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INDEPENDENT AUDIT FIRM RELIABILITY IN TURKEY: A RESEARCH ON CMB SANCTIONS

Abstract

The foundation of sound capital markets lies with effective and independent auditing mechanisms. Without properly working auditors it is not possible to ensure a fraud-free corporation. Thus, tighter regulations have become the target for fraud prevention by regulators, beginning with the Sarbanes – Oxley Act (SOX) coming into effect in 2002. As an emerging market, Turkey has followed the SOX example and updated regulations and audited the audit firms accordingly since. This paper aims to show the differences between audit companies that abide the rules and the audit companies that do not abide the rules. Mann – Whitney U test is applied to data of sanctioned audit firms between 2008 and 2017 gathered from Capital Markets Board of Turkey (CMB), and audit firms are compared according to their number of clients, the number of employed auditors and ownership type. Analysis results indicate a significant difference between sanctioned audit companies and auditor and client numbers. However, ownership is found not significant.

Keywords: *regulation, independent audit, corporate fraud*

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TÜRKİYE’DE BAĞIMSIZ DENETİM FİRMALARININ GÜVENİRLİĞİ: SPK CEZALARI ÜZERİNE BİR İNCELEME

Öz

Sağlıklı işleyen sermaye piyasalarının temelinde etkin ve bağımsız denetim mekanizmaları yer almaktadır. Beklendiği gibi çalışmayan denetçiler olmadan hileden arınmış bir kurumsal yapı için garanti verilmesi mümkün değildir. Bu sebeple, düzenleyici kuruluşların hile önlemede hedefi 2002’de yürürlüğe giren Sarbanes – Oxley Yasası (SOX) ile başlayan daha sıkı yasal düzenlemeler gerçekleştirme hedefidir. Gelişmekte olan bir ülke olarak Türkiye’de SOX örneğini takip ederek yasal düzenlemelerini güncellemiş ve denetim firmalarına bu doğrultuda denetlemiştir. Bu makalenin amacı, düzenlemelere uyan denetim firmaları ile uymayanlar arasındaki farkı ortaya koymaktır. Bu amaçla, Sermaye Piyasası Kurulu (SPK) tarafından 2008 – 2017 yılları arasında ceza verilen denetim firmalarına ait verilere Mann – Whitney U testi uygulanmış ve denetim firmaları müşteri sayıları, çalıştırılan denetçi sayıları ve ortaklık yapısına göre mukayese edilmişlerdir. Analiz sonuçlarına göre, ceza alan denetim firmaları ile ceza almayan firmalar arasında, denetçi ve müşteri sayıları bakımından istatistiksel olarak anlamlı bir fark bulunmakta iken, ortaklık yapısına ilişkin istatistiksel olarak anlamlı bir sonuç bulunmamıştır.

Anahtar Sözcükler: *regülasyon, bağımsız denetim, kurumsal hile*

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Introduction

There has been a flurry of corporate scandals from the 1990s to present day, and these scandals have greatly undermined the trust of investors and the public in capital markets. To protect capital markets and prevent fraud related losses from rising, regulators swiftly imposed stricter rules under new legislation such as Sarbanes – Oxley Act (SOX) in 2002 (Deng, Melumad and Shibano, 2012). EU has promoted similar regulations in 2006 and majority of developing nations also embraced this new trend in legislation.

Since 2002 regulators have been auditing corporations and audit firms according to the new stricter legislation and imposing sanctions and taking legal action where necessary. The researcher suggests that the sanctions imposed by regulators to audit firms can be a sign of audit firm reliability. In other words, the audit firms that are sanctioned by the regulator are not as reliable as the remaining audit companies.

This paper aims to show the differences between audit companies that abide the rules and the audit companies that do not abide the rules in Turkey. Since Capital Markets Board of Turkey (CMB) is the regulatory authority in Turkish capital market, regulating auditors that audit publicly held corporations fall under CMB's responsibility. Thus, CMB sanctions about audit firms are investigated to point out the difference between reputable audit firms and unreliable audit firms by analyzing their number of clients, the number of employed auditors and ownership type.

The analysis results paint an outstanding picture concerning the benefits of increased regulation. Furthermore, the lack of studies concerning the consequences of regulation on companies and capital market enhances the importance of this article.

1. Literature Review

1.1. Importance of Reliability as a Concept in Audit

Enron scandal has been a turning point, because the outcome of the scandal forced the public, investors, regulators and all other related stakeholders to question auditor reliability (Aslan, 2014; Kandemir and Kandemir, 2012; Giroux, 2008). Even though auditors try to defend their profession by stating that independent auditors are not entirely responsible for detecting fraud – at least not responsible like a fraud expert – (Birke, 2004), it is a universally acknowledged fact that one of the main responsibilities of independent auditors is fraud detection (AICPA, www.aicpa.org). The public also believed that auditors were responsible for the spike in the cost of fraud and put pressure on regulators for immediate action (Biegelman and Bartow, 2006).

According to AICPA independent audit process is defined as “the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles” (AS 1001, www.aicpa.org). The auditor needs to be objective to provide assurance of reliable financial reporting.

