audit, by threatening to dismiss NASs. An example from the UK Committee on Economic Affairs UK market supports the foregoing arguments:

'*In addition to auditing Northern Rock, PwC received some £700,000 in 2006 in consultancy income from Northern Rock. The House of Common Treasury Select Committee referred to this as an apparent conflict of interest*'.[53]

From another perspective, the provision of NASs might also create a self-review threat to the auditor independence. An auditor providing consulting services to its client may lose its independence, objectivity and independence because eventually it would have to check a number of accounts which are prepared by it.[54] It may create a situation in which the auditor ignores misstatements.[55] As a result, consulting services may affect the auditor independence, objectivity

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[52] FERREIRA-GOMES, Jose Joao Montes, 'Auditors as Gatekeepers: The European Reform of Auditors' Legal Regime and the American Influence' **Columbia Law Journal,** 2005, Vol. 11, pp. 665, p. 687; KINNEY, William/ PALMROSE, Zoey-Vonna/ Scholz, SUSAN, 'Auditor Independence, NASs, and Restatements: Was the U.S. Government Right?' **Journal of Accounting Research**, 2004, Vol. 42, pp. 561-588, p. 565.

[53] Committee on Economic Affairs, *Auditors: Market Concentration and Their Role* (HL 2011-01) a 24.

[54] QUICK AND WARNING-RASMUSSEN (n 22) p. 145.

[55] BARTLETT, Roger 'A Heretical Challenge to the Invention of Auditor Independence' **Accounting Horizons,** 1991, Vol. 5, pp. 11, p. 13.

and quality because the interest in providing consulting services impairs the auditor independence and objectivity.

There are, however, some empirical researches which could not find an association between the auditor independence in fact (and in mind) and non-audit fees.[56] Nevertheless, in terms of independence in appearance, empirical studies have revealed that consulting services have a negative impact on independence in appearance.[57] As article 22 of Directive of 2006 and Article 290.8 of the International Federation of Accountants of the Code of Ethical Standards 2011 stated, the view of an objective, reasonable and informed third party with regard to auditor independence is of equal importance with the independence in fact in determining whether an auditor is independent. Since NASs have a negative impact on auditor independence in the eyes of an objective and reasonable third party, the NASs could jeopardise that auditor independence. As a result, NASs should be regulated and restricted in order to promote public

[56] JOE, Jennifer/ VANDERVELDE, Scott 'Do Auditor-Provided Non-audit Services Improve Audit Effectiveness?' **Contemporary Accounting Research,** 2007, Vol. 24, Issue 2, pp. 467–487; DEE, Carol/ LULSEGED, Ayalew/ NOWLIN, Tanya 'Prominent Audit Clients And The Relation Between Discretionary Accruals And Non-Audit Service Fees' **Advances in Accounting,** 2006, Vol. 22, pp. 123–148.

[57] CHIEN, Shu-Hua/ CHEN, Yahn-Shir 'The Provision of NASs by Accounting Firms after the Enron Bankruptcy in the United States' **International Journal of Management,** 2000, Vol. 22, pp. 300-308; KRISHNAN, Jayanthi/ SAMI, Heibatollah/ ZHANG, Yinqi 'Does the Provision of Non-audit Services Affect Investor Perceptions of Auditor Independence?' **Auditing: A Journal of Practice & Theory,** 2005, Vol. 24, pp. 111-135.

confidence in the capital markets.

Following the Enron crisis, US has prohibited nine types of NASs.[58] However, the Directive of 2006 preferred not to provide a black list for the NASs.[59] Article 22 of the Directive of 2006 merely set out a principle that an auditor should not provide auditing service where 'an objective, reasonable and informed third party would conclude that statutory auditor's or audit firms' independence is compromised'. Without a definite list of the banned NASs, auditors and companies need to make a case by case examination where NASs lead to a conflict of interest. Therefore, the Directive of 2006 leaves a broad discretionary power to the auditors. Moreover, as SEC stated in 2001, 'certain NASs inherently impair independence'.[60] Likewise, the Treasury Select Committee of the House of Commons stated in 2009 that 'we strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest

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[58] Section 201 of the Sarbanes-Oxley Act.

[59] European Commission, *Staff Working Paper Impact Assessment Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities* (2011) COM(2011)779.

[60] Securities Exchange Office (SEC) 'Final Rule: Revision of the Commission's Auditor Independence Requirements' http://www.sec.gov/rules/final/33-7919.htm accessed 17 July 2012.

opportunity'.[61] However, a significant number of professionals disagree with the idea of prohibition of NASs.[62] It is not known how the matter should be resolved. There are three alternative ways discussed by the EU to regulate NASs: prohibition of any NASs to the same client, pure audit firms, and prohibition on certain NASs.[63]

The first option is to ban an auditor from providing all kind of NASs. Under this option, the audit firm is banned from providing NASs to a client to which it already provides statutory audit. A complete ban seems an easily enforceable rule; however, it would be a disproportionate solution to impose complete prohibition on all NASs.[64] Enhancing auditor independence could be achieved by a less restrictive method. In addition, a complete ban on provision of any NASs would offend the principle of proportionality. Another significant drawback is that if an audit firm provides statutory audit services, it cannot provide NASs to the same client; hence, after audit firm rotation, the company has very limited choice as to audit firms

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[61] House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City' (2009) 84.

[62] European Commission 'Summary Of Responses Green Paper Audit Policy: Lessons From The Crisis' (2011) http://ec.europa.eu/internal_market/consultations/docs/2010/audit/summary_responses_en.pdf accessed 12 July 2012.

