Part I. Approaches to the critique of auditing

Chapter 1. Governance and accountability: a legal approach to auditing

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Abstract

This chapter examines the legal context of company auditing from the perspective of the Australian legal setting for public company audits.[1] It outlines the recent history of legislative review and reform, describes the current legal setting – as set out in legislation and court decisions – for company audits and auditor liability, and investigates the debates concerning auditor independence and the limitation of auditor liability.

Introduction

The legal regulation of company audits in Australia has come under significant scrutiny in the past three years, prompted by some significant corporate collapses in 2001, most notably HIH Insurance (which led to an inquiry by a Royal Commission) and One.Tel. In the wake of these events, there were four major and separately conducted reviews of the legislative framework governing auditors and audit work. These reviews culminated in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2003* (Cwlth).

The first of these reviews commenced in August 2001, when the Federal Minister for Financial Services commissioned Professor Ian Ramsay to review the requirements for the independence of auditors and audits, the findings of which were published in October that year (Ramsay 2001). In addition to the impetus supplied by the recent company failures, the review was also prompted by a perception that overseas developments on auditor independence had moved ahead of the Australian requirements (Ramsay 2001, p. 6). Six months later, in April 2002, the Federal Parliament's Joint Standing Committee on Public Accounts and Audit commenced its own review of independent auditing, reporting in August of that year (JSCPAA 2002). This was the first time that the Committee had undertaken an inquiry into private-sector audit issues (JSCPAA 2002, p. *vi*). Then, in June 2002, the Federal Treasurer announced a review of audit regulation as part of the government's Corporate Law Economic Reform Program. The outcome of

[1] This chapter is based on, but develops material in, Tomasic, Bottomley and McQueen (2002), Chapter 7.

that review (known colloquially as 'CLERP 9')[2] was published in September 2002 (CLERP 2002). Finally, the three-volume report of the HIH Royal Commission was published in September 2003, containing, as part of its broad inquiry into the HIH collapse, a review of and reform proposals for auditor independence, audit reports and audit committees (HIH Royal Commission 2003). Each of these reports was factored into the drafting of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cwlth), which was introduced into Parliament in December 2003. The Bill was debated and amended in Parliament, and was assented to on 30 June 2004. The resulting Act made significant changes to many aspects of the Corporations Act. Most notably these include to the law relating to the conduct of audits, to the appointment and independence of auditors, and to company financial reporting requirements.

The audit requirement

It has long been a basic statutory requirement that a company must have its annual financial report audited and must obtain an auditor's report about the conduct of the audit. Currently, this requirement is found in s. 301 of the *Corporations Act 2001* (Cwlth).[3] This requirement has been imposed since the earliest Australian company law statutes. The first Australian companies legislation to include mandatory financial reporting requirements, the *Companies Act 1896* (Vic), was enacted 'in the wake of large-scale company losses, land fraud, and bank and building society failures' (Peirson & Ramsay 1983, p. 288). Section 28(1) of that Act stated that:

> No balance-sheet of any company shall deemed to be filed … unless the same shall have subscribed thereto or indorsed thereon a certificate signed by the duly appointed auditors that such auditors have audited the same and have certified to the correctness or otherwise of the said balance-sheet.

Before outlining the current legal requirements for company audits, it is useful to examine some of the rationales that have been provided for these mandatory audit rules over the past 100 years.

Rationales for the audit requirement

The mandatory audit requirement must be understood against the underlying requirements about the public disclosure by companies of their financial affairs. Mandatory public financial reporting was introduced in the United Kingdom by the Joint Stock Companies Act in 1844. Whilst these requirements were de-

[2]This was the ninth report published by the Program.
[3]Similar requirements apply elsewhere; for example, see the Companies Act, s. 9, in the United Kingdom, and the Canada Business Corporations Act, ss. 155 and 169. In Australia, the audit requirement also applies to other corporate entities such as managed investment schemes. It does not apply to small proprietary companies unless this is required by at least 5% of the voting shareholders (Corporations Act, s. 293).

emphasised in the subsequent Companies Act 1862, they have since formed a major part of modern corporate legislation and corporate regulation. At the time, these requirements were prompted by concerns over the incidence of corporate fraud. The rationale for these requirements was summed up (some 70 years later) in Mr Justice Brandeis' famous aphorism that 'sunlight is the best disinfectant, electric light the best policeman' (Brandeis 1913, cited in Weiss 1979, p. 575). This concern about the importance of protecting investors from financial fraud has persisted as one of two interwoven rationales for mandatory financial audits. It is premised on ideas of investor susceptibility and lack of expertise. The assumption is that potential victims of corporate misconduct will be able to take note of this publicly available and professionally verified information, and take appropriate steps to protect themselves, or to seek their own remedies.

The second rationale is that audits promote confidence and empower investors to make rational and informed financial decisions. This policy was described by Street CJ in Eq in *re Castlereagh Securities Ltd* ([1973] 1 NSWLR 624, p. 638) in the following way:

> A sound share market and the ability of shareholders to reach reliable conclusions are dependent upon shareholders, brokers and financial experts having access to full and reliable information concerning the affairs of companies. The courts do not, and directors should not, yield to the laconism that the only financial information most shareholders want is the figure on their dividend cheques. It is the clearly discernible intention of the companies legislation that companies should make adequate disclosures to enable shareholders individually, and the market collectively, to reach informed judgments. Over value and under value are both obnoxious. Where authentic details are not forthcoming, inference and even speculation inevitably take over. Decisions based on gossip or on inside information are concomitants of an unhealthy market.

Economic theory has also emphasised this argument. For example, audits are said to 'improve the reliability of financial statements, make them more credible and increase shareholders' confidence in them' (Panel on Audit Effectiveness 2000, cited in Ramsay 2001, para. 4.01). In this way audits are said to 'add value' to the financial statements and to the capital markets in general (Ramsay 2001, para. 4.02). The statutory requirement for an audit is then said to reinforce these credibility-enhancing and value-adding functions, providing an independent third party who can verify the financial information produced by a company. In theory, this reduces the costs that users of that information would otherwise incur if they had to verify it themselves. Auditors thus serve as 'reputational intermediaries', assisting the efficient operation of the market for corporate information (Corbett 1994, p. 850, referring to Gilson & Kraakman 1984).

A different justification for the mandatory imposition of audit requirements can be found in the 'concession' theory of company incorporation. According to this theory, the grant by the State of independent legal status to a company creates a private actor with special powers and capacities (for example, the company's capacity to issue shares and to enter into contracts). This special status is therefore said to carry certain obligations.[4] On this view, the requirement that a company should publicly disclose its financial affairs on a regular basis and be subject to an audit is the quid pro quo for the grant of incorporation by the State. On this view, when an auditor is engaged to meet the company's statutory audit requirement, they can thus be said to be performing a dual function. The first function may be described as 'private'. It arises from the contractual relationship between the auditor and the company. This contract imposes various duties on the auditor, which are discussed later in this chapter. Breach of these duties may result in an action for damages brought by the company against the auditor. Secondly, there is a more public function. The companies legislation not only requires that an auditor should report to the company about its financial statements, but also that this report should become part of the public record about the company. Moreover, while they are conducting the audit and reporting to the company, the auditor is under a number of *statutory* obligations which cannot be contractually modified. The auditor is prohibited by the statute from contracting out of any liability for breach of their duties to the company (Corporations Act, s. 199A). Furthermore (as noted below), an auditor is required to inform the Australian Securities and Investments Commission (ASIC, the regulator responsible for enforcing the Corporations Act) if the auditor suspects a contravention of the Act has occurred. In this sense, the audit is part of the wider public system of corporate regulation. There is, clearly, a tension between these private and public roles which is most evident when considering the question of an auditor's liability to persons outside the contractual relationship (a topic dealt with later in this chapter).

The auditor's appointment and removal

The following discussion focuses on the audit obligations of public companies. A public company is required to appoint an auditor (ss. 327A & B). Following the CLERP 9 reforms, the auditor may be either an individual, a firm or a company (s. 324AA).[5] This requirement first applies within one month after a company has been registered, and this initial appointment must be made by the directors. The auditor who is appointed at this time holds office until the first annual general meeting of the company (s. 327A(2)). At that meeting the company,

[4]There is disagreement about the contemporary relevance of concession theory, given the relative ease with which companies can now be registered. For a discussion, see Bottomley (1999).
[5]As discussed later, CLERP 9 introduced the possibility that an audit firm may incorporate as a company (Corporations Act, Pt 9.2A).

acting through its voting members, is required to appoint an auditor who will hold office until either death, removal from office, resignation, incapacity by reason of lacking the relevant qualifications, or because of a 'conflict of interest situation' (ss. 327B(2)-(2C)).[6]

Two features of these requirements are worth emphasising. First, in the absence of any disqualifying factor, the auditor holds office indefinitely, not for a fixed term. One qualification to this is found in the new provisions (introduced by CLERP 9) concerning audit rotation for companies listed on a stock exchange. If an individual plays a significant role[7] in the audits of a listed company for five successive years, then they cannot play a significant role in the audit of that company for another two years (s. 324DA). Thus, if the company has appointed an *individual* as its auditor, a new auditor must be found at the end of the five-year period. But, on the other hand, if the auditor is a firm or company, and the lead or review auditor[8] has played a significant role in audits for the past five successive years, then the firm or company may continue to act as auditor, provided that it uses another person in the lead or review capacity (ss. 324DC & DD).

Secondly, in formal terms, the appointment of the auditor is a decision that is made by the members of the company, rather than its directors. Indeed, the Act requires that before the annual general meeting, the auditor must be nominated by a member (s. 328B). This underlines the theory that the auditor is part of a process whereby members are able to monitor the performance of the directors and managers of the company. Of course, in practice the board has a significant degree of influence on the selection and appointment of the auditor. The members will usually make their decision by following the recommendation put to them by the board.

The auditor's formal accountability to the members is also emphasised by the fact that an auditor may only be removed from office by a resolution passed at a general meeting, initiated by the directors or members of a company (s. 329). ASIC has indicated its view that this section 'is designed to protect the auditor from manipulation by directors and to protect members of the company from an auditor who wishes to resign rather than conclude an audit which is proving difficult or controversial' (ASIC 1992, para. 2). Notwithstanding the obvious purpose of this section, it is rarely used. For example, a study of the annual general meetings of 271 Australian listed companies found that the removal of the auditor had not been an agenda item in any of the meetings held between 2001 and 2003 (Bottomley 2003, p. 36).

[6]'Conflict of interest situations' are discussed later in this chapter.
[7]A person 'plays a significant role' if they are appointed and act as the auditor or prepare the audit report for the company, or if they are the lead or review auditor for a firm or company that is appointed as auditor (s. 9).
[8]The lead auditor is the person in the firm or company who is primarily responsible for the conduct of the audit. The review auditor is the person who is primarily responsible for reviewing the conduct of the audit (s. 324AF).

Statutory functions of the auditor

The statutory function of an auditor is to provide an independent and expert assessment of the annual and half-yearly financial reports prepared by a company, and to prepare a report to the company's members.[9] The statutory framework for company audits is narrowly defined. First, it does not extend to audits outside the annual and half-yearly timetable. A company may choose to undergo an audit outside of this framework (for example, in preparation for a potential takeover defence).[10] Second, within the framework of annual or half-yearly audits, as Fogarty and Lansley point out, the auditor's role 'is restricted to commenting on historic financial statements produced by the company twice-yearly: … it does not extend into arguably the most important area of disclosure – continuous disclosure' (Fogarty & Lansley 2002, p. 412). Nor does the audit involve any assessment of 'the prudence of business decisions made by management' (Ford, Austin & Ramsay 2003, p. 521). And third, the statutory framework does not regulate non-audit work performed by auditors. The CLERP 9 reforms did not impose any prohibition or restriction on the supply of non-audit services by auditors to audit clients. Instead, amendments to s. 300 simply require the directors of a listed company to include in the company's annual report a statement that describes the dollar amount paid to the auditor for non-audit services during the year, to state whether the directors are satisfied that the provision of those services is compatible with the general standard of independence for auditors, and to explain the reasons why the directors are satisfied about this (s. 300(11B)). This contrasts with the position in the United States, where the Sarbanes-Oxley Act of 2002 prohibits auditors from providing certain non-audit services contemporaneously with the audit (see s. 201).

Looking at the statutory functions in more detail, when conducting the audit of a company's annual or half-yearly financial report, the auditor is required to:

- form an opinion about whether the financial report complies with the Corporations Act and with the applicable accounting standards, and gives a true and fair view of the company's financial position. The auditor must then report to the members about the opinion they have formed.[11] If the auditor forms the opinion that the financial report does not satisfy any of these requirements, then the auditor's report must state why (ss. 307(a), 308(1) & (2))
- form an opinion about whether:
    - the auditor has been given all information, explanations and assistance that is necessary for the conduct of the audit

[9]Half-yearly reports may be reviewed by the auditor, rather than being fully audited (ss. 302(b) & 309(3)).
[10]As occurred in the case of *AWA v. Daniels* (1993) 9 ACSR 383, discussed elsewhere in this chapter.
[11]The requirement to report to the members is a strict liability offence (s. 308(5)).

- sufficient financial records and registers have been kept by the company to enable a financial report to be prepared and audited
- other records and registers required by the Corporations Act have been kept (ss. 307(b)-(d)).

These requirements that the auditor must 'form an opinion' reflect the common law requirement which, as we will see, says that auditors should conduct their audits actively, rather than relying passively on information supplied by company officers and employees. In addition to these 'opinion forming' requirements, the auditor must also:

- conduct the audit in accordance with the auditing standards that are made by the Auditing and Assurance Standards Board (s. 307A). This requirement was introduced by the CLERP 9 reforms; its intention is to give legislative backing to the auditing standards (CLERP 2002, p. 27)
- give the directors of the company a declaration that the auditor has not contravened the auditor independence requirements in relation to the audit (s. 307C, introduced by CLERP 9: the auditor independence requirements are discussed later)
- report on and describe any defect or irregularity in the company's financial report, including any 'deficiency, failure or shortcoming' relating to the corporation's financial records, other records and registers, and information given to the auditor (s. 308(3)). The company has a right to sue for damages as a result of a breach by the auditors of this duty (*AWA Ltd v. Daniels* (1993) 9 ACSR 383, p. 386)
- notify ASIC if the auditor has reasonable grounds to suspect that there has been a contravention of the Act that is either significant or is one that cannot be adequately dealt with in the auditor's report or by bringing it to the attention of the directors. As a consequence of the CLERP 9 amendments, the auditor must also notify ASIC of any attempt to unduly influence, coerce, manipulate, mislead or otherwise interfere with the conduct of the audit (s. 311).[12]

Statutory powers

To discharge their statutory audit and reporting requirements, the auditor has certain powers and entitlements under the Corporations Act.

The auditor has a right of access to the books of the company, and may require any company officer to provide such information, explanations or assistance as the auditor needs for the purposes of the audit (s. 310). For their part, company officers are under a positive obligation to allow the auditor access to the books

[12]This CLERP 9 proposal was criticised by peak accounting bodies because of its possible impact on relations between auditors and their audit clients; see *Butterworths Corporation Law Bulletin* (2004), 7 [202].

(including registers and general documents) and to give the auditor any information, explanation or assistance which is required (s. 312).

In an unlisted company the auditor is *entitled* to attend the general meeting and to be heard on matters concerning the audit (s. 249V). If the auditor does attend the AGM then the members must be given a reasonable opportunity to question the auditor about the conduct of the audit, the preparation of the audit report, the accounting policies used by the company in preparing its financial statements, and the independence of the auditor (s. 250T). As a result of the CLERP 9 reforms, the situation for listed companies is different. In this type of company members have the right to submit written questions to the auditor prior to the AGM (s. 250PA). Moreover, the auditor of a listed company is *required* to attend or be represented at the company's AGM (s. 250RA). The impact of this mandatory attendance requirement will be slight. The study of 271 AGMs referred to earlier found that auditors already attended the AGM in 94% of cases. Having said that, the study also suggests that this attendance has frequently been symbolic rather than functional: the study suggests that most questions directed to the audit report will be answered by the chair of the meeting instead of the auditor, and that auditors rarely speak at meetings (Bottomley 2003, pp. 31-2).

Contract and tort duties and liabilities

In addition to statutory requirements, auditors must also comply with duties imposed by the common law concerning the conduct of the audit and the detection of malpractice. These duties are based in the tort of professional negligence, arising from the relationship between the auditor and anyone to whom the auditor owes a duty of care, and also in contract, arising from the engagement contract with the company.

Duties to the company

The basic duty of an auditor when conducting an audit is to use a reasonable degree of skill and care. The parameters of this duty were first set out in the late 19th century in a series of cases culminating in *re Kingston Cotton Mill Co (No 2)* ([1896] 2 Ch 279). In that case, Lopes LJ used what became a frequently invoked metaphor, stating that the auditor's role was to act as 'a watch-dog, but not a blood-hound'. This meant that:

> ... [the auditor] is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful ([1896] 2 Ch 279, pp. 288-9).

During the 20th century, however, the courts gradually moved away from this image of the auditor as an alert but passive watch-dog. As Moffitt J put it in 1970 in the landmark case of *Pacific Acceptance Corporation Ltd v. Forsyth*:

> Since the classic statements concerning the auditors were made last century there have been considerable changes in the organisation of the affairs of companies either operating singly or as groups, in their merger or takeover and in their accounting systems, and there have been continuing and increasing experience of and notoriety of danger signs in respect of mismanagement, fraudulent or otherwise, of companies often brought to light by "economic squeezes" as they are termed ((1970) 92 WN (NSW) 29, p. 73).

Justice Moffitt's judgment contains a lengthy and sustained analysis of the auditor's duty of skill and care in the conduct of a company audit. The case involved an action by a company against its auditors, alleging negligence arising from a breach of contractual duty. In finding for the company, Justice Moffitt acknowledged that 'auditors are not insurers' – that is, they are not expected to detect any and all errors and fraud that may occur in company financial statements.[13] Nevertheless, he held that in planning and carrying out a company audit, the auditor 'must pay due regard to the possibility of error or fraud' ((1970) 92 WN (NSW) 29, p. 63). The auditor's duty is to go behind the company's books and determine the true financial position of the company ((1970) 92 WN (NSW) 29, p. 63). This means that the auditor must design and carry out procedures which have a reasonable expectation of detecting 'a substantial or material error or fraud' in the company's affairs ((1970) 92 WN (NSW) 29, p. 65). The auditor will design those procedures by drawing on his or her previous experience of how fraud and error are likely to be hidden in corporate financial statements. The implementation of the audit program requires that the auditor must personally check and examine these matters. In particular:

> … if the existence of a document which is under the control of the company is material to the audit, it is the duty of the auditor acting reasonably to examine the document for himself unless there are some specific circumstances which make it reasonable to accept something less than proof by inspection ((1970) 92 WN (NSW) 29, p. 70).

In contrast to the approach taken in the *Kingston Cotton Mills Case*, Moffitt J held that an auditor does not comply with the standard of reasonable skill and care by simply relying on the assumption that company directors and officers have fulfilled their respective duties to the company. Thus, the auditor is required to make inquiries at the appropriate level. The auditor may rely on the corpora-

[13](1970) 92 WN (NSW) 29, p. 60, citing Lindley LJ in *re Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279, p. 284.

tion's system of internal control, but only after it has been appraised, its strengths and weaknesses have been ascertained, and it has been tested.