The classic approach to competency in independent audit services is to ensure the independence of auditors. However, this is not a very solid foundation since corporations pay independent auditors because there is a contractual relationship between audit firms and corporations. Audit firms are not charity organizations, and their main objective is to maximize shareholder wealth like any other company. Thus, auditors cannot be considered as entirely independent.

In 2003 Taylor et al. proposed a new concept to evaluate auditors. This new concept is reliability or ‘Auditor Reliability Framework’ in the researchers’ own words, and it consists of ‘expertise, objectivity, independence and integrity.’ Integrity can be defined as “the quality of being honest and having strong moral principles that you refuse to change” according to Cambridge Dictionary (dictionary.cambridge.org). Integrity is an important quality that auditors need to embrace, in order to perform according to standards and public expectations.

Comparison of audit firms according to their sanctions is in a sense a measure of auditors’ integrity, which is the main objective of this paper. Audit firms that receive sanctions from CMB are deemed as lacking integrity. This research tries to answer the following question in this light: ‘Is there a difference between audit firms that have integrity and audit firms that do not?’ Sanctions of regulators seem to leave a permanent mark in auditors’ careers. Thus such penalties are taken quite seriously by the market. This effect is echoed in self – disciplinary actions as well (Armitage and Moriarity, 2016).

Although fraud cannot be entirely diminished, the cost of fraud has globally dropped after SOX, and other related regulation came into effect. There is a decrease of approximately \$2.9 billion according to ACFE (www.acfe.com).

1.2. Hypotheses

H₁: There is a difference between CMB sanctioned audit firms and non-sanctioned audit firms concerning the number of auditors employed.

H₂: There is a difference between CMB sanctioned audit firms and non-sanctioned audit firms concerning the number of clients.

H₃: There is a difference between CMB sanctioned audit firms and non-sanctioned audit firms concerning ownership type.

2. Do Regulators Find Independent Audit Firms Reliable?

2.1. Data and Methodology

In Turkey, Capital Markets Board of Turkey (CMB) has the authority to audit accounting companies that are auditing publicly held corporations. There are 240 independent audit firms established in Turkey, according to Public Oversight, Accounting & Auditing Standards Authority (POA). CMB has authorized 101 establishments out of these audit firms to audit publicly held corporations (www.cmb.gov.tr).

Data that belongs to these 101 audit firms between January 2008 and May 2017 are gathered from the CMB’s website, including the frequency of fines imposed by CMB. There are four variables investigated in this paper, and these are “Fines,” “Ownership,” “Number of Auditors” and “Number of Clients.” Since the fine frequency is not consecutive, “Fines” is constructed as a dummy variable and it takes the value of 0 if the audit firm is not fined during the period between 2008 and 2017 and vice versa. “Number of Auditors” and “Number of Clients” are in ratio scale and present real numbers. “Ownership” variable takes the value of 1 if the audit firm has a license agreement with a foreign audit firm and if not the variable takes the value of 2.

Mann-Whitney U test is applied to data because of nonnormal distribution and nominal scale variables.

2.2. Descriptive Analysis

According to CMB, all Big Four accounting firms (Pricewaterhouse Coopers, Deloitte Touche Tohmatsu International, KPMG, Ernst&Young Global Limited) are present in Turkey. Table 1 shows that while small in number (4%), they certainly take up a crucial part of the sector. Big Four Audit Firms have a market share of 58% combined. Other International Licensed Audit Firms take up 56% of the industry while having a 35% of the market share. Finally, local companies take up 40% of the industry, on the contrary, they only have 7% market share.

Table 1. Number of Accounting Firms Active in Turkey

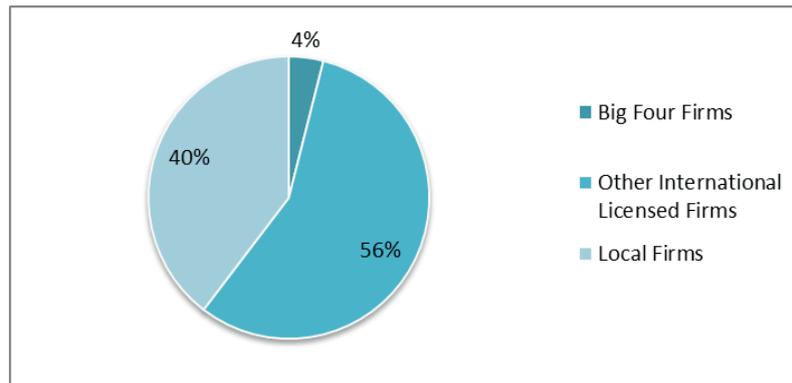
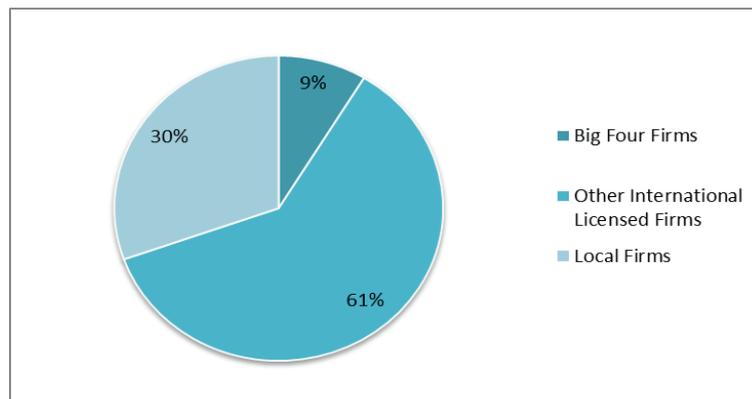