[63] IMPACT ASSESSMENT (n 59) 34.

[64] Max Planck Institute Working Group on Auditor Independence, 'Auditor Independence at the Crossroads-Regulation and Incentives' **EBOLR**, 2011, Vol. 13, pp. 89-103, p. 94.

on the international level under the current auditing market features.

The second option is to prohibit an audit firm to provide NASs to its clients. In other words, an audit firm is allowed to provide only statutory audits under this option. If this succeeded, the problems of the independence in mind and appearance could be resolved, because it would remove the source of conflict of interests. The auditor's credibility would eventually increase due to the perception that the conflict of interest is removed permanently. However, it has significant drawbacks.[65] Firstly, current audit firms would need to split into audit and consulting companies. Secondly, audit firms would not be able to understand the nature of their client's operations. Thirdly, 'pure audit' firms may prevent the growth of small audit firms. As a result, it is not an effective solution for the independence issue.

The final option is that if an audit firm provides statutory and financial audit services to a particular client, it would not provide certain kind of NASs. This final method has clear advantages: First, allowing limited number of NASs means that the self-interest threat will no longer be a threat in terms of auditor independence; secondly, creating a blacklist helps to harmonise audit policy at the EU level and create a level playing field for the audit firms in the EU; thirdly, it removes legal uncertainties as to NASs across the EU; finally, this option is a more proportionate solution to NASs when compared with

[65] IMPACT ASSESSMENT (n 59), 167.

other options.[66] The House of Lords Select Committee on Economic Affairs, which also supported this solution, stated:

'*We are not convinced that a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit is justified. But we recommend that a firm's external auditors should be banned from providing internal audit, tax advisory services and advice to the risk committee for that firm*'.[67]

Likewise, the SEC claims that certain types of NASs inherently jeopardise the independence of the auditors regardless of the magnitude of the fees generated from them.[68] The SEC sets out three criteria with regard to how to determine which kind of NASs should be banned:

'(1) an auditor cannot function in the role of management,

(2) An auditor cannot audit his or her own work, and

(3) An auditor cannot serve in an advocacy role for his or her client'.[69]

According to the above principles, first of all, the provision of bookkeeping services and the preparation of accounting records and

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[66] Impact Assessment (n 59), p. 164.
[67] Committee (n 61) p. 24.
[68] SEC (n 60).
[69] SEC *Proposed Rule, Strengthening the Commission's Requirements Regarding Auditor Independence* (2002) SEC Release 33-8154.

financial statements inherently impair the auditor's independence; accordingly, these kinds of services should be banned. The idea behind the prohibition is that where an auditor provides bookkeeping services, the auditor might later be in a position to check its own work. Nevertheless, the audit firm may not be able to adequately assess its previous work (self-review threat)[70] because if it finds an error in the bookkeeping, it will probably not raise the issue on account of its contract with its client or litigation risk. Similarly, designing a hardware or software which stores the financial information might impair the auditor's independence.[71] Nonetheless, it does not mean that an audit firm should be precluded from preparing all kind of computer tools or programs for its clients, provided that the audit committee approves these tools or programs. Secondly, the appraisal, valuation services or other kind of contribution to those services and fairness opinions might inherently jeopardise the independence of auditors because there is a probability of self-review threat. If appraisal or valuation contains expectations in regard to future cash flow, the auditor might not be sufficiently sceptical as to a future project because it is already involved with the preparation stage of the project.[72] As a result, an auditor should not become involved in the appraisal or valuation services. Thirdly, an external auditor should not be involved in the internal audit stage because, where the auditor

[70] See 100.12 Of The Code Of Ethics For Professional Accountants.
[71] SEC (n. 60) B.I.7.2.2.
[72] Ebke (n 3) p. 529.

conducts the statutory audit, it will depend on the internal audit system and thus will need to control its previous work.[73] From another perspective, if the company hires an external auditor to carry out an internal audit, the external auditor becomes an arm of management and the auditor tenders internal auditing reports to help management of the company and fix problems. In this situation, there is a possibility of inherent conflict of interest and 'auditor integrity is greatest'.[74] Therefore, as Dr. *Sarah Blackburn* of the Chartered Institute of Internal Auditors has stated, '*internal audit should not come from the external auditors of the company'* and that '*it is useful to have more than one source of assurance and more than one point of view*'.[75] Thirdly, legal services fundamentally impair the independence of the auditor. An auditor is not independent from its client where it is also the attorney of the client. An attorney's main duty is to protect the interest of its client; however, the auditor must be independent and objective in order to serve the public. Hence a person cannot be at the same time both a lawyer and the auditor of the same client. In *United States v Arthur Young,* the court stated that '*if investors were to review the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost*'.[76]

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[73] SEC (n. 60) at II.B.4.
[74] SEC (n. 60) at II.B.4.
[75] Committee (n 61) p. 24.
[76] *United States v Arthur Young* 465 US 805, 819-20 (1984).

Likewise, the other expert services with regard to regulatory or administrative bodies impair auditor independence for the very reasons mentioned above. Finally, tax consultancy is a dubious issue in terms of impartiality of the auditors. SOX does not regard tax consultancy as a NAS which inherently impairs auditor independence; thus, it allows the auditors to engage in tax consultancy as long as this service is pre-approved by the audit committee. However, tax consultancy is banned in the Regulation of 2014. It is an effective step to enhance auditor independence because revenue from tax consultancy constitutes a high proportion in relation to the revenue from the consulting services.[77] Since the EU consists of an enormous number and variety of legal systems, prohibitions on the provision of tax consultancy will have a positive impact on the independence of auditor at EU level.