The next major Australian case concerning an auditor's duties to the company did not introduce any new dimensions to the duties already discussed, but the magnitude of the claim did attract considerable attention to the issue of auditors' liability. The case involved an action for breach of contract brought by Cambridge Credit Corporation Ltd against its auditors.[14] Cambridge Credit was a finance corporation involved in real estate development. It had issued debentures under the terms of a trust deed. The money raised from the debentures was invested in real estate. The trust deed imposed a limitation on the ability of Cambridge Credit to issue further debentures. This limitation required the company to maintain a certain ratio of debentures to shareholders' funds; if that ratio was breached, the trustees were empowered to appoint a receiver. The company's 1971 annual accounts wrongly overstated the value of the shareholders' funds. Nevertheless, the auditors certified that the accounts gave a true and fair view of the company's financial position, and also certified that the issue of further debentures would not breach the ratio defined in the trust deed. Cambridge Credit continued to conduct business and to invest in real estate. During the crash of the property market in 1974, Cambridge Credit, along with a number of other property companies, collapsed. When it failed to make an interest payment to the debenture holders, the trustee appointed a receiver to the company. Cambridge Credit sued the auditors, alleging a breach of contract in relation to the certification of the 1971 accounts. At first instance, Rogers J held that the auditors had been negligent in failing to require that adjustments be made to the 1971 accounts. If those adjustments had been made, the trustee would then have been alerted and appointed a receiver. At that time the company's deficit would have been significantly less than that which existed in 1974. That breach of duty in 1971, said Rogers J, was the substantial cause of the collapse of the corporation in 1974, since the corporation had continued trading on an inadequate financial basis. His Honour ordered that $145 million damages be paid by the auditors. On appeal, the decision was overturned by a majority on the grounds that, while the 1971 audit involved a breach of contractual duty, this was not the cause of the loss suffered by the corporation in 1974. The Court of Appeal found that the collapse of the property market, due to government intervention, broke the chain of causation. It was also held that the loss was too remote from the negligent act.

As Chief Judge of the Commercial Division of the NSW Supreme Court, Rogers J had a further opportunity to rule on the duties of auditors, five years later, in

[14]The case was ultimately decided by the Court of Appeal in New South Wales: *Alexander v. Cambridge Credit Corporation Ltd* (1987) 12 ACLR 202. However, the decision of the trial judge is also relevant; see *Cambridge Credit Corporation Ltd v. Hutcheson* (1985) 9 ACLR 545.

the landmark *AWA Ltd v. Daniels* decision ((1992) 10 ACLC 933). AWA Ltd had entered into what was then the relatively new world of foreign exchange dealings. The lone employee appointed to manage AWA's foreign exchange operations was initially very successful: AWA's foreign exchange operation looked as though it would become 'the largest dollar generating department' in the company ((1992) 10 ACLC 933, p. 985). Over time, however, the situation became quite different. Ultimately the employee's foreign exchange activities caused a loss to AWA of almost $50 million. This loss was concealed by various methods, including the making of unauthorised borrowings from a number of banks on behalf of AWA.

During this period the defendant audit firm, Deloitte Haskins & Sells, was engaged by AWA to conduct two audits. The firm had a long association with AWA. The partner in charge of audits (Daniels) was a long-standing friend of both the general manager and the internal auditor of AWA. The first audit was a statutory audit of the company's 1985/86 financial statements; the second was a non-statutory audit conducted between late 1986 and early 1987 in response to AWA's fears of a possible takeover. In neither of the audits was the full extent of the company's foreign exchange problems disclosed, although the Court found that the audit partner had recognised and noted the defects in AWA's system of internal control as early as June 1986.

AWA admitted that, in relation to foreign exchange dealings, its systems of internal control and record- and account-keeping were deficient. Nevertheless, the company sued the auditors for damages from breach of contract, claiming that the loss was caused by the auditor's failure to draw attention to these deficiencies and to note the problems in its reports. The company's claim was that the auditors were responsible for detecting and reporting deficiencies or inadequacies in the company's systems. For their part, the auditors denied any breach of duty to AWA, and claimed for contributory negligence on the part of the company.

Justice Rogers found that the auditors had been negligent. He also upheld the auditor's claim of contributory negligence. His Honour found that AWA's responsibility for negligence was 20%, while the auditor was 80% responsible. The AWA chief executive officer was ordered to contribute 10% of the auditor's 80% liability.[15] In dealing with the liability of the auditors, Justice Rogers emphasised the point made by Moffitt J in the *Pacific Acceptance Case*, namely that an 'auditor's duty has to be evaluated in the light of the standards of today' ((1992) 10 ACLC 933, p. 990). Justice Rogers' decision highlighted a number of specific aspects of the auditor's basic duty to exercise care and skill:

[15]The apportionment of liability is reported in *AWA Ltd v. Daniels (No 2)* (1992) ACLC 1643.

- *A duty in relation to the examination of the company's financial records*: Rogers J emphasised that, consistently with the obligation that is now found in the Corporations Act, s. 307(c),[16] the auditors should form an opinion that proper financial records have been kept by the company. In the *AWA Case*, His Honour found that the auditors had failed in this regard.
- *A duty in relation to the process of gathering information*: when doubts were raised about the scope of authority of the employee in charge of the foreign exchange operations, the auditors were then under a duty to make inquiries from senior management to ascertain the true position about the nature and extent of that authority. As Rogers J put it, 'in case of doubt, an auditor is required to inquire' ((1992) 10 ACLC 933, p. 954).
- *A duty to bring matters to the attention of management during the conduct of the audit*: according to Rogers J, the auditors were under an obligation to bring deficiencies in the company's internal controls to the attention of management in the first instance. This duty persisted for the duration of the audit process. His Honour observed that it was 'negligence of the first order' for Daniels to have waited until the conclusion of the audit to bring these matters to the attention of the managers ((1992) 10 ACLC 933, p. 990).
- *A duty to follow up*: when it became apparent that management had failed to respond adequately, Rogers J held that the auditors had a further obligation to report the matter to the board: '[T]he absence of internal controls in AWA … were of such importance that the defendants came under a duty to report them initially to management. Failing action to rectify the position, they had to be reported to the Board' ((1992) 10 ACLC 933, p. 964).

On appeal by the auditors, Justice Rogers' findings on the negligence of the auditor were upheld (*Daniels v. Anderson* (1995) 13 ACLC 614). The Court of Appeal disagreed, however, with the apportionment of liability made by Rogers J, and reduced the damages by one-third. Nevertheless, the Court stressed the responsibilities of an auditor when problems are discovered:

> If the auditor in the course of evaluating internal control and other auditing procedures becomes aware of material weaknesses in or an absence of internal controls the auditor must ensure, usually by a communication in writing, that management becomes aware of these weaknesses on a timely basis. If management does not react appropriately the auditor must report the weaknesses to the board ((1995) 13 ACLC 614, pp. 645-6 per Clarke and Sheller JJ).

[16]The section requires an auditor to form an opinion about whether the company has kept financial records sufficient to enable a financial report to be prepared and audited.

Duties to persons outside the company

The private/public role of the auditor in conducting a statutory audit raises the question whether the auditor owes duties of care to individuals outside the company. Given that the audit report becomes a matter of public record, is a duty owed to anyone who has access to the audited accounts? In other words, do auditors play a role in the policy of investor protection for which a wider liability is justified?

In Australia, the answer to this question was finally settled in 1997 by the High Court's decision in *Esanda Finance Corporation Ltd v. Peat Marwick Hungerfords* ((1997) 23 ACSR 71).[17] This decision resolved a difference between two lines of cases. One line of cases suggested a broad approach, under which auditors would owe a duty of care to a wide class of persons. One of the most influential decisions in this group of cases was *Scott Group Ltd v. McFarlane* ([1978] 1 NZLR 553), where a majority of the Court of Appeal in New Zealand held that auditors owe a duty of care to any person whom the auditors could reasonably foresee would need to use and rely upon the audit report when dealing with the company. This conclusion was applied subsequently in a number of cases.[18]

The second line of cases – upheld by the High Court – supports a narrow interpretation of auditors' liability to third parties. These decisions have often taken their lead from the words of Cardozo CJ in the US case *Ultramares Corporation v. Touche*. His Honour remarked that the liability of accountants (and auditors) for negligent misstatement ought to be restricted, otherwise they would be exposed 'to a liability in an indeterminate amount for an indeterminate time to an indeterminate class' (255 NY 170, p. 179 (1931)).

Prior to the *Esanda Case*, the standard-bearer for this narrow view of auditors' liability to third parties was the House of Lords decision in *Caparo Industries plc v. Dickman* ([1990] 2 AC 605). That case dealt with two questions: is any duty owed by an auditor to potential investors in a company who do not already own shares in the company, and is any duty owed by an auditor to existing shareholders in the company? On the first question, the House of Lords held that the auditors of a public company owe no duty of care to investors who rely on the audited accounts in deciding to buy shares in the company. The Court acknowledged that it might be foreseeable that potential investors would use the audited accounts, but foreseeability by itself is insufficient to establish a duty. The Court stressed that proximity was also required as a separate element, and that there was no sufficiently proximate relationship between the auditor and a potential investor to give rise to any duty.

[17]This confirmed a trend which had been developing in earlier cases; see Baxt (1990, 1993).

[18]For example, *JEB Fasteners Ltd v. Marks, Bloom & Co (a firm)* [1981] 3 All ER 289, and *Twomax Ltd v. Dickson, McFarlane & Robinson* 1982 SC 113. See also *Columbia Coffee & Tea Pty Ltd v. Churchill* (1993) 9 ACSR 415.

On the second question, the House of Lords held that the auditor's duty in performing his or her statutory function is owed to the shareholders as a body, not to individual shareholders. The Court accepted that facts might arise which established a sufficiently proximate relationship between the auditor and an individual shareholder. This would require the auditor to know that the statement would be communicated to the shareholder for the purpose of a particular transaction or type of transaction, and that the shareholder would rely on the statement in connection with that transaction ([1990] 2 AC 605, p. 641 per Lord Oliver). In such a case, however, the resulting duty of care would only protect the shareholder from losses in the value of shares which he or she already held. It would not protect the shareholder for losses resulting from the purchase of additional shares in reliance on the auditor's report. This is because, as a share purchaser, the shareholder would be in the same position as any other potential investor, to whom the auditor owes no duty ([1990] 2 AC 605, p. 627 per Lord Bridge). Some Australian courts had already accepted and applied the *Caparo* decision prior to the *Esanda Case*.[19]

In *Esanda Finance Corporation Ltd v. Peat Marwick Hungerfords* ((1997) 23 ACSR 71), the High Court was able to lay down decisive guidelines for Australian law about the liability of auditors to third parties. The Esanda finance company had lent money to a number of companies associated with a company called Excel. The loans were guaranteed by Excel. In deciding to make the loans, Esanda had relied on the accounts of Excel, which had been audited by Peat Marwick Hungerfords. The audited accounts did not disclose Excel's true financial position. Excel subsequently went into liquidation and Esanda claimed to have suffered financial loss as a result of the loan transactions. Esanda brought an action against the auditors, claiming that they were negligent in the audit of Excel's accounts.

The High Court held that the auditors did not owe a duty of care to Esanda. The Court confirmed that in an action for economic loss arising out of negligence, mere foreseeability of the possibility of harm arising from giving information or advice is not sufficient to impose a duty of care on the person giving the information or advice. Esanda needed to prove that the auditor knew, or ought reasonably to have known of, three things ((1997) 23 ACSR 71, p. 78 per Brennan CJ). First, 'that the information or advice would be communicated to the plaintiff, either individually or as a member of an identified class'; second, that the information or advice would be communicated for a purpose that would be very likely to lead the plaintiff to enter into a transaction of the kind that the plaintiff did enter; and third, 'that it would be very likely that the plaintiff would enter into such a transaction in reliance on the information or advice'.

[19] E.g., *R Lowe Lippmann Figdor & Franck v. AGC (Advances) Ltd* (1992) 10 ACLC 1168.

Justice McHugh identified several factors in support of this confined scope of liability ((1997) 23 ACSR 71, pp. 102-8), including a mixture of policy-based and empirical claims that:

- imposing a duty of care on auditors in favour of third parties would lead to an increase in the cost of auditing services, a decrease in competition for such services as smaller firms are forced out of business, and a reduction in the standard of those services as auditors reduce overheads in order to absorb the higher cost of insurance
- the intended beneficiaries of such a duty are 'a sophisticated group who have the means in most cases to take steps to avoid the risk of loss'
- the plaintiff's loss is caused primarily by the conduct of the company which is audited, while the role of the auditor in causing the loss is secondary
- sophisticated investors will face problems in proving reliance on the audit report, given that they are likely to regard the report as only one of many factors to take into account
- 'the factual issues that arise in auditor's liability cases ... make it almost impossible for an auditor to avoid a trial or settlement even when the auditor is not liable to the plaintiff'
- such a duty would carry a prospect of 'vexatious or near vexatious litigation'
- such a duty would require an auditor to compensate investors for loss arising from their self-induced reliance where they were not prepared to pay for the auditor's work.

The *Esanda* decision indicates a significant shift away from the broad investor protection rationale discussed earlier in this chapter. It also favours a private conception of the audit function, as opposed to the public role identified earlier.

Current legal issues

Auditor independence

The corporate collapses of the 1980s were seen primarily as the result of neglect and mismanagement by company directors and officers. This led to major reforms to the law, both statutory and judicial, on directors' duties. By comparison, critical scrutiny of the collapses of 2001 has concentrated more on the role of the auditors.[20] In particular, there has been considerable speculation about the extent to which a lack of auditor independence contributed to the high-profile corporate collapses in Australia during 2001.[21] Both the Ramsay Report and the report of the Joint Standing Committee on Public Accounts and Audit had as

[20]The role of directors has not been ignored. There have been some significant cases brought against directors, for example *ASIC v. Adler (No. 3)* (2002) 20 ACLC 576 (relating to the collapse of HIH Insurance), and *ASIC v. Rich* (2003) 21 ACLC 450 (relating to the collapse of One.Tel).
[21]A similar concern with auditor independence is apparent in the United States (see the Sarbanes-Oxley Act of 2002, ss. 201-206) and the United Kingdom (see Companies (Audit, Investigations and Community Enterprise) Act 2004).

their main focus the problem of maintaining auditor independence (Ramsay 2001; JSCPAA 2002), and over half of the reforms in the CLERP 9 legislation were directed at audit reform. Whether this unfairly perpetuates the scapegoating of auditors for company failure is a matter of debate (Fogarty & Lansley 2002, pp. 418-19). Nevertheless, as the Ramsay Report noted, 'the importance of independence in the auditing context has become such that the terms "independent" and "auditor" can no longer be separated' (Ramsay 2001, para. 8.15).

Concerns about auditor independence are not new. There have long been provisions in the Corporations Act and in professional codes of conduct dealing with aspects of auditor independence (Ramsay 2001, para. 4.14). The courts have also commented on the importance of the auditor's independence, and the difficulties in maintaining it. In *Pacific Acceptance Corporation Ltd v. Forsyth*, for example, Moffitt J noted that while the shareholders appoint the auditor, most often it is the directors or senior managers who determine this appointment. Therefore the auditor may be under some pressure to produce a report which pleases those managers. The auditor 'is put in a position where there must often be a real and practical conflict ... between his duty to the shareholders and his interest not to take action which may prejudice his reappointment or his relations with those with whom he works' ((1970) 92 WN (NSW) 29, p. 131).

Prior to the CLERP 9 reforms, the statutory independence requirements for auditors were relatively straightforward. A person could not be appointed as an auditor if they were an officer of the company, or if they, or any corporation in which they were a substantial shareholder, owed more than $5000 to the company or its related entities. As the Ramsay Report noted, these provisions fell short of a general requirement of auditor independence (Ramsay 2001, para. 5.03). The CLERP 9 reforms, based upon the recommendations of the Ramsay Report but also taking into account findings of the HIH Royal Commission, cast the net of auditor independence much more widely and are expressed in much more detail. These reforms include the auditor rotation requirements discussed earlier in this chapter.[22]

Following the CLERP 9 reforms, the Corporations Act specifies both general and specific independence requirements for auditors. The general requirement focuses on the need to avoid 'conflict of interest situations'. It is set out in ss. 324CA-CC (applying, respectively, to individual auditors, members of audit firms and directors of audit companies). A 'conflict of interest situation' exists whenever the auditor is not capable of exercising objective and impartial judgment in conducting the audit, or at least a reasonable person would conclude that this is the case. This involves looking at the relationship between the auditor and the company,

[22]In addition, the Act now imposes a two-year post-audit 'cooling off' period for auditor partners who wish to join a company client as a director or officer (ss. 324CI & CJ).

and its current or former directors and managers (s. 324CD). The effect of this general requirement is that if an auditor engages in audit activity and they are aware of the existence of a conflict of interest situation, they commit an offence unless they take all reasonable steps to end that situation. They must also inform ASIC within seven days of becoming aware that the conflict of interest situation exists. If the auditor is not aware of the situation, they commit an offence if they do not have in place a quality-control system that would have been reasonably capable of making them aware that the conflict of interest situation exists.

The specific independence requirement creates further offences, focusing on particular 'relevant relationships' that constitute a breach of the auditor's independence when they are engaged in audit activity. The Act defines 19 such relationships (s. 324CH). Some are role relationships (e.g., where the auditor is an officer or employee of the audited company), others are property relationships (e.g., where the auditor has an asset that is an investment in the audited company), and the remainder are financial relationships (e.g., where the auditor owes money to, or is owed money by, the audited company). The Act then lists the persons associated with the audit to whom these different types of relationships apply (ss. 324CE-CG). The listed persons include immediate family members of the audit team, and suppliers of non-audit services from the audit firm.

These independence requirements are reinforced by the further requirement that the auditor must declare to the directors of the audited company whether there have been any contraventions of the auditor independence requirements (including the auditor rotation requirements) (s. 307C).

Notwithstanding their detail, the regulation of auditor independence goes beyond these new statutory requirements. The independence requirements introduced by the CLERP 9 reforms are primarily concerned with what Michael Power calls 'organizational independence' (Power 1999, p. 132). That is, the reforms define the independence problem in terms of the relationship between the company and the auditor. Power argues, however, that there is a second dimension to audit independence – he calls it 'operational independence' – which focuses on the *audit process* rather than the auditor (Power 1999, p. 132). Here there are two questions. First, regardless of their degree of organisational independence, how much does/should the auditor rely on company managers for information? This is a question that has tended to occupy the courts, typified by the *Pacific Acceptance* decision described earlier. For example, in defining the common law duties of auditors, the courts have concentrated on the obligation to 'go behind the company's books' and determine the company's true financial position. Of course, auditors must be dependent, at least to some extent, on information supplied by the company. This was recognised in the *AWA Case*, where the court emphasised the auditor's duty to inquire. So the second question is whether the auditor is able to draw independent conclusions from this information. Power suggests that for this to be possible, auditors must have an independent knowledge base on which to assess the information: there must be 'clear rules of auditee conduct and robust techniques for determining compliance with these rules' (Power 1999, p. 133). This aspect of operational independence is the domain of the auditing (and accounting) standards referred to earlier in this chapter. When it is seen with these added dimensions, auditor independence becomes a much more complex regulatory goal.

Limiting auditors' liability

Since the 1970s the quantum of civil claims against auditors has produced continuous debate about the extent to which auditors should be liable for economic loss incurred when a company fails financially. The auditing profession has expressed its concern that there is an 'expectation gap' between the auditors' legally defined role and what the investing public expects:

> The general public believes that the auditor has a responsibility for detecting *all* fraud, while the auditing profession believes its responsibilities are limited to *planning* the audit so that there is a reasonable expectation of detecting *material* fraud (Gay & Pound 1989, p. 118, emphasis in original).