Table 2 shows that although Big Four accounting firms have the majority of customers, their sanction frequency is quite small when compared to other enterprises. International licensed firms have the majority of the sanctions of CMB. However, local companies have more sanctions per customer.

Table 2. CMB Fine Frequency



According to descriptive analysis results shown in Table 3, the minimum number of auditors employed by an audit firm is 1, while the maximum number is 392. There a total of 2832 auditors employed and the average firm has 28 auditors, although the standard deviation is quite high. This variable has a positively skewed and a very peaked distribution.

The minimum number of clients equals 0, and the maximum number of customers an audit firm has is 93. The total number of audited firms equals 502, and five publicly held corporations per audit firm are the average.

The majority of the audit firms do not have a license agreement with a foreign audit firm, and there are 17 sanctions awarded during the investigated period, which is a small number when compared to other regulators.

Table 3. Descriptive Statistics

	N	Min.	Max.	Sum	Mean	Std. Deviation	Variance	Skewness		Kurtosis	
	Statistic	Stats.	Stats.	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
Firm Ownership	101	1	2	141	1,40	,492	,242	,432	,240	-1,851	,476
Number of Auditors Employed	101	1	392	2832	28,04	71,748	5147,778	4,565	,240	19,969	,476
Number of Clients	101	0	93	502	4,97	14,602	213,229	4,602	,240	21,635	,476
Fined companies	101	0	1	17	,17	,376	,141	1,800	,240	1,264	,476
Valid N (listwise)	101										

2.3. Correlation Analysis Results

Mann-Whitney U test results are presented in Tables 4 and 5 below. The grouping variable is “Fines,” and audit firms are grouped and compared according to the presence of CMB sanctions. According to Table 4, the mean rank of companies with penalties for “Number of Auditors” equals approximately 48 and companies without sanctions’ average rank is approximately 67. For “Number of Clients” ranks are approximately 48 and 68; for “Ownership” ranks are approximately 53 and 43 respectively.

Data suggest that regulations indeed have managed to decrease the number of fraud cases and big four firms have significantly improved their practices by following auditing standards and increasing the quality of audits. However, when global regulators’ sanctions are taken into account, it is possible to question this outcome. Are Turkish auditors that rigorous about their work or is it simply a question of inadequate controlling? The researcher suspects that this is due to limited audit missions CMB can perform, and not because of the work ethics of audit firms in question. However, as reported in Table 5, “Number of Auditors Employed” and “Number of Clients” indicate a significant difference between the two groups of audit firms. Accordingly, companies that employ a greater number of auditors are prone to be subject to sanctions. Also, audit firms that have more clients or market share show a tendency to receive a fine from CMB. On the other hand, “Ownership” does not have a significant difference between the groups.

As a result, null hypotheses for H_1 and H_2 are rejected; however null hypothesis for H_3 is not rejected.

Table 4. Ranks

	Fined companies	N	Mean Rank	Sum of Ranks
Number of Auditors Employed	0	84	47,83	4018,00
	1	17	66,65	1133,00
	Total	101		
Number of Clients	0	84	47,58	3996,50
	1	17	67,91	1154,50
	Total	101		
Firm Ownership	0	84	52,64	4422,00
	1	17	42,88	729,00
	Total	101		

Table 5. Test Statistics^a

	Number of Auditors Employed	Number of Clients	Firm Ownership
Mann-Whitney U	448,000	426,500	576,000
Wilcoxon W	4018,000	3996,500	729,000
Z	-2,419	-2,714	-1,479
Asymp. Sig. (2-tailed)	,016	,007	,139

a. Grouping Variable: Fined companies

3. Discussion and Recommendations

Increased regulation in capital markets has become a global trend and rightly so, because of the tremendous cost of corporate fraud endured in the last two decades. Even though SOX was criticized for being rushed, the drop in fraud cost explains the necessity of increased regulation for sound capital markets.

Reliability of independent auditors is investigated in this context to discover a significant difference between audit firms that are sanctioned by CMB and audit firms that are not sanctioned. Research results suggest that bigger audit firms are more liable to receive sanctions. However, there is a major limitation concerning research data. Inadequate controlling of audit firms by regulators makes it probable to affect the results.

In order to overcome the corporate fraudsters, regulators need to put more emphasis on loopholes in the regulation and define all gray areas carefully. Thus, a sound economy with institutionalized corporations can function properly to the future.

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