This final approach is now adopted by the EU. Article 4 of the Regulation of 2014 stipulates that the statutory auditors shall not, directly or indirectly, provide to the audited companies: any tax services; services that involve playing any part in the management or decision-making of the audited company; bookkeeping and preparing accounting records and financial statements, payroll services, designing and implementing internal control or risk management procedures related to the preparation to the preparation and/or control

[77] BARRETT, Matthew 'Tax Services as A Trojan Horse in The Auditor Independence Provisions Of Sarbanes-Oxley' **Michigan State Law Review,** 2004**,** Vol. 2004, pp. 463-504, p. 476.

of financial information or designing and implementing financial information technology systems; legal services, services related to the audited entity's internal audit function; services linked to the financing, capital structure and allocation, and investment strategy of the audited entity; except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity, promoting, dealing in, or underwriting shares in the audited entity; or human resources services.

Prohibiting certain NASs reduces but does not eliminate the general conflict of interest between the role of auditors in corporate governance and financial incentives provided by NASs where the auditors receive considerably higher fees from the NASs. This conflict and the problem of 'low-balling' were not satisfactorily addressed in the Directive of 2006. Article 25 of the latter only prohibited contingency fees and avoided regulating this conflict of interest in detail. Article 4/2 of the Regulation of 2014 sets out that when the statutory auditor provides to the company, for a period of three years or more consecutive years, the allowed NASs, the total fees for such services shall be limited to no more than 70 of the average of the fees paid in the last three consecutive financial years. According to Article 4/3 of the Regulation of 2014, when the total fees received from a public-interest entity in each of the last three years exceed 15% of the total fees received by the auditor, the auditor shall disclose that fact to the audit committee and discuss its impacts on the independence. These thresholds could mitigate the general conflict and the problem of 'low-balling' because they limit the financial incentives for auditors to use the statutory audit service as a door to lucrative consulting services.

Taken together, the prohibition of certain types of NASs, and regulating audit fees might mitigate the conflict of interests between the role of auditors in corporate governance and the financial incentives provided by the NASs. Therefore, Article 4 of the Regulation of 2014 positively contributes to enhancing auditor independence at the EU level, and helps the EU to overcome legal uncertainties and to create a level playing field.

2- *Regulating the Length of Auditing Services (Audit Firm Rotation)*

Since audit firms are profit-making enterprises, they wish to maintain their commercial relationships for as long as possible.[78] Therefore, auditors are often motivated to please the management of the company, so as to ensure their re-appointment as auditors, and this

[78] Average auditor tenure at Fortune 1000 public companies was 22 years see, RAIBORN, Cecily/ SCHORG, Chandra/ MASSOUD, Marcos 'Should Auditor Rotation Be Mandatory' **Journal of Corporate Accounting and Finance,** 2006, Vol. 17, pp. 37-49, p. 40.

motivation creates conscious or unconscious bias.[79] From another perspective, the fact that auditors are paid and dismissed by the companies they audit places considerable pressure on them, and thus they may be motivated to approve the company's financial statements. Moreover, as noted above, after the 1990s, auditing has come to be seen as the ticket to lucrative consulting services. Therefore, the auditors make an investment in the company, expecting to make profit in the long- term. Thus, a threat of termination of contract by the company might serve as an incentive for an auditing firm to distort numbers and conceal the true situation of the company,[80] or not to report the breach in order to retain their audit and lucrative non-audit work, or to avoid issuing critical reports for the fear of

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[79] WATTS, Ross/ ZIMMERMAN, Jerold, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence" **Journal of Law and Economics,** 1983, Vol. 26, Issue 3, 613-633, p. 617-620; Netherland Authority for the Financial Markets, 'Report on general findings regarding audit quality and quality control monitoring' (2012) <http://www.afm.nl/layouts/afm/default.aspx~/media/files/rapport/2010/report-regarding-audit-quality-quality-control-monitoring.ashx> accessed 17 July 2018; Australian Securities and Investment Commission, 'Audit Inspection Program Public Report 2009-2010' (2010) http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/$file/rep242-published-29-June-2011.pdf accessed 17 June 2018; Canadian Public Accountability Board, 'Enhancing Audit Quality: Report on the 2010 Inspections of the Quality of Audits Conducted by Public Accounting Firms' (2011) <http://www.cpab-ccrc.ca/en/content/Public_Report_2009_Eng.pdf> accessed 17 June 2018.

[80] QUICK and WARNING-RASMUSSEN (n 22) p. 146.

losing the client and other short-term drawbacks.[81]

Providing auditing services from the same audit firm for a lengthy period of time may create a troublesome degree of closeness between the firm and the company, and auditor independence, objectivity and scepticism may be adversely affected. This may cause the 'familiarity threat', which is 'the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work'.[82] Actually, a close relationship between auditors and their clients is inherent in the nature of the work, which requires the auditor and the client to be in close interaction.[83] Behavioural psychology provides a further explanation for the root of bias through the concept of 'self-serving bias'.[84] In accordance with this approach, 'our desires powerfully influence the way we interpret information, even when we're trying to be objective and impartial'.[85] Much research revealed that self-serving bias could also impair the independence of auditors.[86] For example, Enron gave a permanent office to Arthur Anderson; the auditors dressed like the employees of Enron and participated in the