The question has been whether the narrowing of this expectation gap is best left to the episodic application by judges of concepts such as foreseeability, proximity and reliance, or whether statutory intervention is required. On one view, legislative reforms are unnecessary, given the tight limitations imposed on auditors' liability to third parties in the *Esanda Case*, and the use of contributory negligence principles in *Daniels v. Anderson* (Fogarty & Lansley 2002, p. 425). The other view looks for legislative certainty. In Australia, the CLERP 9 reforms have taken the latter approach.

CLERP 9 introduced two methods by which the liability of auditors for loss might be restricted.[23] First, the reforms introduced a system of proportionate liability for economic loss or property damage arising from misleading or deceptive conduct in relation to a financial product or financial services. The idea of proportionate liability is that the defendant's liability is directly proportionate to the degree of their responsibility for the loss or damage that has been incurred. This scheme replaces the system of joint and several liability under which a plaintiff can recover the whole amount of the loss from any one or more of the

[23]In addition to these methods of reducing liability, it should be noted that under legislation in New South Wales and Western Australia (the *Professional Standards Act 1994* (NSW) and the *Professional Standards Act 1997* (WA)), professional associations (including accountants) can limit (or 'cap') the liability of their members for financial loss in certain situations. Under the *Treasury Legislation Amendment (Professional Standards) Act 2004* (Cwlth), this state legislation is applied to certain types of liability under the Corporations Act and the Trade Practices Act.

defendants, regardless of the relative degree of fault of the defendants.[24] Secondly, the reforms permit an audit firm to incorporate as a limited liability company on certain conditions (for example, each director of the company must be a registered company auditor). The immediate consequence of incorporation is that the company, unlike a partnership, is a separate legal actor. Prima facie, it is the company, rather than its members or directors, that incurs legal liability for its actions. This separation of the company's liability from that of the auditor members of the company[25] does not, however, insulate the auditor members from liability. An audit member who is negligent in the conduct of an audit may be liable along with the audit company. The advantage of incorporation, though, is that other non-negligent auditor members will be shielded from liability.

Conclusion

It is too early to say what effect the flurry of legislative reforms that were introduced in the wake of the corporate failures of the early 21st century might have. Indeed, the broader literature on law reform and legislation suggests that, notwithstanding the number of reports, reviews and inquiries that preceded these changes, it may be difficult to produce conclusive assessments of their impact and effect. There are likely to be different views about what is to count as an effect of this legislation, and how this is to be measured. This is not a new problem; some years ago John Griffiths drew attention to the distinction between the direct and indirect effects of legislation (Griffiths 1979, pp. 351-6).[26] Direct effects occur when the people to whom the legislation is directed comply with the letter of the rules. Indirect effects are the consequences of that compliance. In the case of the CLERP 9 reforms, the intended direct effects presumably include the delivery of audit services by auditors who are not disqualified by 'relevant relationships' with the audited company. This should be relatively easy to measure. The indirect effects that are hoped for (presumably) are audit processes and reports that are trusted by shareholders and that 'add value' to the company's financial statements. This will be less easy to gauge. One thing is clear, however: the prevention and regulation of corporate wrongdoing and failure cannot be made the responsibility of any one group. Since the 1980s, the roles of directors, senior managers, institutional shareholders and auditors have each come under regulatory scrutiny in Australia. In the United States, lawyers have been added

[24] Two things should be noted about the proportionate liability scheme introduced by CLERP 9. First, it is not restricted to auditors. It applies to any person who causes loss or damage as a result of misleading or deceptive conduct in relation to financial services (see Corporations Act, s. 1041H). Secondly, at the time of writing it is not clear whether the reforms actually apply to audit reports. This is because r. 7.1.29(3)(a) currently excludes the auditing of financial reports from the definition of 'financial service'. It is possible that new regulations will be introduced to correct this.

[25] This is not the same thing as 'limited liability'. In a company context, limited liability refers to the fact that a member's liability *to the company* is limited.

[26] Griffiths also notes the occurrence of independent effects and unintended effects.

to this list.[27] Problems of corporate governance and accountability are complex; regulatory responses need to avoid attempts at simple fixes.

[27]See the Sarbanes-Oxley Act of 2002, s. 307 (requiring lawyers to report evidence of material violation of securities law or breach of fiduciary duty to the chief legal counsel or chief executive officer of the company, at first instance, and to the audit committee thereafter).

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Chapter 2. 'Perfectly legal': a sociological approach to auditing

Doreen McBarnet

Abstract

This chapter offers a sociological perspective on ethics and auditing, drawing on empirical research to put current auditing issues in context and to demonstrate the need for a new ethical approach to law. Taking Enron as its starting point, it widens the focus from outright accounting fraud to techniques of 'creative accounting', which are carefully constructed to undermine accountability and transparency while still claiming to be 'perfectly legal'. The use of such techniques is a matter of routine business practice, and their acceptance a matter of routine audit practice. The chapter suggests that this practice is fostered by a culture which sees it as legitimate to manipulate the letter of the law in ways which defeat its spirit. Changes in the law itself, or in the structuring of auditor independence, will not lead to a change in practice unless this culture is itself addressed, and a new ethical attitude to law adopted by business and auditors alike.

Introduction

The perspective taken in this chapter is that of neither an accountant nor an ethicist but of a sociologist of law. It takes Enron as the starting point for an analysis of accounting practice and accounting law, and ends by raising questions for accounting ethics. In particular, it raises questions about the ethics of both auditors and management in their approach to and application of law, as evidenced not only in fraudulent accounting but in 'creative accounting'. The great attraction of creative accounting over fraud is that it allows companies to circumvent legal control in ways which can nonetheless claim to be 'perfectly legal', complying literally with the letter of the law while nonetheless defeating its spirit. Enron has laid bare not only extensive examples of fraud but extensive examples of creative accounting. But Enron is only the tip of the iceberg. This chapter draws on empirical research to demonstrate the routine nature of creative accounting practice, the challenges it poses for law and the questions it raises for ethics in the preparation and audit of financial reports.[1]

Beyond fraud

Enron in the late summer of 2001 was the world's largest energy trader, the seventh largest corporation in the United States and darling of market analysts, who were urging investors to buy its shares. By 2 December 2001 Enron had filed for bankruptcy, till then the largest bankruptcy in US history. In between, on 16 October, it had announced its third-quarter results for 2001 would include, completely out of the blue, a charge against earnings of US$585 million and previously unreported debts of US$1.2 billion (Powers 2002). The regulators, the Securities and Exchange Commission (SEC), began to investigate, and by November Enron had restated its accounts of the previous five years. As the story unfolded over succeeding months, it emerged that Enron had 'not only wiped out $70 billion of shareholder value but also defaulted on tens of billions of dollars of debts' (Partnoy 2002, p. 1).

The public has been left reeling over how such a huge collapse could occur without warning, and how such enormous debts and losses could have been hidden from the market. Enron has become an icon for corporate wrongdoing on a massive scale, not just for the accounting issues but for all that followed: employees losing their retirement benefits, locked into Enron shares as the value of those shares vanished, while senior executives had been selling at still high rates and taking multimillion-dollar bonuses; accountancy firm Arthur Andersen shredding masses of Enron-related documents; auditors and analysts in general coming under scrutiny and criticism for lack of independence and new structures being introduced to counter this[2] ; allegations of political and regulatory corruption. Civil and criminal lawsuits are in process, there has been a series of investigations by Congress, as well as the SEC and Justice Department, and there has been a rush to new legislation and regulation. Enron's audit firm, Arthur Andersen, has paid the price with its own demise.

Enron is being treated as a watershed. 'After Enron', or the 'post-Enron world', are phrases used repeatedly in the press and in academic analysis to suggest an event of enormous significance, and there may be some temptation to demonise Enron, and Arthur Andersen, in order to shore up the notion that they are rotten apples in an otherwise basically sound and honest corporate world. 'Enron's

[1]This chapter draws on research on 'Regulation, responsibility and the rule of law' funded by the ESRC under its Professorial Fellowship Scheme, as well as earlier work on 'creative compliance'. Papers drawing on the same material on Enron and creative compliance as in this chapter, but focussing on the role of corporate social responsibility rather than on 'ethical compliance', were presented at the colloquium of the International Society of Business, Economics and Ethics, Melbourne, July 2004, and at the colloquium on *Governing the Corporation*, Belfast, September 2004. The Belfast presentation, 'After Enron: Corporate governance, creative compliance and the uses of Corporate Social Responsibility', will be published by John Wiley in O'Brien (ed.) (2005).

[2]This reaction has not, of course, been confined to the United States. Australia, for example, beset by its own examples of audit and accounting failure, instigated the Ramsay review of independence of Australian company auditors (Ramsay 2001).

demise is not business as usual in America', said one investigating Congressman (Tauzin, Subcommittee on oversight and investigations 2002b, p. 32). This chapter focuses on the issues at the heart of the Enron case – its corporate structuring and financial reporting practices – and there the question has to be raised of what 'business as usual in America' – and the United Kingdom and elsewhere – actually is, in order to put Enron in context and draw out its wider implications for business and professional ethics.

There have to date been 30 indictments for fraud in relation to Enron's practices, going to the very top of the executive chain, and it would be easy to focus attention only on the clear breaches of law at the heart of those indictments – outright fraud or law-breaking in the form of lies about products being marketed, structures improperly accounted for in that they failed to comply with the rules on the treatment adopted, insider dealing, frauds against Enron and obstruction of justice. Yet to do so would be to create a disjunction between the legal charges brought by regulators in court and many of the charges made by Congress, the media and the general public. For them part of the outrage of Enron lies simply in the fact that the market was fundamentally misled on Enron's financial status by its use of off balance sheet accounting devices, and the issues this raises for the reliability of financial reporting in general. As two congressional investigators put it, 'Off the books transactions were purposefully designed to mislead shareholders about Enron's precarious financial profits' (Greenwood, Subcommittee on oversight and investigations 2002b, p. 2), and the 'broader issues are capital systems and transparency in accounting' (Deutsch, Subcommittee on oversight and investigations 2002a, p. 4).

These concerns take us deeper than fraudulent accounting. They necessarily raise issues about the widespread and endemic practice of creative accounting.

Enron used a multitude of fraudulent and creative practices to keep profits high, liabilities low, stock prices rising and credit ratings good, but the core technique was the use of what are variously known as Special Purpose Entities (SPEs), Special Purpose Vehicles (SPVs) or 'non-subsidiary subsidiaries'. These were partnerships constructed to fall outside the rules requiring their finances to be consolidated in Enron's group accounts, thus keeping them 'off balance sheet' (OBS). It could be argued from SEC guidelines that if just 3% of the capital investment in the SPV came from an independent outside body and remained at risk throughout the transaction, and the independent owner exercised control of the SPV, then the vehicle could be treated as 'off balance sheet' (Partnoy 2003, p. 210); that is, Enron did not have to include its losses or liabilities (or, in theory, profits or assets, but unsurprisingly OBS vehicles rarely have those) in its group accounts. Complex deals largely using derivatives were then done between the SPVs and Enron itself both to formally manage risk and to further enhance reportable financial performance. Some 4300 SPVs were in play by the time of Enron's demise.

These transactions were astonishingly complex and the indictments involve clear allegations of fraud in the construction of the deals. My concern, however, is broader, and it is this: much has been made of Enron's breach of accounting and other rules, and in relation to the core SPVs, the fact that they did not always comply with the rules which allow such entities to remain off the balance sheet. There were instances, for example, where 'the 3% rule' was invoked to justify an accounting treatment, but not, as later investigation demonstrated, actually adhered to (Powers 2002). Yet even if it had not broken the rules, it seems clear that Enron would have been misleading the market just as much. If it had only engaged in OBS structuring within the rules, it could still have kept significant debts and losses out of its own accounts. Indeed, it is arguable that much of Enron's OBS activity did not breach the rules. Rather, it creatively exploited the rules or utilised regulatory gaps, including the 'regulatory black hole' of derivatives (Partnoy 2002, p. 2).[3] Certainly, Enron's OBS vehicles were not, as has sometimes been said, 'secret' partnerships. Their existence was disclosed in the notes to the accounts as is required by the rules. They may have been disclosed in ways which were economic with the truth, or via other forms of 'non-disclosing disclosure' (McBarnet 1991), but they were disclosed.

This is not to defend Enron. On the contrary, it is merely to refine the charges. It is to suggest that Enron engaged in creative accounting as well as fraudulent accounting, and to underline the fact that the creative accounting, just as much as the fraudulent accounting, was, to cite our first congressman again, 'purposefully designed to mislead shareholders about Enron's precarious financial profits' (Greenwood, Subcommittee on oversight and investigations 2002b, p. 2). What is more, Enron has been far from alone in engaging in such creative accounting, raising with a vengeance the 'broader issues' which so concerned our second congressman, the issues of 'capital systems and transparency in accounting' in general (Deutsch, Subcommittee on oversight and investigations 2002a, p. 4).

Public reaction has been raised not only by the outright fraud involved, but by the capacity of both business and auditors to mislead the market and violate trust through OBS structuring – whether fraudulent or not – and indeed through creative accounting more generally. And that to me is the more fundamental issue. Indeed, the second biggest collapse in history – Enron has been upstaged in size if not complexity by WorldCom – could still have happened, completely out of the blue, even if it had *not* been breaking specific rules. It has certainly happened before.

[3]Partnoy (2002) has also observed in testimony to an investigating Senate Committee: 'Even if Enron had not tripped up and violated the letter of these rules, it would still have been able to borrow 97% of the capital of its special purpose entities without recognising these debts on its balance sheet'.

There are parallels, for example, with Polly Peck in the United Kingdom (*re Polly Peck International plc* 1996). Polly Peck went bust in August 1991, just weeks after the analysts had been describing it as 'undervalued' and a 'must-buy'. When it collapsed, what had been reported in the books as £2 billion in assets was suddenly redefined as £1.5 billion in liabilities. As with Enron, there were allegations of fraud on related issues, but the accounting figures themselves were largely down to creative use of the rules – or, in this case, of gaps in the rules. One commentator noted: 'This is the other side of the Polly Peck miracle. Stated profit margins … are perfectly correct within generally accepted accounting standards, but they tell a misleading story' (David Brewerton, *The Times*, 2 October 1990).

That is why we need to contextualise Enron in the wider world of corporate legal practice and to see that if Enron is unusual, it may be unusual not because it misled the market – not because it used SPVs and other OBS techniques to do so – but because it sometimes used them improperly, because it got caught out and had to expose the reality behind the façade, and perhaps because it was an extreme case, not so much using creative accounting to enhance a business as to create one. There is a lot of technically proper but still thoroughly misleading creative accounting going on out there. There may also be a lot of technically *improper* accounting that never gets exposed. Certainly, large numbers of US corporations seemed to suddenly find it necessary to restate accounts after Enron and before the new Sarbanes-Oxley legislation took effect. But the important point is this: even where accounting is technically proper and can claim to be, in the oft-repeated phrase'perfectly legal'[4] , – creatively exploiting rules and regulatory gaps rather than engaging in outright fraud – it can still be highly misleading.

Outright fraud is not, then, the only practice to raise ethical questions in accounting and audit. Significant questions are also raised by the construction of 'perfectly legal' techniques of creative accounting. In the following sections this chapter will, first, set the practices of Enron and Arthur Andersen in context by looking briefly at the kind of 'perfectly legal' OBS structures which have constituted widespread, routine corporate practice, regularly receiving auditor approval. Second, it will ask what can be done through accounting law to constrain creative accounting, and will assess some such attempts. Third, it will explore the culture underlying creative accounting and the ethical questions it raises for business and the accounting profession.

[4]This is not only used frequently in research interviews, but is something of a cliché in newspaper stories on creative accounting, tax avoidance or similar practices.

Enron in context: perfectly legal creative accounting

Enron is far from alone in setting up OBS SPVs to hide liabilities and create paper profits, and Arthur Andersen far from alone in endorsing this in audit. Nor is the practice new. My own research in the United Kingdom in the late 1980s and 1990s demonstrated the widespread use of SPVs and other OBS techniques to manipulate accounts. [5] Creative accounting more generally was, indeed, shown to be rife in the United Kingdom in this period (Griffiths 1986, 1995; Smith 1992). Similar practices are in use in the United States.[6] Nor is creative accounting an Anglo-Saxon phenomenon. One Enron indictment concerns abuse of reserves but again our past research, this time in Germany, demonstrated use of reserves to be common practice there as a way of manipulating accounts.

OBS SPVs were commonly used in the United Kingdom in the 1980s to manipulate accounts. 'Non-subsidiary subsidiaries' were set up, companies which were in economic substance subsidiaries, but which were carefully structured in their legal form to fall outside the rules defining a subsidiary (subsidiaries' finances having to be included in group accounts). Debts or losses could then be tidied away in them, off the balance sheet, and therefore out of the accounts of the company setting them up. Such techniques were used routinely by household-name companies such as Cadbury Schweppes, Habitat, Burtons, Storehouse, Dixons and many more.

As company law rules defining subsidiaries stood, it was far from difficult to keep bad financial news hidden in a way which could claim to be not breaking the rules but complying with them and therefore 'perfectly legal'. True, company law also contained the overriding principle that accounts should give a true and fair view, and the accounts produced after the set-up of such SPVs, it could be (and was) argued, did not do that, but accountants and lawyers looked to the detail of the law, to specific definitions and precedents, queried the meaning of 'true and fair' and its capacity to override specific rules, and endorsed the practice. Companies could properly claim they had the approval of their advisers. Auditors endorsed their accounts. Just like Enron.

Also like Enron, they sometimes had to shop around to get accountants and lawyers who would say that some of their more exotic structures and accounting

[5] I will draw on this research, much of which was carried out with Chris Whelan, in this section of the chapter and the next (see, for example, McBarnet 1991, 2003; McBarnet & Whelan 1991, 1997, 1999). Key parts of this body of work are also brought together in a recent volume of collected essays (McBarnet 2004b). The final section of the chapter relies on new research being conducted under the ESRC Professorial Fellowship Scheme.

[6] In hard-hitting testimony to the investigating Senate Committee, Partnoy (2002, p. 4) noted:

> Transactions designed to exploit these accounting rules have polluted the financial statements of many US companies. Enron is not alone. For example, Kmart Corporation – which was on the verge of bankruptcy as of January 21, 2002, and clearly was affected by Enron's collapse – held 49% interests in several unconsolidated equity affiliates. I believe this committee should take a hard look at these widespread practices. Partnoy notes too that 'accounting subterfuge using derivatives is widespread' (Partnoy 2002, p. 5).

innovations were indeed perfectly legal. But then there was and is no requirement to disclose just how much ‘opinion shopping’ had gone on until an endorsement was achieved. So long as one barrister was prepared to take a ‘bullish’ interpretation of the law in providing a legal opinion, and one accountancy firm to accept that, or posit its own bullish approach in audit, this was all that was needed in practice to claim reporting treatments were perfectly legal.

OBS SPVs were used for all sorts of things, including manufacturing paper profits. A property development company, for example, would set up an SPV to do its development for it. It then lent it money for the purpose and charged interest. The SPV did not pay the interest but since the interest was *payable*, the company could add it to its books to enhance its profits (by many millions of pounds at a time). Meantime, the SPV used another creative accounting technique, defining the interest as capital expenditure so the cost did not appear on its own profit and loss account (as a loss). The result is like magic: profits from nowhere and vanishing losses. Just like Enron. Property development company Rosehaugh, for example, had 16 SPVs. Just like Enron, their existence was disclosed in the notes to the accounts (at length, indeed, with seven pages of detail) but, also just like Enron’s ‘impenetrable footnote disclosure’ (Partnoy 2002), or ‘obtuse’ provision of information (Powers 2002, p. 17), disclosure was so opaque that it was later said by one analyst that one would need to be a professor of accounting to have any hope of deciphering their significance (Christopher Hird, *House of Cards*, Radio 4 (UK), 1991). Such ‘non-disclosing disclosure’ is a recurrent theme in both creative accounting and tax avoidance (McBarnet 1991; McBarnet & Whelan 1999).

Unlike Enron, most companies did not collapse, but they were still misleading the market. And keeping debts off the balance sheet and profits up had a number of valuable consequences, indeed purposes. Performance-related pay and bonuses for senior executives could boom. Just like Enron. Huge debts could be taken out that would not have been possible if they had to go on the balance sheet – or at least would not have been possible without upsetting the debt/equity ratio. This ratio is key in corporate finance and corporate governance. It is used most obviously for assessing good/bad buys in the stock market. But it is also used as a trigger in loan covenants for calling in loans if banks think the company’s debt is getting out of hand, and is also frequently used in a company’s ‘constitution’, its memorandum and articles of association, as a trigger requiring shareholder consultation before, for example, directors may make a highly leveraged acquisition. Artificially protecting the debt/equity ratio, then, meant basic corporate governance controls could be bypassed.

This was exemplified in the case of Beazer, a UK housebuilding company. It acquired, through an SPV, the US corporation Koppers, worth twice Beazer’s own value, in a deal described by Angus Phaure, an analyst at County NatWest, as 'impossible' and 'sheer magic' (*Accountancy*, April 1988, p. 9). Just as in Enron, derivatives formally shifted the risk, which, however, ultimately fell on Beazer not the SPV, and indeed came back to haunt it within a few years (McBarnet & Whelan 1997; *The Times*, 26 June 1991).

And some companies did collapse. When property development company Rush and Tomkins went bust in 1991, an estimated £700 million-worth of hitherto unreported debts suddenly emerged from associated but OBS joint ventures (*The Times*, 30 April 1990). Sometimes the scope to take on more debt than could really be sustained itself led to collapse – or fraud to try to hide it. Again, just like Enron. Maxwell Corporation is best remembered for raiding pensions, but one of the reasons it did so was because it had overextended itself by buying MacMillan via huge debts (Bower 1992). The purchase was made via an OBS SPV. It could not have been done without it, there being too much debt already. But in practice, as is often ultimately the case, the risk came back to Maxwell.

There are many other direct parallels with Enron. One Enron SPV was set up to take advantage of the beneficial regulatory treatment available for wind farms it owned (*SEC v. Fastow* 2002). If the wind farms were more than 50%-owned by an electric utility or electric utility holding company, they would not be eligible for the benefits, and since Enron was about to acquire Portland General Electric it would lose out. It therefore used an SPV to buy the wind farms. There is a close parallel to this in the United Kingdom in the context of broadcasting. A broadcasting company, EMAP, wanted to take over another broadcasting company, but if it did so it would hold eight licences. Since the statutory limit for one company's holding was six, the takeover would be disallowed. It therefore set up an OBS SPV to formally make the takeover. This was contested as mere form but upheld in court (*R v. Radio Authority* 1995).

In short, Enron's manipulation of its accounts, and Arthur Andersen's auditing, need to be understood in this wider context of normal business practice – normal and arguably 'perfectly legal' practice, 'creative' rather than fraudulent accounting, yet nonetheless routinely frustrating the whole idea of true and fair accounts, and routinely distorting market information.

What is to be done? Strategies for legal control and their limits

The immediate reaction to a scandal such as Enron is a demand for legal change. The United States has already produced the Sarbanes-Oxley Act. Auditor independence has become a key issue, with new rules aimed at securing this proposed or established in and beyond the United States.[7] But new structures for auditor independence are not themselves likely to be enough, as we shall see, and new

[7]For discussion of this in the context of Australia, see Ramsay (2001).

law in general is not always the panacea hoped for. Such problems as compromises built into new law, inadequate sanctions and inadequate resources for policing can all be listed as potential factors in the law's failure to offer effective control. It is also increasingly recognised that new rules, even if they are fully resourced and uncompromised, can themselves prove inadequate simply because of the ability of the regulated to adapt to them. A new rule may stop today's objectionable creative accounting device, but leave the way open for the new device ingeniously constructed tomorrow to thwart the new rule. The more specific and prescriptive the rule is, the clearer the criteria the new structure has to meet or circumvent.

In the post-Enron United States, proposals have therefore been put forward not just for a tightening of regulations and strengthening of sanctions, but for a change of regulatory style. The suggestion is that there should be less emphasis on specific rules and more on principles.[8] Harvey Pitt, for example, former SEC chairman, noted to the House of Representatives: 'We seek to move toward a principles-based set of accounting standards, where mere compliance with technical prescriptions is neither sufficient nor the objective' (Pitt 2002; and see Bratton 2004). This is exactly the strategy adopted by the United Kingdom in the 1990s in a bid to constrain creative accounting and specifically OBS financing.

Enron's SPVs were built on rules and guidelines which determined whether or not an entity should be consolidated into a group's accounts partly on the basis of specific thresholds of equity ownership. This was also the case in 1980s' company law in the United Kingdom. The rules on consolidation (the requirement for a holding company to include all its subsidiaries in its group accounts) at that time involved two questions for determining whether Company B was a subsidiary of Company A, and therefore had to have its financial accounts included in A's. First, does A own more than 50% in nominal value of B's equity share capital? Second, is A a member of B and does it control the composition of B's board of directors?

There were simple and complicated ways to ensure B fell outside these criteria and therefore could stay off A's balance sheet. It would be one of the aforementioned 'non-subsidiary subsidiaries'[9] , a subsidiary in substance but not in form. One way was to set up a 'diamond structure', in which A set up two subsidiaries, B and C, owning 100% of B and 50% of C. B and C then owned 50% each of D. A in effect owned 75% of D, but D fell outside the definitions of a subsidiary. Another route was for A to get a friendly bank, B, to hold 50% of the SPV, C, in the form of preference shares. C had a board of four directors, two from A and two from the bank, but A's directors had more voting rights and A therefore

[8]Many have advocated this approach; see, for example, Partnoy (2002), p. 5. The Sarbanes-Oxley Act has charged the SEC with producing a more principle-based regime (Sarbanes-Oxley Act 2002, s. 108(d)).
[9]There were various other terms for this kind of structure, e.g. a 'controlled non-subsidiary' or an 'orphan subsidiary'.

controlled the vote of the board without controlling, as the statute phrased it, its 'composition'. Though such practices might have been constrained by concerns over a challenge under the purportedly 'overriding' principle that accounts give 'a true and fair view', the *Argyll Case* (Ashton 1986; McBarnet & Whelan 1999, p. 90), and wider legal discussions of the exact nature and status of the 'override', provided ammunition to counter any such challenge, and indeed encouraged the spread of the practice.

Creative accounting using OBS techniques was rife, but there also followed scandals, collapses, review committees, a campaign to clean up accounting (spearheaded by David Tweedie, then chair of the UK's Accounting Standards Board, now chair of the International Accounting Standards Committee, the IASC) and significant changes in law and in accounting regulation. The story, and the changes made, are complex and are detailed elsewhere (McBarnet & Whelan 1999), but for the purposes of this chapter the point is that radical changes in the law were made with the express purpose of controlling creative accounting, and specifically the abuse of OBS financing and SPVs. What were these changes, and how has the new regime fared?

At the core of the new regime was the view that law was failing to control creative accounting because of weak enforcement, inadequate regulation and too much emphasis on rules. Precise rules and thresholds were too easy to circumvent; creative accounting thrived on repackaging transactions and structures to fall just outside them. They provided too clear a recipe for avoidance. Changing from one precise rule to another to catch the latest device simply stimulated the creation of yet another new device designed to escape the latest legal criteria. A new approach had to be adopted. Lord Strathclyde, for example, in the House of Lords, stated: 'Our intention is to curb the use of off balance sheet financing schemes through controlled non-subsidiary undertakings. Any definition of the term will encourage attempts to avoid the provision by artificial constructions with the intention of escaping from the letter of the definition' (Strathclyde, Hansard, HL Deb, vol. 03, col. 1018).

In essence, therefore, the new regime adopted a philosophy of shifting regulatory style from detailed prescriptive rules to broader purposive principles, from narrow criteria to broader catch-all ones in the drafting of definitions, and from an emphasis on legal form as the criterion for deciding on appropriate accounting treatments to an emphasis on economic substance. There was also a revision of the law on the 'true and fair override' to make it more accessible. The stated mission was that there be a shift of focus in financial reporting, and by implication in auditing, from the letter of the law to its spirit (e.g., Sir Ron Dearing, *The Times*, 24 January 1991). A new standard-setting body was set up under creative accounting's arch-enemy, David Tweedie, and a new agency, the Financial Reporting Review Panel, was set up to investigate accounts, policing no longer being left entirely to auditors. New sanctions were introduced for directors found in breach of regulations.

The OBS SPVs of the 1980s, and the rules which were interpreted as permitting them, were clearly targeted. So in the 1989 Companies Act (itself implementing European company law's Seventh Directive), the definitions of a subsidiary included a 'catch-all' definition which avoided mention of 50% thresholds or precise forms of control and instead required consolidation in broader terms. B would have to be included in A's group accounts, in the event of A having 'a participating interest' in B (which might take forms other than equity ownership) and 'exercising an actual dominant influence' ('actual' rather than in any particular legal form). A linchpin of the new regime was Financial Reporting Standard 5 (ASB 1994). This stated categorically that transactions should be reported according to their economic substance, putting economic reality before formal legal structuring. It also specifically tackled 'quasi-subsidiaries', entities which fulfilled the functions of a subsidiary despite falling outside the statutory definitions of one, and required their inclusion in the accounts of the 'quasi-holding company'.

Great hope has been attached by opponents of creative accounting to the potential of a principle-based regime for avoiding the limitations of rule-based regulation and providing a more effective means of controlling creative accounting. Tweedie noted, for example: 'We believe this is the surest means of forming standards that will remain relevant to innovations in business and finance and which are most likely to discourage ingenious standards avoidance practices' (FRC 1991, para. 5.5). Close analysis of the new regime, however, and of other jurisdictions following similar strategies[10] , suggests even a shift to principles poses problems for effective legal control. Again, this is detailed elsewhere (McBarnet & Whelan 1991, 1999; McBarnet 2003) and I will simply note some of the main problem areas.

First, there is a problem with sustaining principles as principles. There are too many factors which can produce a drift from principles to rules, clarifying and narrowing the ambit of their control, and providing more recipes for creative accountants to work on. Lobbying, demand for guidelines, court cases and just the build-up of informal precedents on what is allowed in practice and what is not are examples of the factors that eat away at principles and can convert them in effect back to rules.

Second, our empirical research suggests enforcers face problems in putting principles, and indeed stronger powers in general, into practice. There is too much room for contestability over what is true and fair – what is substance. There is concern about losing in court. Indeed, there is concern about winning

[10]For example in relation to tax avoidance in the United Kingdom, Germany and Australia.

in court if the win would nonetheless lead to tighter definitions of what is not allowable, and by implication what is. There is concern about losing control to the judges.

The strength of a principle-based regime as a means of control also lies in the uncertainty it generates. Hence David Tweedie's response, when asked early in the new regime how it would fare: 'We're like the cross-eyed javelin thrower at the Olympic Games. We may not win but we'll keep the crowd on the edge of its seats…'[11] Not knowing where the regulatory javelin will fall may make for greater caution among would-be creative accountants and their auditors. It also encourages settling with enforcers rather than contesting them; there is reluctance to be the company that puts its head on the block to test the legal interpretation of the new regime. On the other hand, if uncertainty is strength, the last thing the regime wants is to have its limits clarified, and regulators too may be too wary of a court case to flex their muscles too much. Yet there is a paradox here, because if the javelin is never wielded it will cease to deter.

What is more, the strength provided by uncertainty is also a potential weakness in terms of issues of legitimacy. Principle-based regimes can be readily open to criticism as too uncertain, as open to retrospectivity, as giving regulators too much power, as opening the way to arbitrary decision-making. The strategic response to creative accounting is itself susceptible to critique as 'creative control', and as an unacceptable violation of the rule of law. One empirical consequence of this is a tendency on the part of enforcers to limit themselves in how they use their powers. In turn, the consequence of that is to limit in practice the theoretical scope of the principle-based regime for control.

Whether rule-based or principle-based, there are then problems in controlling creative accounting through law. Yet one could argue that ultimately creative accounting is only a problem because of another issue, and that is not just the law itself but the attitude taken toward law by those allegedly subject to it, and those policing it. Turning to that takes us from accounting law to accounting ethics.

Towards ethical compliance?

Even principle-based systems can fall prey to creative accounting. Regulations, even regulations based on principles, have to be based on words, and even abstract words can be scrutinised for creative interpretations or uses. Alternatively, co-existing rules or even other principles can be brought in to limit the reach of the principles in question.

The 1989 Companies Act, we saw, introduced the 'catch-all' phrase 'actual dominant influence' in an effort to stop novel methods of control slipping through

[11]Providing Chris Whelan and myself with the title of our book (McBarnet & Whelan 1999).

the net of more specific definitions. Yet that phrase then spawned 'deadlocked joint ventures', where A and B set up a partnership, C, in which the equity was held 50-50 and the power of each was 'deadlocked': neither A nor B exercised 'actual control' and C remained off the balance sheets of both. Rush and Tomkins' partnerships, unheard of until its bankruptcy as noted above, were deadlocked joint ventures of this kind. Though further regulations, especially FRS5, might be thought to catch this now, accountancy firms have suggested there could still be ways of constructing entities to keep them, arguably, OBS; for example by making C a corporate joint venture, and using an exemption in the Companies Act to avoid consolidation. Another suggested route was to use 'revolving chairs', with A and B appointing a chairman for C with a casting vote each alternate year. Other sections of company law, and GAAP[12] principles on consistency, could then be invoked to keep C out of the accounts of both (Ernst & Young 1997). Even the idea of 'substance over form' itself has been used creatively and counter-purposively.[13]

In fact, whatever law, and whatever kind of law, is put in place as a mechanism for controlling business, it is mined for opportunities for circumvention. That is the reality of business regulation in action, whether in the arena of accounting or elsewhere.[14] Routine techniques are to search out gaps in the law ('Where does it say I can't?'); to scrutinise the 'ex-files' of law – exemptions, exclusions, exceptions – to see whether transactions or structures can be repackaged to fit within them, whether they naturally do so or not; to find or press for specific definitions and thresholds as guidance then 'work to rule'; and to construct completely innovative techniques which the law has not yet regulated and avoid control that way. Examples of all of these techniques can be found in creative accounting.[15] The OBS SPV, whether Enron's variation or the UK examples demonstrated here, are examples of 'working to rule'. They depended on close scrutiny of the rules and guidelines defining what *forms* of business entity or relationship require inclusion in group accounts, in order to construct or reconstruct forms which fall outside those definitions – even if they are equivalent in *substance*.

What this underlines is not just the nature and inherent limitations of law, but the fact that limitations of law are also a product of the way law is received and acted upon. Creative accounting is in fact the product of two factors. Limitations inherent in the nature, substance and enforcement of law provide the opportun-

[12]Generally Accepted Accounting Principles.
[13]For example via 'in-substance defeasance'. See McBarnet and Whelan (1999), Chapter 11; Rosenblatt (1984); FASB (1996).
[14]Tax avoidance, a close cousin of creative accounting, is another obvious example, but legal creativity is to be found in any legal area where there are attempts to control corporate activity through law, be it in the context of employee protection, environmental issues, health and safety, food and drugs or tenancy controls (McBarnet 1988). The concept 'creative accounting' captures the practice in financial reporting, but we need a broader concept to capture the pervasiveness of the practice. I've dubbed it 'creative compliance' (in McBarnet & Whelan 1997, for example).
[15]For examples of all of these techniques in action, see McBarnet and Whelan (1999).

ity, but that opportunity also has to be actively taken up by those subject to the law and by those charged with guiding and policing them – in this case, corporate management, their professional advisers and their auditors. It is not just how law is constructed and enforced that determines its impact but how it is received. If change is to come, therefore, it is not just the law we need to address but the attitude towards law assumed by those subject to it. The same is true of those charged with enforcing the law. Focussing on structures or rules to secure the independence of auditors will not resolve the situation so long as auditors, whether structurally independent or not, share the same attitude to law. The issue is not just legal or structural, but cultural and ethical.

What is the culture underlying, and facilitating, creative accounting? Ongoing research[16] suggests the following characteristic attitudes to law:

- The attitude to law is essentially one of 'Why not?' If a practice is not expressly and specifically defined as illegal, why should it not be used and claimed as legal? If a particular type of transaction is expressly outlawed, why should it not be refashioned in form if not in substance and claimed to be different?
- It is an attitude which defines compliance in a minimalist way, focussing on compliance with the letter of the law rather than its spirit, and which sees it as the responsibility of legislators and regulators to get the letter of the law right. If the way the law is drafted allows loopholes to be teased out, then it is deemed perfectly legitimate to utilise them, regardless of the intentions of the lawmakers.
- It is an attitude which treats law not as an authoritative and legitimate policy to be complied with, but as an obstacle to be circumvented, indeed as a 'material to be worked on' (McBarnet 1984) and, regardless of the policy behind it, tailored to one's own interests.
- It is an attitude which is highly attentive to law, but which looks to law not to ask, 'Is what I want to do allowed by law?', but, 'How can I find a way to justify it regardless?'
- It is an attitude in which law is a game, a game in which it is legitimate to come up with any interpretation one can, any argument one can dream up, however, *in one's one view*, 'spurious', 'bullish' or 'sailing close to the wind' that argument may be.[17]

This approach to law raises issues that can be addressed in a number of ways.[18] In the context of this book, the key question must be, 'Is this ethical?' *Should* this approach to law be seen as acceptable in either business ethics or professional

[16]Research in progress under the ESRC Professorial Fellowship Scheme.
[17]To cite from interviews with senior lawyers, accountants and business executives.
[18]These traits could be seen, for example, as reflecting a formalistic or positivistic approach to law.

ethics? It can be seen as ethical if business and professional ethics are equated with compliance with law, *and* if compliance with law is defined at a minimalist level as literal, 'bullishly' interpreted compliance. But the debates sparked by Enron and other accounting scandals may provide an ideal moment for those premises to be questioned, and for an expectation to be fostered that *ethical* compliance means compliance with the spirit and not just the letter of the law.

There may be ways in which law itself can be further enhanced to ensure compliance with the spirit and not just the letter, and we have yet to see what signals the Enron cases finally give out. But it may be time to also tackle the other side of the coin, not only the way law is made and enforced but the way it is received. It may be time to put the spotlight on the corporate and professional culture which sees as acceptable, indeed applauds as smart, the manipulation of law and defeat of legal control. It may be time to question the ethics of this attitude to law, and to ask *why* creative compliance is deemed legitimate when fraud is not. The intention, to defeat legal control, and the consequences, in terms of the frustration of legal policy and the impact on victims, are after all the same. What is clear is that changes in the law alone will not lead to a change in practice unless this culture is addressed, and a new, more ethical attitude to law and compliance is adopted by business and auditors alike.