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[81] See BAZERMAN, Max/ LOWENSTEIN, George/ MOORE, Don, 'Why Good Accountants Do Bad Audits' **Harvard Business Review,** 2002, Vol. 80, p. 97.
[82] 100.12 of The Code Of Ethics For Professional Accountants.
[83] MOORE (29) p. 15-29.
[84] CUNNINGHAM (n 27) p. 345-50.
[85] BAZERMAN (n. 81) p. 99.
[86] See Babcock, Linda/ Loewenstein, George 'Explaining Bargaining Impasse: The Role of Self-Serving Biases' **Journal of Economic Perspectives**, 1997, Vol. 11, p. 109.

social activities of Enron's workers. *Kevin Jolly*, a former employee of Enron in the finance department, recalled, 'people just thought they were Enron employees'.[87]

Studies on the familiarity threat and self-serving bias show that people tend to select and highlight reasons which are in their favour, without taking into account the overall situation,[88] and this has a significant impact upon the executive decisions.[89] In such a situation, when the auditors obtain information about irregularities in the company, they are no longer in a position to evaluate the position objectively. *Dopuch, King and Schwartz* have found that the highest rate of biased audit reports occurred in places where there was no mandatory rotation.[90]

The idea of mandatory rotation is not new.[91] The European Parliament (EP), as well as some legal and accounting experts and auditing professionals, have not supported the change. The EP posits that '*the existing partner rotation arrangements provide the*

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[87] HERRICK, Thaddeus/ BARRIONUEVO, Alexei 'Were Enron, Anderson Too Close to Allow Auditor to Do Its Job' *The Wall Street journal* (New York January 21, 2002) accessed 25 June 2012.

[88] See, DIEKMANN, Kristina 'Implicit Justifications' And Self-Serving Group Allocations' (1997) 18 *Journal of Organizational Behaviour* 3.

[89] Babcock and Loewenstein (n 86) p. 115-126.

[90] See, BABCOCK, Linda/ LOEWENSTEİN, George/ ISSACHAROFF, Samuel/ Camerer, Colin 'Biased Judgments of Fairness in Bargaining' **American Economic Law Review,** 1995, Vol. 85, p. 1337.

[91] ZEFF, Stephen 'How the U.S. accounting profession got where it is today' **Accounting Horizons**, 2003, Vol. 17, pp. 189-205, p. 200.

independence necessary for audits to be effective'.[92] In the first instance, the opponents of forced rotation contend that there are numerous factors playing a role in the quality of audit statements, such as the experience and specialisation of the auditor, and the auditor's knowledge and understanding of the company as well as the sector in which it operates. The new audit firm's lack of knowledge regarding the operations of the company will not only result in lower quality audit reports but also lead to the loss of the valuable experience and knowledge acquired by the previous audit firm.[93] Secondly, it is stated that at least a two or three year training period is required for an audit firm fully to understand the client and its business, and issue quality reports.[94] Some researches indicate that, since the new audit firm will not have sufficient knowledge and experience of the company, the probability of audit failure in the learning period will be higher.[95] In addition, during this period, costs for both the audit firm and the client increase by about 20%.[96]

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[92] European Parliament, 'Report on audit policy: lessons from the crisis' (2011) 2011, INI/2011/2037 http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2011-359 accessed 13 June 2018.

[93] Deloitte: 'Response to European Green Paper' (2010) <http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Press/Response%20to%20EC%20GP_Audit_ltrandresponse.pdf> accessed 18 June 2018.

[94] RAIBORN, SCHORG, and MASSOUD (n 78), 40.

[95] U.S. General Accounting Office, 'Required Study on the Potential Effects of Mandatory Audit Firm Rotation' (2003) <http://www.gao.gov/assets/250/240736.pdf> accessed 17 June 2018 p. 6.

[96] U.S. General Accounting Office (n 95) p. 6.

The objections raised by academics and audit professionals against mandatory rotation seem convincing; however, they focus on the secondary impacts of mandatory rotation and ignore its primary aim, which is to enhance the independence and improve the scepticism of auditors. Italy is the only Member State which has mandatory rotation. A survey conducted in Italy indicates that 69% of managers of listed companies and the association of Italian listed companies agreed that mandatory rotation enhances and guarantees the independence of the auditor.[97] The mandatory rotation system will limit the tenure of the service contract. When the audit firm knows that the tenure of the service contract is limited, it will be able to resist pressures from the company and will no longer need to please its management.[98]

This is the first point that key audit partner rotation could not resolve. Under the internal rotation system, the audit firm feels itself under pressure not to lose the client. Moreover, compulsory rotation will introduce a new firm following the expiry of each tenure, thereby automatically providing for a fresh look at the financial statements of the company. As *Hoyle* stated, the present auditor will be aware that

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[97] CAMERAN, Mara 'A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy' (2003) **Manchester University Symposium Paper**, 6-7 https://www.uam.es/otros/catedraccc/docs/prencipe.pdf accessed 17 June 2018 .

[98] RAIBORN, SCHORG, and MASSOUD (n 78) 39.

the new audit firm may identify its acts of misconduct, and this will reduce the possibility of audit failures, since firms will act with greater caution.[99] Moreover, the additional costs generated as a result of mandatory rotation will be lower than the additional costs associated with audit failures. The estimated cost of mandatory rotation is $1.2 billion per year, while the failures of Enron, Quest, Tyco and Worldcom caused a loss of $460 billion in the market.[100] With respect to high rates of failures during the learning period, a handover requirement will significantly shorten the learning period and diminish the number of failures within it. Finally, since audit contract terms will be limited to a certain time period, the familiarity threat will be minimised, a point which an internal rotation system could not adequately cover. In addition, the possibility of unconscious bias arising out of long-term relations will be significantly reduced with mandatory rotation.