This issue is not purely speculative. Many companies in their codes of conduct have made a point of declaring their commitment to compliance with the law. Indeed, Enron did just that, stating in its last social and environmental report that: 'We are dedicated to conducting business according to all applicable local and international laws and regulations' (Enron 2000). Given the fraud that was going on as this code was published, this does not do much to foster confidence in codes of conduct. More to the point of this chapter, however, even if Enron had complied totally with its code, it would have done nothing to constrain creative as opposed to fraudulent accounting. Although Enron's code committed it to compliance with the law, it did not spell out *how* the company would comply. A commitment only to minimalist, literal and creative compliance would foster, not prevent, creative accounting.

That point is, however, beginning – implicitly – to be acknowledged. We are already seeing a handful of companies expressly committing themselves in their codes of business ethics not just to compliance with the law, but to compliance with the *spirit* of the law.[19] Not all commitments in corporate codes of conduct can be taken at face value, as Enron amply demonstrates (though even commitments undertaken lightly may rebound when they are used to hold their instig-

[19]The current trend in big business of adopting policies of 'corporate social responsibility', though also complex and in need of critical assessment (McBarnet 2004a), might also prove a facilitative factor here.

ators to account).[20] And commitment to the spirit of the law could yet raise all kinds of legal controversies. However, the move suggests some acknowledgement, at least at the level of rhetoric, that it is not just breaking the letter of the law but breaking the spirit of the law that raises ethical questions. Helping place this issue on the agenda for corporate and professional ethics could prove one of Enron's more constructive consequences.

[20]See McBarnet (2004a) for an analysis of how rhetoric can rebound. Even if a code is seen mainly as PR, companies can still find themselves held to account on their commitments, with negative reputational and market consequences.

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Chapter 3. Public oversight: an international approach to auditing

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Abstract

The predominant structure initiated or proposed by various jurisdictions for reforming all of the recent ills attributed to the auditing standard-setting processes has been a public oversight board (POB). This includes mainly people independent of the audit profession, who oversee the activities of the standard-setting board (which includes mainly auditing practitioners). The rationale behind this structure is that there is a public-interest dimension to auditing. The aim of this chapter is to compare and contrast the various structures that have been instigated or proposed by the leading national and international bodies with regards public oversight of the auditing standard-setting process. This chapter compares and contrasts the oversight structure that is to be set up in Australia under the CLERP 9 reforms against similar recent initiatives in Canada, the United Kingdom and the United States, as well as the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). This comparison and contrast is undertaken on the following dimensions: membership, the procedures relating to appointment on the POB, the relationship between the POB and the standard-setting board, the powers of the POB, and whether the POB assumes responsibility for both accounting and auditing oversight.

Introduction

One of the key initiatives that has become a popular mechanism for reforming all of the recent ills attributed to the auditing standard-setting processes has been to instigate public oversight over these processes. The predominant structure initiated or proposed by various jurisdictions has been a public oversight (or equivalent) board (POB) (which includes mainly people independent of the audit profession), the purpose of which is to oversee the activities of the standard-setting board (which includes mainly auditing practitioners). The rationale behind this structure is that there is a public-interest dimension to auditing. It is generally, although not universally, believed that the setting of standards requires significant practical and technical expertise, and that this resides largely with practicing auditors. However, if auditors are given free rein to produce the standards that are required to be followed by members of the auditing profession, the concern is that they will produce standards that reflect the interests of the profession, rather than the public's interest.

The aim of this chapter is to compare and contrast the various structures that have been instigated or proposed by the leading national and international bodies with regards public oversight of the auditing standard-setting process. Such an oversight structure is to be set up in Australia under the CLERP 9 reforms, and follows similar recent initiatives at the national level in Canada, the United Kingdom and the United States, as well as at the international level with regards the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). The second section of this chapter examines what public oversight entails and what it is expected to achieve. The third section compares and contrasts the POBs in these jurisdictions on the following dimensions: membership, the procedures relating to appointment on the POB, the relationship between the POB and the standard-setting board, the powers of the POB and whether the POB assumes responsibility for both accounting and auditing oversight.

The fourth section of the chapter evaluates specific implications for Australia of moving to the proposed POB structure. (The issues considered may also have implications to varying degrees for other national bodies.) It firstly examines the tension that is created between oversight of a national standard-setting process and convergence with international auditing standards. The advantages of having public oversight at the national level, given that there is public oversight at the international level, and the proposed convergence of national with international auditing standards are also examined. A related consideration of the tensions produced by having national POBs set objectives that compete with a policy of converging with international auditing standards is also discussed. Finally, the extent of the POB's responsibilities in Australia with regards the development of auditing and assurance standards for assurance services other than financial report audits are considered.

The final section of the chapter contains a summary of the major findings and implications for Australia. In the Appendix, a comparison and summary of the key characteristics of POBs in the major national and international jurisdictions is provided. This includes all of the dimensions discussed in the chapter, as well as a comparison of some of the more structural aspects of POBs – oversight structure and funding mechanisms.

What is public oversight and what will it achieve?

Public oversight has been defined by the European Commission as comprising 'the responsibility for the education, the licensing and registration of statutory auditors as well as for standard setting on ethics and auditing, quality assurance and disciplinary systems' (European Commission 2003a). It has been operationalised by way of independent national bodies charged with the responsibility to carry out one or more of the above functions. In Australia, it has been proposed that public oversight will become the responsibility of an expanded Financial Reporting Council (FRC)[1] , whilst the Companies Auditors and Liquidators Disciplinary Board (CALDB) will maintain its responsibility for taking disciplinary action in the case of auditor misconduct. The FRC's duties will include monitoring, advising, reporting and assessing the audit standard-setting process, independence issues and systems to deal with them, compliance with audit-related disclosure requirements, teaching of professional and business ethics, and the disciplinary procedures of the accounting bodies (CLERP 2002).

It has been widely claimed (both nationally and internationally) that the 'present audit standards and practices are severely deficient' (Sharav 2003). This apparent deficiency has been associated with a loss of credibility of the audit profession as investors become aware of the largely self-regulatory nature of this profession, and the conflicts of interest evident within such a structure (European Commission 2003a). It has also been widely accepted that the solution for restoring investor confidence in the audit profession is to improve its independence and transparency.[2] Public oversight of the profession has been the often suggested[3] and accepted solution[4] ; it is posited to be a 'major element in the maintenance of confidence in the audit function' (European Commission 2003b).

Theoretically, public oversight by an independent body will restore confidence in the audit profession through the introduction of neutrality and transparency. However, the manner in which this theoretical solution is operationalised will severely impact the degree to which it achieves its goals of protecting 'the interests of investors and further[ing] the public interest in the preparation of informative, fair and independent audit reports' (PCAOB n. d.).

[1]Internationally, similar bodies include the Public Companies Accounting Oversight Board (PCAOB) in the United States, a restructured FRC taking on the roles of the Accounting Foundation in the United Kingdom, and in Canada the Auditing and Assurance Standards Oversight Council (AASOC), which will oversee standard-setting, whilst the Canadian Public Accountability Board (CPAB) will oversee the conduct of audits.
[2]Auditor independence and transparency are the 'two main thrusts' (PNG Institute of Directors n. d.) of CLERP 9.
[3]The Ramsey Report was one of many documents to make this suggestion. More recently, the Task Force on Rebuilding Public Confidence in Financial Reporting, an independent group commissioned by IFAC, released its report entitled 'Rebuilding Public Confidence in Financial Reporting', which also outlines the merits of public oversight. The European Commission has further put forward a set of principles for public oversight on the EU audit profession (see European Commission 2003a).
[4]As seen in the establishment of public oversight bodies in Australia, the United Kingdom, Canada and the United States, the principles of the European Commission and IFAC's current process of creating an oversight function (IAASB n. d.).

A comparison and evaluation of the dimensions of public oversight

This section compares and contrasts the approaches that have been adopted by the various jurisdictions with respect to POBs, and the implications of this for the proposed oversight structure in Australia. This comparison and contrast concentrates on the following dimensions: membership, the manner of appointment to the POB, whether clear separation of the POB and the audit standard-setting body is achieved, the powers of the POB, and whether the POB assumes responsibility for both accounting and auditing oversight.

Membership

There has been much international debate as to who should form the membership of a POB. The European Commission identified significant participation by non-practitioners as an essential characteristic of an oversight body, with independence being critical to maintaining public confidence (see European Commission 2003 a). However, of equal importance in an oversight regime is the capability of board members to understand the practical implications of the audit framework, and for them to have appropriate knowledge, experience and capability (McNamee 2002).

In addressing the appropriate balance between experience and independence, Australia has taken a passive, neutral approach. As in the United Kingdom and Canada, Australia's oversight board, the FRC, is comprised of 'senior-level stakeholders from the business community, professional accounting bodies, governments and regulatory agencies' (CLERP 2002, p. 24). There are no rules regarding members' responsibilities, rather they are simply 'required to act independently and not as representatives of any stakeholder group' (Priest 2003). This can be contrasted to the stringent attitude employed in Canada, whereby the chairman and a majority of the Auditing and Assurance Standards Oversight Council (AASOC) members must be drawn from outside the accounting profession (CICA n. d.). Similarly, three of the five members of the US Public Company Accounting Oversight Board (PCAOB) must not be certified accountants, whilst currently four of the five, including the chairman, have no public experience in accounting (McNamee 2002).

The absence of a specific policy regarding the proposed Australian POB's composition induces uncertainty regarding the intended level of neutrality and experience of this body. Whilst recent appointments have been made independently from the nominations of key stakeholder groups (Priest 2003), one may question the ability of such members to always act truly independently of their originating body, as well as the level of experience such members possess. In comparison to the structures in other jurisdictions, what Australia is lacking is not a balance between experience and independence, but some guidance on how this balance should be struck.

Appointment to the board

The manner in which members are appointed to POBs is an important factor in ensuring the independence and transparency of the oversight process.[5] Theoretically, for an oversight body that aims to 'increase public confidence in … standard setting activities' (IAASB n. d.), members should be appointed by the public. Practically, however, the costs of such a process would likely outweigh the benefits.

In Australia, the Treasurer will continue to appoint members to the FRC, either on the basis of nominations from key stakeholder groups[6] or independently.[7] This method of appointment is similar to the United States where the SEC appoints members of the PCAOB, and can be contrasted to that of both the United Kingdom and Canada, where the FRC and AASOC, or subcommittees thereof, appoint members to their own boards.[8]

There are clear advantages and disadvantages to both methods of appointment. A system of self-appointment may decrease the transparency of the process and independence of members. In such a structure, the council could develop its own agenda and appoint members in this pursuit. Conversely, appointment by a government agency has been described as a 'contentious and politicized process' creating 'doubts about the group's credibility and capability' (McNamee 2002). It is not possible to determine which method would induce a greater bias; a government may have larger incentives to manipulate the council[9] , but also faces larger political costs (disincentives) for doing so (Watts & Zimmerman 1986).

One area of general agreement is that the procedure for appointment 'should be subject to a high level of scrutiny that is expressed in an independent and transparent nomination procedure' (European Commission 2003a). Such a procedure exists in Australia, providing support for the current process. Thus, whilst Australia's current appointment system is not perfect, it is no less perfect than the alternative and must simply be monitored for undue political influence.

[5]Principle 2 of the European Commission's Principles for Public Oversight states that 'persons involved in public oversight should be selected under an independent and transparent nomination procedure' (European Commission 2003a).
[6]Nominations are currently made by the Business Council of Australia, the Australian Institute of Company Directors, the Securities Institute of Australia, the Australian Institute of Financial Services Association, ICAA, CPAA, the Australian Shareholders' Association, the Australian Stock Exchange, ASIC and the Commonwealth, state and territory governments.
[7]See http://www.frc.gov.au/content/about.asp
[8]In the United Kingdom, an appointment committee comprised of FRC members and its chairman have the responsibility of appointing members to their FRC.
[9]In the United States, it has been alleged that the 'PCAOB was designed to be [a] weak underling for SEC Chairman' (McNamee 2002, p. 37).

Separation of standard-setting and oversight

'Clear separation between standard setting and regulatory oversight' (ACCA n. d.) is essential in ensuring the credibility of a 'transparent independent oversight' (CPA Australia & ICAA n. d.) regime. If there was not clear separation, the new regime would be no more independent than the old, in which auditors oversaw their own standard-setting. The approach taken by Australia conforms to this generally accepted best practice, whereby the FRC will 'oversee auditing standard setting arrangements' (CLERP 2002, p. 1) and monitor the profession, whilst the AuASB will continue to independently set the auditing standards. This is consistent with the United Kingdom, Canada and IFAC, where standard-setting responsibilities have remained with existing bodies, which have come under the supervision of an independent oversight council.[10]

The United States has taken a different, and arguably less independent, approach. The PCAOB has 'put an abrupt end to the era of self regulation' (Carlino 2003) by announcing that it will take on the role of setting auditing standards to apply to all SEC-listed entities (*Accounting Office Management and Administration Report* 2003). An advisory committee containing 15 to 30 'experts' (*Business Times* 2003) from the business community, with less than one third of this membership comprising accountants, will be established to aid in this pursuit.[11] Whilst standards are subject to SEC approval, the fact that this so-called 'oversight' body sets rather than oversees an independent standard-setting process suggests that public oversight was not the primary objective. On the basis of the above discussion, the Australian system, which 'set[s] standards by calling on the experience of those who are on the front lines, doing audits every day, and learning from every audit they conduct' (Rankin 2003), is arguably superior to the US system. It allows independent oversight whilst ensuring the most efficient and effective body remains responsible for the setting of standards.

Powers

According to the European Commission, 'public oversight must include the exercise of investigative and disciplinary powers' because 'without such powers public oversight would lack public credibility' (European Commission 2003a). However, there also exists the view that 'in principle … standard setting should be separated from enforcement' (ACCA n. d.). It is argued that this separation of activities is essential to ensure the transparency, independence – and thus credibility – of the oversight council.

[10]Namely, the FRC in the United Kingdom, AASOC in Canada and the PIOB for IFAC respectively.
[11]This indicates the independence is highly valued in the United States, even at the expense of experience. The minimal experience, however, raises doubts as to how effective the standard-setting process will be.

The United Kingdom has successfully applied both principles through the establishment of the Investigation and Discipline Board (IDB). The IDB operates under the FRC and has the ability to 'impose appropriate sanctions, including removing the eligibility to perform an audit' (Williams 2003). The establishment of this body as separate from the standard-setters, but working under the umbrella of the same oversight council, has been commended as 'a balanced and robust approach' (Hewitt 2003).

In contrast, the PCAOB in the United States has been granted 'sweeping powers' (Hudson 2003). The PCAOB will not only set audit standards and monitor compliance with them, but will also 'enforce compliance with the act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports' (KPMG LLP 2003). In fulfilling this role, the PCAOB will conduct trial-like hearings where board staff act as both prosecutor and hearing officer, the latter having the authority to 'render a written decision, including findings of fact and conclusion of law' (PCAOB 2003). The PCAOB explains that this hearing officer will be 'insulated from the enforcement staff by a "Chinese Wall"' (PCAOB 2003), suggesting acknowledgement by the PCAOB that the transparency and independence of their system is flawed – and that their sweeping powers oppose the foundations upon which public oversight was established.

Not only will the PCAOB act as prosecutor and judge, it will also act as the only appeals commission; 'in the event of an appeal, the Board will render the final decision' (PCAOB 2003). Such sweeping powers in an area of public interest give cause for concern. The concentration of power within this board eliminates any credibility being placed upon its judgment – and can evoke feelings that such judgments are simply the outcome of political witch-hunts. It has been argued that 'the board's broad powers ... might do more harm than good' (Hudson 2003). Given the dictator-like powers that it has over the accounting profession, such a claim indeed seems warranted.

The FRC in Australia, however, may equally be criticised for sitting at the other end of the continuum; it possess no disciplinary powers. Instead, disciplinary procedures have been left in the hands of the professional bodies, with the FRC fulfilling passive responsibilities to monitor, advise, report, promote and assess. The highest power the FRC possesses is to advise government if improvements are required, and to refer matters to the CALDB or to ASIC. Whilst many have commended this approach as 'achieving an appropriate balance between self-regulation and co-regulation' (McGregor 2002), a more cynical critic might express concern regarding the FRC's lack of authority, particularly in comparison to the approach being employed in the United Kingdom. Given that the PCAOB has been described as 'a weak underling for SEC Chairman' (McNamee 2002), one questions how Australia's FRC could be viewed as anything other than a mere veil of oversight established to induce perceptions of an efficient oversight regime.

Separate oversight bodies for auditing and accounting?

It is generally believed that a separation between responsibility for accounting and auditing standard-setting oversight is beneficial to enhancing the perceived quality of the auditing function. Where auditing and accounting standard-setting oversight is undertaken by the same body, some concerns have been expressed that the auditing function is perceived as the 'poorer cousin' by being prioritised below the accounting oversight responsibility.

As outlined in the Appendix, the United States, Canadian and other international auditing and accounting standard-setting processes are all overseen by separate independent bodies. In the United Kingdom, the FRC oversees both the Accounting Standards Board (responsible for setting accounting standards) and the Auditing Practices Board (responsible for setting auditing and assurance services standards). In addition, the Professional Oversight Board for Accountancy of the Accountancy Profession (POAB) oversees the application of accounting standards and also supervises the Audit Inspection Unit, which monitors the public company audits.

The structure proposed in Australia is closest to that used in the United Kingdom, where the FRC will undertake responsibility for oversight of both the auditing and accounting standard-setting function. It is hard to compare the relative merits of the different approaches. It is anticipated that having one oversight body will achieve a reduction in oversight costs. However, this must be offset by the fact that effective oversight of both bodies may be hard to achieve unless considerable new resources are added to the current ones. Another consideration is that oversight of accounting and auditing may require separate oversight expertise, a reason for separating such supervision. However, if you consider the constituencies of the various oversight bodies of accounting and auditing standard-setting in order to see whether these constituencies are separate and distinct, it is not clear that this is so.

Specific implications of public oversight for Australia

There are a number of issues arising as a result of recent developments in the area of public oversight of the auditing standard-setting process. One of these is that, with the recent IFAC proposal to have public oversight of the international auditing standard-setting process, if countries are planning to converge with international auditing standards, the benefits of an additional level of oversight are less clear. It may even be that the oversight at the national level may create additional tensions with the objective of converging with international auditing standards. Finally, auditing standards boards have traditionally undertaken broader agendas than only setting financial statement auditing standards for public-interest entities, including setting assurance standards for other services and setting auditing standards for private entities. Tensions arising from these issues are examined in the following sections.

Do we require public oversight at both the national and international level?

The advantages arising from public oversight of the auditing standard-setting process for Australia and other countries planning to converge[12] with international auditing standards become less clear given that the IAASB is also working towards establishing a public-interest oversight board (PIOB) for the setting of International Standards on Auditing (ISAs) (IFAC 2003). Australia, like Europe, has adopted a policy of converging with ISAs as from January 2005 (AuASB 2003). It must be questioned whether there is a need for public oversight at a national level if a country is proposing to converge with ISAs that are developed under a public oversight structure. On the whole, the agenda for standard-setting will be set at the international level, and it is at this level that the content of the actual standards will also be determined.

One possible advantage of this dual level of public oversight may be an increase in the perceived independence of the standard-setting process of the individual country. There is also the potential advantage that if a country works towards what is commonly being termed an 'ISA+ model' (which involves including additional material in the ISAs as a result of the specific national requirements), the national POB may have a role in overseeing the process by which the ISAs are added to in the creation of the national auditing standards. These benefits must, however, be balanced against the significant increased costs associated with national public oversight.

Will tension develop between public oversight at a national level and achieving other objectives?

Where a country has an objective of converging with ISAs, and the national POB sets any other objective for the national standard-setting body, it is possible that these objectives may conflict. For example, in Australia it has been flagged that attempting to get a category one rating from the PCAOB for the Australian audit standard-setting process is an objective that may be considered desirable and be pursued by the FRC.[13] Although it is not yet clear as to what would be

[12]In this situation, convergence is defined as adoption of international auditing standards with minimal change.
[13]Mr Charles Macek, Chairman of the FRC, at the advisory meeting of the AuASB, October 2003.

required in order to gain such a rating, it is possible that such an objective may conflict with the policy of convergence with ISAs.

It is also possible that other objectives, such as legislative backing for auditing standards, as is proposed for Australia, may conflict with the policy of convergence with ISAs. To the extent that legislative backing will involve the rewriting of any auditing standards (there have been a number of comments claiming that the current standards are too detailed and unclear for such backing), such an objective has the potential to conflict with a convergence policy.

Thus, it can be argued that greater clarity is needed as to the functions that are expected of the POB in Australia or any other country that is contemplating convergence with ISAs. The role of any national POB in these circumstances will be limited. In fact, any POB will be very limited in its ability to do anything other than oversee convergence with ISAs. A desire to set any other objective or agenda for the auditing standards board which will impact the content of standards or the process of standard-setting will have the potential to conflict with the international convergence objective.

Will the public oversight body assume responsibility for audit and assurance services other than those under the Corporations Act?

Auditing standard-setting bodies have traditionally undertaken more activities than just setting standards for the financial statement auditing of public-interest entities. For example, they have also taken responsibility for setting assurance standards for other services such as performance auditing or reporting on internal controls, as well as setting auditing standards for private entities. In Australia, it is unclear as to whether the FRC will assume an oversight responsibility for the setting of auditing standards for other than Corporations Act audits. If the FRC is not to assume this responsibility, then the accounting bodies would have to run an equivalent standard-setting process for non-Corporations Act audits. This will be similar to the system which is proposed in the United States, with the PCAOB taking responsibility for SEC registrant audits and AICPA taking responsibility for providing standards and guidance for non-SEC registrant audits. Such an approach has the advantage of focussing resources on the audits of greater public interest, but this needs to be compared with the costs associated with the inefficiencies of running two parallel standard-setting processes within a particular country.

It is also unclear to what extent national POBs will assume responsibility for the setting of assurance standards, which may or may not be under their mandate, and, if they do assume responsibility, what attention they will pay to these services. The advantages and disadvantages of the national POB taking responsibility for oversight of such services is similar to the arguments for and against when considering providing oversight for the setting of auditing standards for other than public-interest audits; the advantage of focussing resources on the services of greater public interest compared with the costs associated with the inefficiencies of running parallel standard-setting processes.

Conclusion

There is much empirical evidence to suggest that high-quality audits are demanded (and thus supplied) by the market to protect firm reputation (Carcello et al. 2002), decrease the cost of capital (Blackwell, Noland & Winters 1998), avoid legal liability (Carcello et al. 2002) and avoid agency cost (Abdel-khalik 1993; Carcello et al. 2002; Carey, Simnett & Tanewski 2000). The demise of Arthur Andersen, as a result of its loss of credibility and associated exodus of clientele, has also been cited as proof that market mechanisms ensure audit quality (Gunther & Moore 2002). Commentators have thus criticised governments and policymakers for their failure to consider the successful track record of the market in 'disciplining ineffective auditors and promoting an effective audit function' (Gunther & Moore 2002). Such critics argue that governments 'should avoid restrictive measures that unnecessarily increase audit costs' (Gunther & Moore 2002) and rely instead upon the proven disciplinary procedures evident in the market. In support of such views, it is often argued that 'structures, standards and regulations can never be a complete defence against individuals bent on wrongdoing' (Hewitt 2003).

Whilst the oversight structure proposed in Australia is less authoritative than some of its overseas counterparts, those who believe in the efficiency of the market may argue that the Australian model appears superior. Unlike the US response, it can be argued that the proposals under CLERP 9 are not guilty of ignoring the effect of market forces in disciplining auditors. This can be seen in the fact that the professional bodies are still largely responsible for disciplining members. Rather than developing black-letter laws to ensure audit credibility, the Australian Government is 'supporting a system of "competitive capitalism" … strong enough to create confidence among investors while not so over-regulated that "those who are doing nothing wrong are treated as if they are"' (Abernethy 2002b).

It has been claimed that 'what is developing in this country [Australia] is the world's best system of co-regulated corporate governance'[14] , based in part on CLERP 9's proposal to establish public oversight of the audit profession. In addressing the issue of public oversight, the Commonwealth Government's actions mirror those of governing bodies worldwide, although the manner in which

[14]Steven Harrison, CEO of ICAA, cited in Abernethy (2002a), p. 38.

Australia has responded differs in some respects from that of other nations. Whilst Australia's response can be criticised for lacking black-letter laws and an oversight body containing enforcement power, perhaps it is the more mature one. It establishes oversight to increase investor confidence, without imposing regulations that will hinder market efficiency or create the authority for further misuse of powers.

However, the functioning of any POB must be considered alongside competing aims such as the policy of harmonisation and convergence with international standards. As the ISAs board moves to establish a public oversight body of its standard-setting process, and the policy of convergence with ISAs means that the setting and contents of standards will be carried out at an international rather than national level, the roles, duties and expectations of any national public board overseeing the development of auditing standards must be clearly established.

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Appendix

Summary of key characteristics of public oversight boards in major jurisdictions *

	Australia (proposed)	US	UK	Canada	International (proposed)
Oversight structure	Proposed that FRC be expanded to oversee audit setting process, advise on issues of independence and monitor aspects of the profession. Original role of	Public Company Accounting Oversight Board (PCAOB) established by Sarbanes-Oxley Act. Broad powers to oversee and discipline audit profession.	Financial Reporting Council (FRC) taking on roles of Accountancy Foundation to form new regulator which will have three responsibilities: to	Auditing and Assurance Standards Oversight Council (AASOC) established October 2002 by Canadian Institute of Chartered	Proposed that IFAC create a public interest oversight board (PIOB) for its activities which would include the IAASB. The PIOB shall be

	overseeing work of AASB remains.		oversee setting of accounting and auditing standards, enforcement or monitoring of standards and oversight of regulatory activities of professional accounting bodies.	Accountants (CICA) to oversee activities of ASB. Canadian Public Accountability Board (CPAB) is an independent body which oversees the conduct of audits of public companies.	responsible for overseeing the public interest activities of IFAC related to auditing, giving priority, at least initially, to those standard-setting activities related to audits and other financial statement assurance activities.
Membership	Comprised of senior level stakeholders from the business community, professional accounting bodies, governments and regulatory agencies.	Five members, four of whom have no public track record in accounting. Must have three members that are not CPAs.	Include wide and balanced representation at the most senior levels of preparers, auditors, users of accounts and others interested in them.	AASOC: 9-12 members. The chair and majority of members must be drawn from outside the audit profession; that is, not be CAs. Consists of prominent leaders from business, finance, government, accounting, legal professions and regulators. CPAB: 11 members including seven non-CAs.	The precise size of the PIOB, yet to be determined, shall not be more than 10 members. Members shall not be currently in public practice as auditors or working for a firm that performs audits, but might be persons practicing in another area of auditing (e.g., an auditor-general) or accounting.
Member selection	Members appointed by the Treasurer on nomination by the Business Council of Australia, Australian Institute of Company Directors, Securities Institute of Australia, Investment and Financial Services Association, ICAA, CPAA, Australian Shareholders Association, ASX, ASIC, and Commonwealth, state and territory governments.	SEC appoints members.	An appointment committee is responsible for the appointment of members to both the FRC and its subsidiary units. This committee comprises the chairman, deputy chairman and three other members of the FRC.	AASOC appoints own members. CPAB members will be appointed by a group, the chair of which is Ontario Securities Commission Chair.	PIOB members shall be selected by the current members of the monitoring group – currently, the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Supervision (Basel Committee), the International Association of Insurance Supervisors (IAIS), the World Bank and the European Commission.
Funding of body	AuASB will be established under ASIC Act, and funded by government, accounting profession and business.	Annual levy on all listed companies with market capitalization greater than US$25 million. This level is higher for managed funds.	Costs of FRC will be shared by government, business and the professional bodies. Costs of cases coming before IDB borne by professional bodies. Costs of audit inspection unit borne by audit firms.	Individual firms will have to meet the additional costs of this new regime.	It is expected that initially the annual budget will not exceed US$1.5 million. As a general principle, both IFAC and the monitoring group consider it to be in the public interest that parties other than IFAC shall fund at least 50% of the cost of the PIOB.

Powers/roles of body	Responsibilities to oversee audit standard-setting, advise professional bodies on independence issues, monitor and report on systems of firms to deal with independence issues, monitor and report on companies compliance with audit-related disclosure requirements, advise on adequacy of teaching of professional and business ethics, and monitor and assess adequacy of the disciplinary procedures of the accounting bodies. FRC cannot involve self in setting of standards. FRC will not have direct role in disciplining members, but rather refer attention to CALDB or government.	Primary functions include registration of public accounting firms, to establish or adopt the auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports, conducting inspections of public accounting firms, conducting investigations and disciplinary proceedings and imposing appropriate sanctions upon registered public accounting firms, enforcing compliance with Sarbanes-Oxley Act, rules of board, professional standards and securities laws relating to audit reports, and performing other duties or functions as the board or SEC determines appropriate. Advisory group will help board set new auditing standards and will include experts from the accounting profession, corporate finance and investments.	Will form the umbrella under which separate bodies will set audit standards, review alleged departures from standards, hear disciplinary cases, and review regulatory activities of professional bodies. APB will set audit standards as well as independence, objectivity and integrity standards. Professional oversight board will have audit inspection unit which will monitor the audit of listed companies and major charities/pension funds. Investigation and Discipline Board (IDB) will be forum for hearing significant public-interest disciplinary cases, and will have power to impose sanctions and remove eligibility to perform audits.	AASOC to oversee Assurance Standards Board (ASB), providing input, strategic direction and the perspective of users into the setting of auditing and assurance standards in Canada. Will be responsible for appointing its own members, and those of ASB, provide input into activities of ASB, inform ASB of diversity of views represented on AASOC, be satisfied that standard-setting process is appropriate, and monitor and evaluate ASB. It reports publicly at least annually. Meetings are open to public observation at the discretion of the chair. CPAB will conduct rigorous inspection of auditors of public companies. There are tougher auditor independence rules and quality control requirements for firms auditing public companies.	The PIOB shall approve the terms of reference (i.e., duties and scope of work, charter, operating procedures, etc.) of relevant IFAC boards and committees, such as the Ethics Committee, Education Committee and the IAASB, as well as their consultative advisory group(s) (CAGs). The PIOB shall have the authority to finally approve or reject the choice of the chair of the IAASB. The PIOB shall have the right to meet with all or some of the members of the IFAC boards or committees, to discuss matters of interest to the PIOB. The PIOB chair may attend, or may designate a PIOB member to attend as an observer, any IFAC meeting (other than those held in executive session) which it considers might have an impact on the public interest.
Separate oversight bodies for auditing v. accounting	The Financial Reporting Council will be responsible for overseeing both accounting and auditing functions as outlined in the recent CLERP 9 regulations.	The Public Company Accounting Oversight Board (PCAOB), established by the Sarbanes-Oxley Act 2002, oversees auditors of public companies. Auditing rules made by the PCAOB do not take effect unless approved by the SEC. The Financial Accounting Standards Board (FASB) is the private-sector body responsible for establishing	The Financial Reporting Council (FRC) oversees both the Accounting Standards Board (responsible for setting accounting standards) and the Auditing Practices Board (responsible for setting auditing and assurance services standards). An additional subsidiary of the FRC, the Professional Oversight Board for Accountancy of the Accountancy	The Accounting Standards Oversight Council oversees the accounting function. It does so through supervision of the Accounting Standards Boards (AcSB), responsible for establishing accounting and reporting standards applicable to the private sector, and the Public Sector Accounting Board, responsible for the accounting and reporting	The International Auditing and Assurance Standard Board (IAASB) will be overseen by its own PIOB. This will be separate from the oversight of accounting, undertaken by the International Accounting Standards Committee Foundation.

		financial accounting and reporting standards. The SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies (Securities Exchange Act 1934), however the SEC's policy is to rely on the private sector for this function.	Profession (POAB), will oversee the accounting standards. The POAB will also supervise the Audit Inspection Unit which will monitor the public company audits.	standards applying to the public sector. The Auditing and Assurance Standards Oversight Council (AASOC) oversees the auditing function through supervision of the Auditing and Assurance Standards Board (AASB). The AASB has the authority to establish audit and assurance standards for both the public and private sectors.	
* These jurisdictions were chosen due to the similarity of the environment in which the audit takes place. They were chosen based on comparisons most frequently made within the literature and are not an exhaustive list of possible comparable oversight frameworks.					

Chapter 4. The role of markets: an economic approach to auditing

Jane Hamilton
Donald Stokes

Abstract

The current institutional regulatory framework for auditing is a product of the philosophy that individual property rights exist and are to be protected. These notions of property rights create the tension to which auditing is a partial solution.

In this chapter, we describe the institutional regulatory framework for auditing and its relationship to markets, corporations and professional associations. Our thesis is that all the institutional arrangements are incentivised as contracting cost-reducing mechanisms to deliver 'audit reform' but residual losses are to be expected. Ethics is viewed as central to the contracting process, facilitating functional completion of contracts and helping to reduce residual losses in contracting. Auditing is also demanded (*ex ante*) to reduce the expected contracting residual economic loss resulting from attempts to protect individual property rights. Market participants have incentives to minimise contracting residual losses, and regulatory intervention is valued to the extent that the reforms are more efficient contracting solutions to minimise those losses.

We review fallacies in the market failure arguments used as rationales for regulatory intervention and suggest that the costs of regulation could be underestimated and the benefits could be overstated. The result is that regulatory intervention could increase future bonding and monitoring costs beyond what is optimal, and thus contribute to inefficient allocation of the costs of property rights.

In the same way that ethical behaviour by contracting parties can reduce contracting residual losses, ethical behaviour by politician-regulators in the political process could contribute to lowering the political residual losses and enhancing society's well-being through facilitating the economic outcomes sought by contracting parties.

Introduction

Australia and other countries have been experiencing a new wave of regulatory 'reform' of the institutional arrangements governing audits of company accounts.[1] In Australia, key developments in the regulatory debate are the Ramsay Report (Ramsay 2001), the report of the HIH Royal Commission (HIH Royal Commission 2003) and various reports and submissions at government level, including the CLERP 9 discussion paper (CLERP 2002)[2] and subsequent legislation, the CLERP (Audit Reform and Corporate Disclosure) Act. Internationally, major reforms affecting auditors include the US Sarbanes-Oxley Act (2002).[3] These reforms potentially affect the relationships between statutory regulation and other institutions and actors in the economy and society. As such, they are likely to affect the distribution of costs and benefits in society. It is important to understand these effects when making regulatory changes, including those directed at ethical issues.

In this chapter, we review the role of markets, companies, audit firms and their partners, professional associations, and accounting and auditing standard-setting and statutory regulation. We do so by drawing together the key ideas and findings from research into the economics of the firm, auditing and regulation to outline a framework for understanding these relationships. We argue this current institutional regulatory framework, and the regulatory developments placed within it, reflect an underlying philosophy about the existence of individual property rights and how to protect them. This notion of property rights creates a tension to which auditing is a partial solution. We focus on the economics of auditing as a method of explaining the ethical dimension, because contracting, including for auditing, implicitly and explicitly relies on and influences society's institutions and norms. Ethics and the economics of auditing are interrelated.

Our underlying thesis is that auditing is a social construct based on the current institutional framework in which contracting parties expect some residual (economic) loss. Furthermore, in the absence of regulatory intervention, firms and markets have incentives to minimise contracting residual losses and auditing is demanded (*ex ante*) to do this. Ethics is viewed as central to the contracting process, facilitating functional completion of contracts and helping to reduce residual losses in contracting. We will suggest that it is too easy to put in place crisis statutory regulation solutions without understanding the intricate relation-

[1]While many of the arguments in this chapter can be adapted to other types of audits and assurance engagements, the focus here is on corporate audits and reform.
[2]The Australian reform process is summarised in CLERP (2003), p.1.
[3]Overseas developments in auditor independence regulations prior to the release of Ramsay (2001) include the International Federation of Accountants' (IFAC) proposals for updating its ethical requirements on audit independence, the European Commission's release of a consultative paper containing proposals designed to achieve greater uniformity among member states of the European Commission, and the US Securities and Exchange Commission's (SEC) rules on auditor independence, which were released in November 2000.

ships between these institutional features and the roles they can play-out to generate 'reform' in their own right, in the absence of regulatory intervention.

While the demand for auditing predates the demand for regulatory intervention, such intervention, however, can be viewed as a rational response to 'crisis'-solving to protect those individual property rights affected by the residual loss. We review the fallacies in the market failure rationales used for regulatory intervention and stress the concept of political residual loss. We suggest that the costs of regulatory intervention could be underestimated and the benefits overstated, raising questions about whether regulatory solutions really do serve the public interest. We suggest too that, in the same way that ethical behaviour by contracting parties can reduce contracting residual losses, ethical behaviour by politician-regulators in the political process can contribute to lowering the political residual losses and enhancing society's well-being through facilitating the economic outcomes sought by contracting parties.

The chapter is organised as follows. The second section reviews the role of markets and firms and the demand and supply of auditing services. The third and fourth sections respectively address the role of professional societies and the setting of accounting and auditing standards. An evaluation of the regulatory process for audit reform follows in the fifth section, and the sixth section provides concluding comments.

The role of markets and firms in auditing

It was Coase (1937) who gave us a basis for understanding the role of firms in markets and ultimately gave us an economic framework in which to understand the role of auditing. Coase advocated that contracting solutions between parties, such as investors, suppliers and customers, will be demanded and supplied through firms up to the point where it is more efficient to do so than to establish multidimensional contingent claims contracts between the individual parties directly in markets. Firms exist only as efficient contracting mechanisms to lower the costs of contracting between and within the customer markets and factor markets. In the absence of contracting costs, there would be no demand for firms to exist because parties could costlessly contract directly in markets.

As discussed by Jensen and Meckling (1976), and extended by Ball (1989), contracting covers how to search for and bring parties together (e.g., investors with entrepreneurs and customers); how to design, negotiate and execute contracts (e.g., prospectuses to raise equity capital and customer service contracts) to fairly protect the interests of the parties so that they benefit from combining their investment and human capital to provide services/products to customers; how to establish bonding mechanisms such as performance contracts to align the interests of the parties; how to monitor that the parties are contracting fairly (such as agreeing perhaps to have the firm's performance audited); how to arbitrate where there are claims of unfairness of outcomes (e.g., through common law courts dealing with contracts and the tort of negligence); and how to make contract payments and how to *ex post* settle up where there are unfair contractual outcomes (again through, for example, the courts or through negotiation/arbitration). Contracting directly within and between parties in customer markets and factor markets is also aimed at such outcomes, but the combination of relying on market and firm contracting solutions depends upon their relative contracting efficiency, or as Ball (1989) suggests, where there are increasing returns to scale from contracting.