Despite the initial reluctance of the EU regarding mandatory rotation, Article 17 of the Regulation of 2014 now sets out that the duration of the audit engagement should not exceed 10 years. However, it also allows members to extend the maximum period to 20 years in the case of the public tendering process or to 24 years in the case of joint audits. It is clear that mandatory rotation will have a positive effect on auditor independence at the EU level. However,

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[99] HOYLE, Joe 'Mandatory Audit Rotation: The Arguments and An Alternative' **The Journal of Accountancy**, 1978, Vol. 145, Issue, 5, pp. 69-89 p. 72.
[100] RAIBORN, SCHORG, and MASSOUD (n 78) p. 39.

some necessary modifications regarding termination of contract, justifiable grounds for termination, and groups of companies are missing in the regulation. An eight-year period would balance the interests of the audit firm and the risks and costs of the acquiescent audit. Therefore, it seems better to reduce the duration of the service contract to eight years. The initial appointment could be made for four years and renewed at the expiry of that period, subject to the change of audit partner. This must be complemented by a system of protection that would remove the client's ability to dismiss the auditor, except on strong and justifiable grounds to terminate the contract, and the parties would be unable to change the terms and conditions of the contracts during the fixed term tenure.[101] The guaranteed period will enable the audit firm to balance additional costs incurred as a result of mandatory rotation.

To conclude, the EU's reform in the rotation system is timely and appropriate. However, it must consider some necessary modifications regarding the tenure and termination of contracts to minimise the negative impact of mandatory rotation and balance the interests of the audit firm.

[101] MOORE (n 29) 24.

3- Auditor Liability

The primary deterrents for the acquiescent auditing in the market is the expected financial costs arising from civil liability and lost revenue resulting from reputational damage. Until Enron, it was often argued that a reputational cost provides sufficient deterrence for an auditor to preserve its independence, objectivity and scepticism.[102] The rationale behind the reputation theory was explained by *Adam Smith* as:

'*A person engaging a substantial number of repeated transactions with neighbours cannot cheat because of the reputational consequences, while a person dealing with strangers is disposed to cheat because of the lack of reputational consequences*'.[103]

It is argued that the most valuable asset of the auditor is its reputation,[104] since the auditor pledges its own reputation to its client in order to make the client use its trust to reduce the transaction costs.[105] The assumption is that it is irrational for an audit firm to sacrifice its reputational capital for short- term gain because the truth will eventually be discovered and ultimately the audit firm will suffer

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[102] GOLDBERG, Victor, 'Accountable Accountants: Is Third-Party Liability Necessary?' **Journal of Legal Studies**, 1988, Vol. 17, pp. 295-312, p. 302.
[103] PARTNOY, Frank 'Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime' **Washington University Law Review**,2001, Vol. 79, pp 490, 495.
[104] *Dileo v Ernst&Young* 901 F. 2nd 624, 629 (7th cir 1990).
[105] GILSON, Ronald/ KRAAKMAN, Reiner 'The Mechanisms of Market Efficiency' **Virginia Law Review**, 1984, Vol. 70, pp. 549-644, p. 604-605, p. 613-622.

long-term losses due to the decline in reputation, given the investors' noticing, sooner or later, that the auditor overstates the strength of the company based upon its financial statements.[106] Likewise, *Coffee* states that '*at least in theory, a gatekeeper would not rationally sacrifice this reputational capital for a single client who accounts for only a small portion of its revenues*'.[107] In *DiLeo v. Ernst&Young*, the court acknowledged the foregoing theory:

> 'The complaint does not allege that the auditor had anything to gain from any fraud by its client. An accountant's greatest asset is its reputation for honesty, closely followed by its reputation for careful work. Fees for two years' audits could not approach the losses that the auditor would suffer from a perception that it would muffle a client's fraud…The auditor's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with the client'.[108]

The past audit failures - Enron, Worldcom, Independent Insurance, Lernout &Hauspie, Vivendi and Parmalat in Italy - have showed that

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[106] PARTNOY (n 103) p. 104.
[107] COFFEE, John 'The Attorney as Gatekeeper: An Agenda for the SEC' **Columbia Law Review,** 2003, Vol. 103, pp. 1293-1316, p 1299.
[108] *Dileo v Ernst&Young* 901 F. 2nd 624, 629 (7th cir 1990).

mere reputation is no longer an effective constraint for the auditor to protect its independence and provide quality audit reports where the benefits of acquiescence more than counterbalance the value of its reputation.[109]

The threat of legal liability is considered as a potential deterrent for an auditor, to protect its independence and to ensure effective and fair audit service.[110] From this perspective, the logical response to a crisis is to strengthen the liability and to encourage audit firm to take reasonable care. For example, in the case of misstatement or omission, section 11 of the Securities Exchange Act imposes strict liability on the issuer. However neither SOX nor the Directives of 2006 and 2014 adopted a similar approach. Nevertheless, the judicial tendency moves towards imposing greater liability on auditors in the U.S.[111] To illustrate, in *Re Enron Corporation Securities, Derivative & Erisa Litigation*, the court decided that anyone who aids materially for the preparation of the misleading documents could be primarily liable for the damages.[112] In addition, the *Lernout* constitutes an example for this tendency.[113] It might seem reasonable that if joint and

[109] HAMDANI, Assaf 'Gatekeeper Liability' **Southern California Law Review**, 2003, Vol. 77, pp. 53-122, p. 53-7.
[110] KERSHAW (n 40) 388-392.
[111] COFFEE, John 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' **Boston University Law Review**, 2004, Vol. 84, pp. 301-364, 353.
[112] *Re Enron Corporation Securities, Derivative & Erisa Litigation* 235 F. Supp. 2nd 549 (S.D Tex. 2002) 580-594.
[113] *In Re Lernout & Hauspie Securities Litigation 286 B.R. 33 (2002)*; *In Re Lernout & Hauspie Securities Litigation* 236 F. Supp. 2d 161 (2003).

several liability for the auditor had been accepted, the auditor would pay the maximum attention to auditing due to the threat of litigation, and the failure of the auditors would be minimal. Likewise, *Assaf Hamdani* stated that '*First, it (strict liability) would provide wrongdoers with optimal incentives to exercise precautions while relieving courts from entering the thicket of determining what constitutes 'reasonable care' in a given set of circumstances. Second, strict liability compels wrongdoers to adopt an optimal level of activity*'.[114]

That would be, however, contrary to the realm of the highly concentrated auditing market since under strict liability, an auditor might face a situation in which it has to pay all damages which its client or a third party incurred. The damages might include increased capital costs, unfair paid dividends, and compensation to the directors of the company. For example, the failure of Enron roughly costs $ 87 billion in the capital markets.[115] Thus, an auditor might simply go bankrupt or leave following the failure of its client by virtue of the great amount of losses.

With the collapse of one of the big audit firms, it will be almost impossible to meet the demand of the auditing service of international

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[114] HAMDANI (n 109) 58.
[115] Coffee (n 111) 68.

companies.[116] In addition, since the auditor is liable with its client, the plaintiffs may prefer to bring an action against any of the joint debtors. Thus, the chosen party has to compensate the whole amount of losses. Frequently, the auditor is chosen by the plaintiff because the collapse of the companies is realized after the insolvency of the companies, the auditors will then sit in the spotlight as party with 'deep pockets' and the auditors will probably not be able to recover catastrophic losses and the firms will most likely collapse because of the great amount of damages. As said, the demise of one of the big auditing firm might cause the unavailability of the auditing service in the market.[117] Moreover, under strict liability regimes, the statutory auditors are not able to access adequate insurance coverage because the extent of liability is not clear.[118] According to a recent study, current insurance coverage would recover less than 5% of damages suffered by the auditors.[119]

As mentioned above, the strict liability, at least in theory, provides optimal incentives for an auditor to pay attention to auditing service and to prevent the auditor from acquiescent auditing.

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[116] Flores (n 5) 427

[117] Doralt, Walter, 'Auditors' Liability And Its Impact On The European Financial Markets' **The Cambridge Law Journal,** 2008, Vol. 67, Issue 01, pp. 62-68.

[118] European Commission, *Accompanying Document to the Commission Recommendation Concerning The Limitation of the Civil Liability of Statutory Auditors and Audit Firms.*

[119] London Economics, 'Study on the Economic Impact of Auditors Liability Regimes' (2006) < http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf> accessed 24 April 2018 21.

However, the theory is not consistent with the realm of the commercial life. It might lead to the collapse of the audit market. In short, the strict liability for negligence can cause more than good.[120]

A balance must be provided between inadequate deterrence of the legal liability and excessive litigation risk. The legal liability rules must carry these characteristic features: first, they should be able to punish the acquiescent audit and deter an auditor from acquiescent audit; secondly, there should not be an overwhelming level of deterrence.

As a result, the limitation of liability is a necessity for a well-functioning audit market. Otherwise, there could be no auditor to check the financial statements of the companies. However, the limitation should not significantly decrease the deterrence effect of the threat of the legal liability at the same time. The EC published a recommendation[121] as to the limitation of the auditor liability. It seems that the EC tends to limit the auditor's liability to the extent where liability still functions as a deterrent and a lawsuit does not cause a collapse of the audit firms due to the foregoing reasons. Nevertheless, the EC needs to strike a balance between excessive litigation risk and

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[120] Commission of the European Communities, 'The Role, the Position and the Liability of the Statutory Auditor within the European Union' (1996) 198.

[121] Commission Recommendation concerning the limitation of the civil liability of statutory auditors and audit firms [2008] OJL 162/39.

inadequate deterrent for an effective auditing market.[122]

A harmonised legal liability regime does not exist at the EU level; on the contrary, there are various differing legal liability regimes within the EU and primarily it is argued that the regulation of liability issues should be left to the Member States.[123] However, the legal liability regime should be regulated at the EU level for a well-functioning integrated market. There are three alternative ways to balance inadequate litigation risk and excessive litigation risk at the EU level: a fixed monetary cap or a formula to calculate the maximum limit of the liability, proportionate liability and limiting liability by agreement between the auditor and its client.