We support a view that ethics is about the exercise of power[4] between contracting parties for the benefit of all the parties brought together under the explicit and implicit contracts that define the firm and the markets in which firms operate. Ethics is central to the contracting process because it contributes to fairness in functional completion of the contracts through the exercise of power held by the contracting parties.[5]

Using a contracting cost framework to examine firms and markets, Watts and Zimmerman (1986) summarise much of the foundation literature of the 1970s and 1980s in the economics of auditing as well as accounting. They emphasise a 'property rights' perspective, with rights established by contracts in which self-interested parties contracting through the firm have incentives to take actions to transfer wealth from other parties associated with the firm, but who recognise that their welfare depends upon the firm's survival as a contracting mechanism relative to other contracting mechanisms. They describe a concept from the literature – 'price protection' through markets; that is, markets charge a higher cost (e.g., for capital) if the parties do not contract to minimise self-interested value-reducing actions in the firm. The process of price protection causes parties to bear the costs of their actions. This incentivises the parties to take any lower-cost contracting solution to bond themselves to the firm to restrict those actions, and to have them monitored through the firm rather than the market's price protecting for the risk.

Some firms bring in an external auditor to monitor and arbitrate on the accounting for firm performance and financial position, in order to meet the demands of customers, investors and suppliers for information about their contracts. Auditors supply an opinion on the accounts' fairness, and where the auditors believe there are unfair revelations of what was expected under the contracts, they provide details to alert parties to what they know about the unfairness. The threat of such audit qualifications can be a discipline mechanism that motivates management to deliver a fair set of accounts. Audits also provide a form of

[4]Ethics as an exercise in power is discussed in Howieson (2003).
[5]The notion of functional completion of contracts is described by Ball (1989), drawing upon the work of Cheung (1983).

insurance in that, if some aspect of audit failure can be demonstrated, investors can litigate to recover where their economic losses can be attributed to the audit failure (see, for example, Menon & Williams 1994). This notion of *ex post* settling up with an auditor is a cost of contracting as defined above. It is important to stress that the insurance bond being offered here again facilitates functional completion in contracting, and is in respect of the risk with the quality of the audit and not the total risk with the quality of the investment. Distinguishing audit failure from investment failure is important in the first instance in understanding the focus of regulatory reform in the audit area.

Empirical evidence supports the general price protection argument for contracting through the firm versus markets, and shows the value audits provide in making it cheaper to contract through the firm. Blackwell, Noland and Winters (1998) show that borrowing interest rates are 25 basis points lower for companies that voluntarily choose to be audited than for unaudited firms. This discount is after controlling for other determinants of interest rates. In other words, companies that choose to be audited do so because it lowers the cost of contracting compared to using the market mechanism *ex ante* to price the risk of misleading accounting numbers into interest rates.[6]

The Blackwell, Noland and Winters study is interesting because it demonstrates how the potential for unfair outcomes to be derived by one party over others who contracted through the firm is priced in the relevant markets. In this case, debt-holders priced the potential for management/shareholders to supply an unfair set of unaudited accounting numbers, but lowered the interest rate to recognise the value to them of having an audit carried on within the firm. This firm contracting solution is offered up to the point where it is justified in the lowering of interest rates.

Empirical evidence also supports extending the concept of the effect of auditing on price protection to the effects of choices between auditors with reputations for different quality. Competition for auditors' services informs market prices, allowing the conclusion to be drawn that in the audit market, audit reputations are priced. Research beginning with Simunic (1980), and continuing with a series of Australian and overseas studies, shows that auditors with reputations for higher audit quality are valued highly in the auditmarket.[7]

An audit firm that fails to deliver the expected audit quality (i.e., an audit failure occurs) can expect to find that its services are priced lower in audit markets, their insurance premiums are likely to be higher in insurance markets, and in the extreme, they are unable to hold clients for any fee or attract insurance

[6] Fama (1980) makes a case for the relative efficiency of market solutions in situations where firm solutions are less efficient in handling *ex post* unfair outcomes.
[7] For a review of these studies, see Ferguson, Francis and Stokes (2003).

coverage. The failure of an audit firm is an extreme form of *ex post* price protection in markets, and is discussed more fully below in the specific case of Arthur Andersen's collapse. Audit firms that don't survive in markets are evidence of how markets and firms work in tandem to facilitate contracting. A corporate firm's choice (or failure) to put in place quality control over its accounting, or an audit firm's choice (or failure) to put in place quality control over its audit services, is rationally priced in the respective markets. Market pricing of quality forces owner-managers of the respective firms to bear any reduction in firm value. This gives them an incentive to enhance quality by offering contracting cost-reducing mechanisms through their respective firms.

The extent to which such contracting solutions are adopted depends on the costs of the best available solutions associated with reducing or eliminating the problem (i.e., the self-interested value-reducing actions of the relevant party/ies) relative to the costs borne through the price protection mechanisms employed in markets. Even in the absence of an explicit contract to behave fairly, there will be reliance upon the implicit contract conditions that all parties are trusted to act fairly. These implicit contracting terms in part facilitate the completion of the contracting process *ex ante*, and lower contracting costs in preference to contingency contracting for all specific circumstances that can arise. The ethical exercise of power under the contracts by all parties – including shareholders, investors and customers as well as managers, and auditors if appointed – is part of the process of acting fairly in the execution of contractual obligations, and is in the interests of the firm.

Residual losses are the reduction in firm value caused by any remaining divergence between the interests of the parties that cannot be eliminated by contracting through the firm (Jensen & Meckling 1976). Residual losses are to be expected in firm solutions where further contracting solutions (explicit or implicit) cannot be cost-benefit justified. While ethical behaviour can contribute to reducing the residual losses, it cannot eliminate it because implementing fundamental ethical principles is an imperfect process (Howieson 2003, p. 20). There are at least two implications that follow which are relevant here. First, contracting parties expect residual losses; for example, there is some risk of audit failure. Second, regulatory solutions – for example, auditing reforms – are only valued if they are cost-benefit justified in lowering the costs of contracting. In the fifth section of this chapter, on the role of regulation in auditing, we examine in more detail how politician-regulators utilise a focus on any residual losses to create political opportunities or crises, and then 'solve' those crises with so-called 'public-interest' regulatory solutions to 'market failure'. Before so doing, however, we examine further how market participants have incentives to minimise the risk of audit failure.

Variation in audits

A contracting demand for auditing is not contingent on a regulatory demand for audits. Even in the absence of regulatory codification of best contracting practice or regulatory intervention because of market failure, demand for audits is based on the existence of firms as a means of facilitating contracting between parties. Watts and Zimmerman (1983) document a history of the demand for accounting and auditing and show that auditing was in demand long before regulations emerged for audits, and that the survival of auditing suggests it is a part of the efficient contracting technology for organising firms. They also provide evidence that auditors had incentives to be independent long before regulatory requirements to do so.

There is a body of accounting and auditing research that demonstrates that firms exercise discretion in auditor choice consistent with this contracting perspective. Some firms, given the contracting solutions they address, do not demand audits, relying instead on other monitoring mechanisms to report and monitor firm performance. Anderson, Francis and Stokes (1993) provide evidence of a mix of monitoring mechanisms being used in firms dependent upon the types of investments under managers' charge. Other work has shown that, for example, smaller firms have lower demand for audits (Chow 1982). Where there exists demand for an audit, firms can vary in their demand for the quality they require. Firms with more complex operations, for example, and related contracting and accounting issues, demand higher quality audits and are prepared to pay higher audit fees.[8]

Audit quality is defined as consisting of two components – auditor competence to detect errors or irregularities with the accounting, and auditor independence to report their existence in the auditor's opinion (Watts & Zimmerman 1986, p. 314). Auditor independence only exists in the supply of audit services to a client if the client in the market is convinced the auditor has something to lose by never reporting errors or irregularities (Watts & Zimmerman 1986). DeAngelo (1981a, 1981b; and see Watts & Zimmerman 1986, p. 314) argues auditors that are independent are prepared to give up fees associated with incumbency because, while they forego these in respect of one client where the manager switches auditors, they maintain the fees from other clients who are prepared to value independence. Larger audit firms offer a larger bond because they have more clients (with fees at risk for failure to deliver an independent audit).

Audit firms and audit partners

The auditor's reputation acts as a collateral bond in the contracting process with the firms utilising their audit services. Auditors can organise and invest in pro-

[8]See, for example, Simunic (1980), Ferguson, Francis and Stokes (2003), and Godfrey and Hamilton (2005).

cesses to supply higher audit quality in order to capture the higher audit fees that are in evidence where quality is valued. Watts and Zimmerman (1983) argue that with the expansion in the number of companies in the United Kingdom and the United States in the latter half of the 19th century – and, in particular, the enormous growth in foreign companies, with the associated complexity of accounting for the operations – there came a demand for specialisation in auditing (audit competence) and hence the growth of professional accounting firms. The growth in scale of the capital markets increased the fixed cost of an auditor's establishing a reputation that would serve as a bond for the auditor's independence (Watts & Zimmerman 1983, p. 630). Large professional accounting firms emerged as contracting cost-reducing mechanisms for delivering specialisation in auditing (competence) and to establish a reputation that would serve as a bond for auditor independence. A key feature of large accounting firms that enhances the collateral bond is their organisation as unlimited liability partnerships. Unlimited liability partnerships mean that there is more 'skin in the game' for the auditor partners. The partnership form also leads to mutual monitoring (through internal quality controls) by the partners because they are liable for other partners' actions.[9]

As we noted in the second section, on the role of markets and firms in auditing, to the extent that an auditor's reputation is called into question by virtue of problems perceived by the market with the audit firm's internal processes, the contracting process allows parties to engage in *ex post* settling up through the courts and the audit market price-protects by lowering the value of the services being provided. In the extreme case, the audit market can price the services of the audit firm so low, where significant uncertainty about the value of the bond is created, that it is no longer viable. The brand name loses value and the firm goes out of business, as in the case of the Arthur Andersen audit firm. The case of Arthur Andersen's demise demonstrates how audit markets deal with audit failure in this way, and it is important to note too the efficiency with which the market's solution emerged in 2001-02, compared to the ongoing regulatory response to the Arthur Andersen audits called into question in the United States in particular.

In a related case[10], in the early 1990s a US accounting firm, Laventhol & Horwath ('L&H'), went into bankruptcy. Menon and Williams (1994) investigated the effect of the bankruptcy on the share prices of the companies audited by L&H. Consistent with the insurance benefit of the audit in the collateral bond disappearing with the auditor going into bankruptcy, the research showed that the share prices of L&H's clients declined relative to the market. The effect was more

[9]Limited liability partnerships have taken away the size of the bond on the auditor's independence and the potential for higher fees (Watts & Zimmerman 1986, p. 317).
[10]The outline of this case, and the implications of the results of its study for Arthur Andersen's disappearance from the market, draw on an analysis by Stokes (2002).

pronounced for those clients who had sustained recent losses, and the extent of security price declines correlated with the size of the sustained losses. In addition, the share price declines were greater for those clients that had recently made initial public offerings and incurred losses relative to those with seasoned equity offerings.

The implication from these findings is that the insurance benefit/bond – which provided the client contracting parties with a right to litigate against the auditors in the event of audit failure – declined with the audit firm going into bankruptcy. This study demonstrates that litigation against auditors is a valued mechanism for *ex post* settlement, and settlements in and out of court are anticipated parts of the contracting process. Auditors carry professional indemnity insurance and self-insurance to meet settlement claims. Furthermore, the mix of insurance from the market versus firm insurance reflects the same principles of costly contracting discussed above. The audit firm will self-insure and contract accordingly up to the point where it is cheaper for all contracting parties that define the audit firm (this includes the client company and its shareholders) to do so, compared to insuring through the insurance market.

So these insurance benefits are valued by shareholders of audit client companies, and they agree to contribute capital on terms that recognise there is not an unlimited pot of insurance benefits to access if there is audit failure (because it would be too costly to have taken out such insurance *ex ante*). That is, they expect there will be some residual losses, whereby any insurance benefit provided may not cover all the costs for them from an audit failure that they knew *ex ante* was a possible contracting outcome. There are no guarantees of a contracting risk-free investment in a world of costly contracting. So audit failures are anticipated and losses due to audit failure are compensated – though perhaps not fully – to the extent that after *ex post* settlement there remains a residual loss. It is important to emphasise that the shareholders who are parties to the contracts that define the client company accept this potential outcome when they contribute their capital. That is how the contracting process works in a world of costly contracting.

Combined with the broader empirical evidence that shows how reputations are priced in markets, this suggests audit markets, insurance markets and *ex post* settling up via contracting in the firms can generate a type of 'reform' in their own right, in the absence of regulatory intervention. Auditors bear costs of audit failure as audit and insurance markets revise the value of the reputation of the auditor. This creates incentives for auditor partners to improve the audit quality through internal contracting arrangements (e.g., better quality controls within the firm) in order to reduce the costs of dealing in audit markets (via lower audit fees) and insurance markets (through higher insurance premiums or lower professional indemnity coverage). As noted, larger firms have more at stake and therefore contribute more to setting best practice, an issue we return to in examining 'reform' through the standard-setting process. And importantly, the 'reform' brings to the audits going forward more efficient contracting solutions, because partners in these firms have been incentivised to be more efficient in contracting to lower residual losses. In other words, the 'reform' focuses on lowering the risk of audit failure in future audits given what is known at this time.

The role of the profession and ethics

As mentioned earlier, professional accounting bodies came into existence in response to the expansion of the number of companies operating in the latter half of the 19th century; Watts and Zimmerman (1983, p. 630) cite evidence of a fourteen-fold increase in the number of companies listed on the London Stock Exchange between 1853 and 1893. Similar rates of growth were also experienced in the United States. The growth created a demand for a low-cost contracting mechanism for accrediting auditors. While the initial impetus for the professional societies in the United Kingdom was to provide information on accountants' reputations for dealing in bankruptcies, this expanded to cover their services in other areas such as auditing (Watts & Zimmerman 1983, p. 631). In the United States, their formation was based on the work of accountants as auditors and investigators.

Professional accounting bodies play an important role in the contracting process by lowering the costs of contracting for parties contracting through firms and in markets. They do this, according to Watts and Zimmerman (1983, 1986), by providing contracting parties with information about an auditor's independence and competence. Watts and Zimmerman (1986, p. 316) argue that professional societies develop brand names such as 'CPA' or 'chartered accountants' by establishing processes for training and qualifying auditors who, as members of the society with the brand name, are assumed by contracting parties to deliver a minimum level of competence and independence. These processes involve maintaining educational entry requirements, completion of 'articles' with an existing member, professional ethics/standards/guidelines, professional year programs, exams, continuing education, quality-control monitoring of members and their firms, and ethics committees and disciplinary mechanisms and publicity of their outcomes.

Membership of the society acts as a collateral bond in the contracting process in the same way as the auditor and audit firm's reputations, in that loss of membership results in loss of fees (Watts & Zimmerman 1986, p. 316). Also, to the extent that the professional society's processes break down and an audit failure occurs, the decline in the member's brand name affects the brand name of the society, and other members' reputations also decline. This decline is more pronounced for fellow members of the same firm because they are liable for the miscreant's actions (Watts & Zimmerman 1986, p. 318).

So in the case of Arthur Andersen's demise, we have seen the other 'Big Four' reviewing their operations in an attempt to protect and repair any damage to their reputation from being members of the same professional society as Arthur Andersen's partners.[11] Also, we have seen the professional societies attempting to repair any reputation damage with initiatives such as publishing opinion pieces and articles designed to lead the debate on accounting and auditing reform and making proposals for tightening their quality-control procedures.[12] Professional societies, as parties to the contracting processes in firms and markets, are incentivised for their own survival, as contracting cost-reducing mechanisms, to engage in reform to minimise the risk of audit failure in future contracts, and thus protect the brand name and ensure their own survival.

Breakdowns in professional society processes are another source of market failure targeted by regulatory solutions. It is arguable that the transfer in the CLERP 9 legislation of the Australian auditing standard-setting authority (the AuASB) from the professional accounting bodies' control to statutory control is related in part to the perceived failure by the profession in setting and enforcing auditing standards in the wake of recent corporate failures. In part, it could also be a matter of Parliament incorporating into law a version of best practice that has been in existence for some time (Watts & Zimmerman 1983, p. 626). These two explanations could equally apply to the earlier transfer of accounting standard-setting authority under statutory law in Australia. However, the issue of codifying accounting and auditing standards under statute versus leaving it to professional accounting bodies, or for that matter being completely unregulated, demands the same attention as any other proposed regulatory reform in auditing. It requires an understanding of the relative efficiency with which these standards are delivered to the contracting process under the alternative regimes. We offer some observations on this issue in the following sections.

The role of accounting and audit standard-setting

In the absence of regulatory coercion, professional accounting bodies have met a demand for codification of accounting choices in accounting standards. Codification possibly assists the process of adaptation of accounting choices that are

[11]Witness PricewaterhouseCoopers Australia establishing the Auditing Standards Oversight Board in August 2002 to assess PwC systems of monitoring quality control. The board provided a report to the PwC board of partners in June 2003 and published this on its website. KPMG Australia commissioned a review by two Australian academics (Keith Houghton and Ken Trotman) of their policies and procedures in respect of independence, conflict resolution and main quality controls. KPMG publicised this report in 2002.

[12]The professional accounting bodies have increased in recent years the running of 'best practice' conferences and seminars in the area of corporate governance and aligning themselves with key self-regulatory initiatives such as the ASX Corporate Governance Council.

used in certain contracting circumstances to new contracting circumstances (Ball 1989, p. 66). Likewise, standards for auditing have evolved from generally accepted best practices and the professional accounting bodies have provided, through their centralised standard-setting processes, scale economies in accounting and auditing to facilitate more efficient contracting (Ball 1989). Auditing standards, like accounting standards, are implicit terms of contracting for the preparation of the accounts. Standard-setters execute the accounting and auditing standards' design, the accounting firms specialise in applying them, and individual audit partners adapt them to the particular contracting circumstances (Ball 1989). The process of application in turn reforms the standards. Concepts like 'fairly present' and 'generally accepted' serve to govern adaptation choices where there are no specific rules, and in a sense provide some functional completion to the contracting process that relies upon codified accounting and auditing standards.

The notion that these standards need to be regulated to remove choice, and that there is an optimal set of accounting and auditing standards, was dispelled by Demski (1973). He argued against the possibility of attaining an optimal set of accounting standards. His arguments could equally apply to auditing standards. Rather, cross-sectional and cross-temporal variation in accounting (and arguably auditing) techniques are to be expected as different contracting circumstances create demand for different techniques (Ball 1989).

The case for the regulatory control of auditing standards through statute is poorly made, as is the case also with other audit regulatory reforms (Culvenor, Stokes & Taylor 2002), and in the next section we turn to analyzing this in more detail.

The role of regulation in auditing

Regulators typically argue that their reforms are in the public interest. If regulators' actions are unbiased, we would expect them to be supported by the existing research literature, and regulators to be actively interested in subsequent research that provides evidence against the proposed regulatory change (Watts & Zimmerman 1979).[13]

Regulations are the result of a political process where self-interested parties such as politicians, regulators and constituents come together for the purpose of creating 'public-interest' outcomes. The political process operates through implied contracts between the parties and in circumstances where firms and markets are less efficient at lowering contracting residual losses. Like the contracting process, the political process entails contracting solutions for bonding (e.g., policies and

[13]To claim that regulation can't wait for research to shed light on issues, and to regulate to be seen to solve a crisis, carries a risk of underestimating the costs of the regulatory change and those of undoing poor regulation.

voting at elections) and monitoring of politician-regulators (e.g., through Parliament and the Auditor-General). Political residual losses are to be expected because it is costly to participate in the political process and monitor the actions of politician-regulators.