Capping liability includes two methods: a fixed monetary cap and a method to calculate a cap in cases of lawsuits arising out of breach of duty, excluding intentional breaches.[124]

The first method is the fixed monetary cap at the EU level. However, it would be very difficult for all Member States to set a limit providing fair protection for damaged parties, due to different economic conditions and legal systems within the EU.[125] Liability caps exist in Germany, Austria and Belgium: Belgium implemented €3 million for non-listed companies and €12 million for listed companies; Germany implemented €1 million for non-listed

[122] European Commission (n 120) 198.
[123] European Commission (n 120) 200.
[124] FLORES (n 5) 421.
[125] European Commission (n 118) 31.

companies and €4 million for listed companies and Austria implemented cap ranges of between €2 million and €12 million, depending on the size of the auditors' client.[126] Largely, the cap is seen as being inconsistent with fundamental principles of civil liability.[127] Controversy and injustice are caused by the fact that the damage might not be covered by the cap and the victim would be most likely to turn to officers of the audited company, which would in turn probably increase D&O insurance cost at the EU level.[128] Furthermore, the cap would constitute the extent of damages, regardless of the size of the auditing work or company. If the cap were set too low, that would be an ineffective deterrent for an economically large company, as the cap might well be too far small for this kind of situation. In the case of an excessively high cap, the smaller audit firm might exit the market due to excessive litigation risk. Moreover, it is not stated that the cap constitutes a maximum limit for all claims or each separate claim. In our view, the single monetary cap is not an efficient and effective way to limit liability due to the different economic conditions and legal systems within the EU. It would dilute the deterrent effect of threat of legal liability for a big audited entity,

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[126] European Commission (n 118) p. 37-39.

[127] DORALT (n 117) p. 64.

[128] Insurance and Reinsurance Federation 'CEA Response to the EC Consultation on auditors' liability and its impact on the European Capital Markets' (2007) <http://www.insuranceeurope.eu/uploads/Modules/Publications/position324.pdf> accessed 10 June 2012 at 2.

which more likely pays audit fees above the cap, and fail to enhance the auditor independence or constitute over-deterrent effect for a small audited entity, which pays audit fees significantly below the cap. In short, a fixed monetary cap does not fit all.

The second method is to establish a formula to calculate the maximum limit of the liability. There are several ways to create a formula for capping liability. The first way is to establish a cap based on the company size. Austria applies this method of limitation. Nevertheless, it seems that it is less likely to suit the EU. A method depending on the company size requires a formula to estimate the size of the company. Once again, it is difficult to establish a formula which is applicable in all Member States. The second possibility is the cap based on the audit fees. *Coffee* revises the strict liability due to the foregoing arguments and argues that the maximum limit of the auditor liability should be based on a multiple of the audit fees.[129] According to *Coffee*, 'the gatekeeper's liability would be divorced from any showing of fault, but would also be limited to a level that achieves adequate deterrence without causing the market for gatekeeping services to unravel'.[130] For example, if an auditor receives € 2 million audit fees from a client, it will be liable up to € 20 or 30 million. An example from real life is that *Anderson* received $ 52 million in the last year.[131] *Anderson* would be liable up to $ 520 million. Under this

[129] COFFEE (n 111) p. 69
[130] COFFEE, (n 111) p. 68.
[131] COFFEE, (n 111) p. 68.

system, as the auditor knows the maximum limit of its liability, it could buy insurance to cover potential damages. However, it is not a realistic approach because, as said above, the audit fees are mostly below the costs (low-balling); thus, the limitation could not reach the goal.

As a result, due to the problems of a fixed cap at the EU level or a formula to calculate the maximum limit of liability, it seems that establishing a cap at the EU level is not appropriate for a competitive market and the auditor independence.

The second method is the limitation of the auditor's liability by agreement. It allows the parties to restrict the amount of the liability owed by the auditor to its client. This system has been introduced in the UK by the Companies Act 2006.[132] The UK system allows the parties to introduce the proportionate liability by agreement. The limitation of liability by an agreement is possible in the UK as a result of the *Caparo Industries Plc v Dickman* .[133] In the UK, the limited liability agreements are valid for one year, need to be approved by members at a meeting, and must be 'fair and reasonable'

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[132] Companies Act 2006 (CA 2006), s 532 to 538.

[133] Caparo Industries v. Dickman [1990] 1 All E.R. 568 (H.L.); more recently, in *Moore Stephens v. Stone&Rolls (2009) UK HL 39* case, The House of Lords applied the Capora Rule.

according to circumstances.[134] Hence, the limitation of liability by agreement might achieve the goals of limitation in those legal regimes where the auditors are not liable to third parties as in the UK. On the contrary, since the auditor would continue to be liable to an unlimited extent to third parties outside the contract in other jurisdictions, the limitation of liability might not be effective. In addition, where concentrated ownership exists, the limitation by agreement could be abused by holding shareholders. Thus, the limitation by agreement does not seem the correct solution for the balance.

The third method is the proportionate liability which stipulates that an auditor is not liable beyond its contribution to the loss suffered by victims.[135] In fact, it is not a limitation of liability since, under this regime, an auditor is still liable for the damages to the extent of its contribution to the loss.[136] Thus, the auditor would be no longer liable for the whole amount of damages suffered by victims. It is argued that the proportionate liability reduces the deterrent effect of the litigation. However, the opponents of the proportionate liability ignore the fact that proportionate liability does not limit the damages caused by the auditor. It merely limits auditor liability to the extent of the auditor's negligence.[137] Thus, it provides an adequate incentive for the auditor to

[134] DAVIES, Paul/ RICKFORD, Jonathan, 'An Introduction to the New UK Companies Act: Part II', **European Company and Financial Law Review**, 2008, Vol. 3, p. 258.
[135] European Commission (n 120) p. 204.
[136] FLORES (n 5) p. 424.
[137] European Commission (n 120) 204.

enhance its independence. Despite the fact that the duty of care to the client is mostly recognised in the Member States, the duty of care to the third party varies greatly among the Member States. For example, in the UK, the auditor does not owe a duty of care to third parties unless there are special circumstances.[138] The House of Lords concluded that in order for the auditor to owe a duty of care to a third party, the plaintiff must demonstrate that the auditor is aware of the fact that the report will be used by him (i.e special relationship must be established). Thus, it is almost impossible for a third party to bring a successful claim under the common law system. It is worth noting that the decision does not provide an incentive for the auditor to improve audit quality and enhance the independence of the auditor and ignores the role of auditors against the public at large. The EU must set out the rules of third-party claims against the statutory auditor in order to achieve the auditor independence at the EU level. The rules shall require an auditor to owe a duty of care to third parties who have relied on the audit reports. This does not lead to indeterminate consequences because the auditor would be liable only if he had acted negligently. From another perspective, a manufacturer is expected to owe a duty of care to each consumer.[139] Why would an

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[138] *Caparo Industries Plc v Dickman* [1990] 2 A. C. 605, H.L.

[139] COUSIN, Jim/ MITCHELL, Austin/ SIKKA, Prem 'Auditor Liability: The Other Side of the Debate' **Critical Perspective on Accounting**, 1999, Vol. 10, p. 305.

auditor be different? Otherwise, the auditor liability will mainly be possible for its client. In this case, it does not provide enough incentives for auditors because the managers of the company would primarily be able to bring an action against the auditor and they would mostly not prefer this option due to the relation between them and the auditor. Further, another point which should be mentioned is the viewpoint of the insurers. The concerns of insurers are not satisfied in terms of predictability and amount of the claims,[140] as under that system the amount of liability is not known prior to the court decision or settlement. However, insurance companies are able to determine their insurance policies by investigating the history of each auditing firm, as in other sectors such as car or life insurance.

In negligence-based systems, the burden of proof is on the plaintiff. Therefore, since the plaintiff has to prove the negligence of the auditor, the number of cases brought against auditors will decrease and frivolous litigation risk will be minimised.[141] Since the auditing service is extremely technical, the conduct of the auditor must be analysed and penalised commensurate with its negligence, so as to prevent auditors voluntarily declining their engagement when they feel they will be under heavier litigation risk.[142] Moreover, the proportional liability protects the auditor in the event of insolvency of

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[140] European Commission (n 118) p. 32.
[141] FLORES (n 5) p. 425.
[142] KRISHAN, Jagan/ KRISHAN, Jayanthi 'Litigation Risk and Auditor Resignations' **The Accounting Review,** 1997, Vol. 72, pp. 539-560, p. 558.

other defendants, since in unlimited liability regimes, the auditor has to provide compensation in the entire amount of damages, regardless of its own degree of negligence, in the event of the insolvency of other debtors. From this perspective, the proportionate regime creates fairness.[143] It also limits deep pocket syndrome. Furthermore, the auditor is still liable to the plaintiffs in its full assets; thus, it ensures the significant level of deterrence and provides incentives for the auditor to retain its independence.

Since the proportionate liability system mitigates the negative effects of joint and several liability and still provides the deterrent effect for the auditor, it seems that proportionate liability is the best way to strike a balance between the needs of the auditing market and the interests of investors. This method has two clear advantages: First, it provides adequate threat of legal liability because the liability of the auditor is not limited to a fixed cap, but it is limited to the extent of the auditor's own negligence in the failure. Secondly, it does prevent and balance the excessive and frivolous litigations. The proportionate liability mitigates the negative effects of joint and several liability and it still provides the deterrent effect for the auditor and enhances the auditor independence at the EU level. Nevertheless, the third-party claims should be regulated in the Directive. Otherwise, if discretion

[143] FLORES (n 5) p. 426.

is recognised to national courts, the deterrent effect of legal liability could significantly be diluted at the EU level. Under this system, it is reasonable to require an auditor to owe a duty of care to third parties because it will be liable only if it is negligent. Moreover, the view that allows third party claims against the auditor fits the public role of auditors.

IV- CONCLUSION

It has been clearly demonstrated above how serious and all-pervading the problem of achieving total auditor independence is, as there are so many human and psychological factors militating against this and working in the opposite direction. There has always been a challenge to the independence of the auditor from the basic fact that an auditing firm is appointed and dismissed by the companies that it audits. This alone creates a situation where pressure can potentially be brought to bear on the auditor to acquiesce in the manipulation of audit reports to make the company look healthier than it is, or at least to be insufficiently sceptical about the information under review. The possibility of profitable consultancy work being available to the auditing firm from the company is an added incentive.

There was a loss of equilibrium in which the scales tipped towards acquiescence as the more beneficial course for an auditing firm to take; the consulting divisions of the auditing firms became more powerful and the statutory auditing teams found themselves under pressure to do whatever was necessary to increase the flow of business from the client company. A further element that added to this imbalance was the existence of long-term contracts, during which auditors became over-familiar with the client company and over-sympathetic to its interests.

The Regulation of 2014 and the Directive of 2014 seek to regulate and restrict the length of audit contracts, the audit fees, and the provision of NASs to audited companies on the basis of conflict of interest. These reforms enhance the auditor independence at the EU level and rebalance the incentive equilibrium of auditor independence. Therefore, it is hard to see how further 'Enron-type' disasters could recur in the future. However, there is also a need to harmonise legal liability so that auditors can be held to account without the existence of the firm being threatened.

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