Watts and Zimmerman (1979) argue that regulators are self-interested, wealth-maximizing individuals who have incentives to employ the powers of the State to make themselves better off, and can do so with legislation that redistributes wealth through welfare benefits for themselves (via their voting public) by imposing costs on firms. Proponents of change need arguments for the positions they advocate, and theories which serve as justifications are useful. Such theories will usually contend that the political action is in the public interest, everyone is (or most are) made better off, and that the action is 'fair'. The typical argument is that there is a market failure which can only be remedied by government intervention (Watts & Zimmerman 1979, p. 282). In other words, regulators imply they have a more efficient solution(s) than that generated by firms and markets to lower the residual losses of future contracting.

The self-interest view of regulators' actions is supported by the high costs of participating in the political process. The expected impact of an individual's vote on the outcome of an election is trivial, and hence the individual voter has very little incentive to incur the costs of becoming informed on political issues. However, economies of scale in political action can encourage group participation, allowing voters to share the fixed costs of becoming informed and increase the likelihood of affecting the outcome of an election by voting as a block (Downs 1957; Stigler 1971; Watts & Zimmerman 1979).

The result of high political costs is that regulators motivated by self-interest will not always act in the public interest to reform with more efficient solutions than those provided by firms and markets, and the best theory is not always accepted (Watts & Zimmerman 1979, p. 284). It is too costly for an individual to take control of the political process, so the market mechanism does not ensure that public interest prevails over the self-interest of regulators. The adoption of regulation motivated by self-interest does not require people to be 'fooled'. An individual will rationally fail to investigate the validity of the proposed regulation because the expected benefits to that person of so investigating are small. So, in a similar way to understanding that contracting parties to the firm incur contracting residual losses because it is costly to contract, voters in effect incur 'political' residual losses because it is costly to take control of the political process.

Watts and Zimmerman (1979) state that they do not intend to disparage the integrity of the researchers supplying the theories which are used as justifications for the regulators' actions. Watts and Zimmerman use economic analysis to show that high political transactions costs create a demand for excuses to use as weapons in the political arena. The effect is that the political process generates theory, not that theory generates political debates. They suggest that we can reject the alternative notion that theories are used to further the public interest (i.e., they assist politicians to produce regulations to further the public interest) if theories do not precede the regulations. Their analysis of several significant regulatory changes, including the US Securities Acts of 1933-34, supports their proposition. The Securities Acts emphasised the use of accounting as information useful for investors' decision-making. The accounting theories that were quoted and promoted after introduction of the Acts prescribed accounting principles consistent with greater priority for users external to the firms at the expense of internal users.

The demand for 'excuses theory' suggests that proponents of regulatory changes affecting auditors have vested interests and use theories and research evidence selectively to provide excuses for their preferred position. The argument that theories are being used as excuses when regulation temporally precedes the research evidence can be tested in the context of the most recent set of regulatory reforms in auditing, which emerged in response to the Ramsay Report on the Independence of Australian Company Auditors released in October 2001 (Ramsay 2001). We have analyzed the report in detail elsewhere (Culvenor, Stokes & Taylor 2002) and draw heavily upon parts of that analysis in this section.

The report was commissioned in mid-2001 because of regulatory developments in auditor independence overseas and publicity surrounding the auditor's role in recent Australian corporate collapses (Ramsay 2001, p. 6). The report reviews overseas auditor independence regulations extensively, and suggests these as appropriate benchmarks. However, although recent Australian events are used as motivators for the review of auditor independence regulations, the report does not discuss them further or use evidence from these events to support the recommendations.

The use of overseas developments as justification for regulatory change is an 'appeal to authority' approach. It implies that the differences between Australian and overseas regulation results in lower auditor independence in Australia. Explicit detailed analysis of expected costs and benefits of adapting overseas regulations to lower the risk of audit failure in Australia is absent from the report. It is also limited by its terms of reference to focus exclusively on auditor independence because it fails to address the other most likely underlying cause of any alleged audit failure, namely auditor competence.

The appeal to authority approach in the report is also revealed by the way it uses the research evidence. For example, while the report cites Pincus, Rubarsky and Wong (1989) as evidence supporting the recommendation for mandatory audit committees, it downplays the key message of that study. Pincus, Rubarsky and Wong suggest that market incentives exist for voluntary audit committee formation. There is evidence of variation in companies' use of audit committees, despite the history of published guidelines for best practice and professional and academic debate about the role and value of audit committees. The report does not acknowledge that the formation of audit committees depends on the company's circumstances. It also overlooks existing theory of the firm (outlined in the second section of this chapter) which argues that differentiation in contracting solutions is the key to firm survival. The recommendation for mandatory audit committees is not supported by the existing research evidence and as such appears to support the demand for excuses theory.

Ramsay (2001) and CLERP 9 (2003) both advocate mandatory audit partner rotation as a solution to audit failure because it is argued to increase auditor independence. The case for mandatory rotation is not explained in the Ramsay Report, except to say that it accepts the conclusion of the Audit Review Working Party and the US and UK practice of rotating partners every seven years. No effort is made to describe the arguments or evidence relied upon by the working party. The report offers no additional insight into why there should be mandatory rotation. There is only one paper cited as support for mandatory rotation, but it relates to auditor tenure (rather than rotation) and is acknowledged as flawed by Ramsay. The recommendation appears to rest on an appeal to authority – that is, overseas regulation – rather than the research evidence, and is also consistent with the selective use of excuses to support preconceived notions described in Watts and Zimmerman (1979).

CLERP 9 (2003) adopts recommendations in Ramsay (2001) and the HIH Royal Commission (HIH Royal Commission 2003) without further comment on the research evidence. The HIH Royal Commission recommends mandatory audit partner rotation despite there being little apparent direct relationship between the HIH failure and the audit partner's tenure. It is possible that mandatory engagement partner *retention,* rather than rotation, could have been beneficial in the HIH situation because it might have prevented the removal of the long-standing engagement partner at Arthur Andersen from the HIH audit, following his decision to meet with some of the non-executive directors of HIH in the absence of management (HIH Royal Commission 2003, vol. 1, p. 36).[14]

Regulations requiring mandatory audit partner rotation appear to be leading the research evidence, supporting the Watts and Zimmerman (1979) argument. However, it is possible that although there is little research on audit partner rotation, related research could provide evidence consistent with the partner rotation recommendation, thereby supporting the public-interest argument. Related research includes the association of audit firm tenure and accounting

[14]See also the analysis in Hamilton and Stokes (2003).

and auditing quality. Support for mandatory rotation would be provided by evidence of a decline in financial statement quality as audit firm tenure increases. However, recent studies of audit firm tenure provide evidence of audit quality and earnings quality problems associated with initial engagements or short tenure periods. This suggests this regulatory reform could impose unforseen costs and not generate the anticipated benefits.

Geiger and Raghunandan (2002) find that auditors are less likely to modify audit opinions immediately preceding bankruptcy during the initial years of audit engagements, providing evidence that audit quality increases as tenure increases.[15] Myers et al. (2003) find that the association between audit firm tenure and financial statement restatements is context-specific and could be either positive or negative. They conclude that their evidence provides no clear support for mandatory auditor rotation. Myers, Myers and Omer (2003) show that mean, median and standard deviation of accruals are smaller the longer the auditor-client relationship, suggesting that mandatory firm rotation could lower earnings quality.

In the period between Ramsay (2001) and the CLERP legislation, research into audit partner rotation had been conducted using data on audit partners signing audit reports for listed Australian companies (Daly, Hamilton & Stokes 2003; Bond, Hamilton & Stokes 2003) and publicised in the national press and bulletins (Culvenor & Stokes 2002a, 2002b, 2003). The evidence is of voluntary audit partner rotations and does not provide support for mandatory audit partner rotations. The lack of referencing in the commentary to the draft Bill of these studies leaves open to suggestion that the regulators seek to quote only evidence that buttresses their preconceived notions, as suggested by Watts and Zimmerman (1979, p. 274).[16]

Daly, Hamilton and Stokes (2003) investigate whether audit partner rotation is associated with changes in audit quality as revealed through both audit fees and the audit opinion. They use data from the Big Five/Six accounting firms in Sydney, and show that voluntary partner rotation is associated with an initial 10.9% audit fee discount. Where the rotation leads to a less competent partner (as measured by the market share of audit fees that they command), the magnitude of the audit fee discount is greater, while a partner rotation to a more competent partner is associated with no significant audit fee discount. The study's results also show that a partner rotation is not significantly associated with a change in the audit opinion issued. A partner rotation does not lead to a greater propensity to issue a qualified audit opinion. These results suggest that the

[15]Additional evidence of audit failure associated with short audit firm tenure is provided by Elitzur and Falk (1996), Walker, Lewis and Casterella (2001), St. Pierre and Anderson (1984), Stice (1991), and Ragunathan, Lewis and Evans (1994).
[16]An alternative explanation is that the research by Daly, Hamilton and Stokes (2003), and Bond, Hamilton and Stokes (2003), was unpublished and was therefore open to scrutiny as to the veracity of the findings. But not to have even requested a copy of a draft paper to form a view on the quality of the research at all reinforces the selective quotation approach.

practice of partner rotation possibly does not have the desired audit quality benefits that proponents suggest.

Bond, Hamilton and Stokes (2003) investigate whether audit partner industry expertise affects audit fees. They attempt to determine whether it is the audit office or partner expertise that dominates. The 'office-wide' perspective considers an accounting firm's office practice in aggregate, with no differentiation presumed to exist across the partners in the practice office of the firm. The 'partner-level' perspective views each individual partner in the practice office as a unique and relevant unit of analysis in their own right, due to the importance each plays in the audit contracting process. Bond, Hamilton and Stokes' results support the view that market pricing of industry expertise in Australian audit is primarily based on partner-level industry leadership in city-specific audit markets. The study implies that partner rotation within offices of large accounting firms could have significant costs.

If this recent research evidence does not support proposals for regulatory change, the question arises how the proponents convince their opponents of the need for change. It is simpler to point to the apparent costs of the corporate failure as the proxy for the costs of audit failure than to specify the costs and benefits of the proposed change. For example, the HIH Royal Commission report (HIH Royal Commission 2003) begins with a discussion of the harm to individuals, community distress and consequences for the public of HIH's failure. There would be many individuals and organisations willing to provide evidence to such an inquiry of their losses. However, the critical issue is not, as we have noted above, whether a particular corporate failure leads to loss, because there are many factors that add risk to investing in firms that contribute to losses beyond auditing failure, and some residual loss from contracting involving audits is expected. Rather, the issue is whether regulatory intervention for audit reform is more efficient in lowering the costs of contracting from auditing and generates benefits to the contracting parties. The arguments and evidence in this section suggest that the regulatory reform process for auditing and some of the solutions that emerge are not likely to meet this test and therefore be in the public interest. The regulatory audit reforms could increase future costs of contracting and contribute to inefficient allocation of the costs of property rights.

Conclusions and implications

We argue that the onus of proof for regulatory reform of auditing resides with the proponents of change. Their tasks are to measure the relevant loss used as justification for the reform, to identify the causes of the loss, and to justify the reforms as efficient and beneficial solutions. Appreciation of the nature of contracting and markets and the role of research informs the analysis of proposed regulatory reforms.

The theory and empirical evidence of audit contracting suggest that audits are demanded because they reduce contracting costs. Contracting parties search for the lowest cost solution and use auditing to monitor activities within firms to avoid the costs imposed by price protection in markets. Audited financial statements, and contracts based on those statements, are fair to the level determined by societal norms and enforced by courts and other institutions (Ball 1989). The greater uncertainty about norms of 'fairness' and contract enforcement, the greater the likely demand for detailed specification of contract terms: the greater the acceptance of auditors as ethical and fair arbitrators and monitors, the greater the likely reliance placed on auditors in contracting to determine the economic outcomes for contracting parties.

We have drawn on literatures that raise questions about whether the proponents of regulatory reform in auditing have satisfied the onus of proof for the reforms. We have argued that the policy-makers are liable to fall victim to fallacies of thinking and increase future bonding and monitoring costs on firms. The result is an inefficient allocation of the costs of property rights, adversely affecting the conditions that would lead to audit market reform. We have outlined a concept of political residual losses in relying on the political process for regulatory reform. These losses can occur when politician-regulators decree a firm/market failure exists that warrants regulatory intervention, overstate the losses from firm failure, and do not consider contracting residual losses in advocating regulatory reform. The political residual losses can also arise when politician-regulators define the likely cause of the decreed failures and thereby the focus for regulatory reform, as well as specifying the conditions for assessing value in the proposed regulatory reforms. We also show these residual losses can arise when politician-regulators identify the justification (theory) for the selected solutions – 'demand for excuses' – through appeals to authority.

In the same way that contracting parties' ethical behaviour can reduce contracting residual losses, ethical behaviour by politician-regulators in the political process can contribute to lowering the political residual losses and enhancing society's well-being through facilitating the economic outcomes sought by contracting parties. To the extent that philosophical debates contribute to increasing ethical behaviour by all parties in the contracting and political process (not just the auditors and the politician-regulators, but also shareholders, management, directors and the professions), they can contribute to achieving these objectives.

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Chapter 5. True and fair to whom?: a philosophical approach to auditing

Tom Campbell

Abstract

This chapter is a philosophical exploration of auditing ethics through an analysis of the role of the concept of a 'true and fair view' (TFV) in auditing discourse and practice. The chapter examines the meanings and uses of the concept in the context of the contrast between rule-based and principle-based approaches to accounting and auditing standards, concluding that the idea of a TFV is better seen as an objective of auditing regulation than as a basis for overriding or supplementing rules in audit practice, and going on to suggest that there are some difficult ethical issues that arise in determining who constitutes the audiences to which audits ought to be addressed, issues that have bearing on current controversies about auditor independence and probity.

The scope of auditing ethics

The crescendo of interest in auditing (and external accounting generally) arises from the perceived failure of auditors to do what has traditionally been expected of them – to alert shareholders and others with a stake or potential stake in a business to doubts about the published accounts of a company as a representation of the trading position of that company that is sufficiently accurate for them to make rational economic choices in relation to that company.

Critiques of auditing failures range from allegations of technical incompetence (often due to cost-cutting and inadequately trained staff) and lack of diligence in getting beyond the paper figures to the underlying economic realities, to charges of illegality and deception that amount to gross immorality, in particular where the failure to conduct a proper audit is attributed to a conflict of interest whereby auditors do their job in a way that secures their personal careers, their continuing contracts as auditors or promotes the other business interests of their firm, rather than a way that fulfils their legal and moral professional obligations to shareholders and other stakeholders (Bowie 2004, p. 61f).

It is at the point when illegality and immorality are involved that, it may be thought, ethics comes into the picture as a basis for blaming those who put profit before professional duty and personal gain before law-abidingness. Such failings are indeed ethical failings, but the interface of ethics and auditing goes much further and deeper than the critique of such evident sins. Ethics is not just about whether or not people do what they ought to do in their personal or professional lives and how to regulate conduct so that there is greater compliance with agreed norms. Ethics is also about how to determine more precisely what it is that people ought to do in their personal and professional lives. These normative questions include asking what should be the form and content of the laws, codes and standards by which we judge their conduct. What are the norms by which we ought to critique auditors' conduct? How are these norms to be justified? And then, yes, there are the further questions: why is it that auditors ought to conform to these norms and what ought to be done if they fail so to do?

To raise questions as to what auditing norms ought to be is to enter a realm of immense technical complexity with which few ethicists have the minimal competence to engage. In fact few people, other than experienced accountants, have such a capacity and it may be considered a defect of the existing system that company accounts have become so technical as to be incomprehensible to even well-informed members of the public. This certainly makes ethical reflection of accounting and auditing more difficult. The result is that adequately-informed opinion is largely confined to those who have a vested interest in how auditing is evaluated. As in so many fields, specialist knowledge and self-interest go unhappily hand in hand, thus making it problematic to leave the resolution of normative issues entirely to unsupervised experts and the perceived need; for instance, to have a majority of non-accountants on bodies responsible for standard-setting for accounting and auditing practice, as exemplified in the Sarbanes-Oxley Act in the United States and the CLERP 9 proposals in Australia.

Ethics, as well as accounting, has its technical aspects. Certainly, the nature of ethics as applied to phenomena such as auditing is often misunderstood. One common misunderstanding is that ethics is a matter of intuiting that there are certain things we must or must not do as we go about our daily business. These 'intuitions' are assumed to be mainly about normative limitations on how we go about reaching our basically amoral objectives, such as making money. Examples include 'do not lie' or 'be polite'. These moral 'oughts' are perceived to be separate from our legal obligations and may differ from the conduct that other people expect of us. Although they are routinely used to criticise the conduct of other people, such moral imperatives are experienced as binding on each of us as a matter of individual conscience. Irrespective of what the law or other people say, we believe that we should not steal, we should tell the truth and we should be kind and considerate to others, even if we could get away with behaving differently, whatever else we may be doing. This is known as 'deontological' morality.

Yet morality is not always a list of dos and don'ts that mark out the limits of morally correct or acceptable conduct. A great deal of morality is not captured by the deontological model. In practice most ethics is consequentialist; that is, it is a matter of working out what is the most effective means to produce morally desirable results. In the classic utilitarian version of consequentialism, the morally right action (or rule or system) is the one that produces the greatest happiness of the greatest number ('utilitarianism'), although other consequentialists are more concerned with maximising preferences, or other morally valued outcomes. Utilitarianism is, of course, the moral philosophy – deriving from the likes of Thomas Hobbes and coming down to us through Adam Smith, John Stuart Mill and Ricardo – that provides the moral foundations of modern economics.

In so far as consequentialism is an acceptable approach to ethics – and no one says that consequentialist reasoning has *no* place in an acceptable morality – moral questions are crucially dependent on matters of fact. Working out consequences is an empirical question that takes us deep into the factual details of actual and possible economic and political systems.

Of course, there can be morally detached debates about what will happen if you do this or that which have in themselves no moral content, but as soon as you take, or assume, a position about the desirability of the results, then you are on a trail of reasoning that terminates in the acceptance or rejection of some values that we take to be important for their own sake, be they happiness, preferences, wants or satisfactions. Indeed, no technical factual discussion about economics, or accounting or auditing, has legitimating or justificatory force unless it terminates in such ethical or moral evaluations.

It follows that, if the technical auditing experts want us to give moral or political weight to their knowledge and expertise, they must show us how this knowledge and expertise produces morally desirable results and be prepared to consider whether these results are indeed morally optimal. In so doing, whatever accounting technicalities are involved, they are also engaging in a form of moral discourse. It has to be remembered that Adam Smith wrote a book (Smith 1790) about the foundations of morality and the economic role of moral values that is almost as long as *The Wealth of Nations*. This enabled him to assume in his economic works that, for instance, the wealth that he is talking about is constituted by satisfaction rather than by money, and that failure to rectify breach of contract is inefficient and immoral – and to some extent immoral because it is in efficient.

This is to claim that much of what passes for technical accounting and auditing debate is a form of ethical debate about what rules, what standards, what systems we ought to have in place to reach what are accepted as morally desirable results.

Ethics does not start when the deontological intuitions are brought to bear on limiting or channeling such outcomes, but underpins all technical accounting issues that have a bearing on practical outcomes. Conversely, it is a mistake for ethicists to consider the economic and other consequences of accounting practice as morally neutral simply because they do not offend deontological morality. Whatever moral theory is adopted, consequences do – always to some extent and perhaps exclusively – count. Thus, the issue debated throughout this book, as to whether rules designed to increase audit independence impair or enhance the quality of the audit, is, when followed through, a moral issue (Dunfee 2004, pp. 79-85).

The distinctiveness of consequentialism as a moral theory is its claim that *all* morality can be reduced to consequentialist calculations. On this view, the moral 'intuitions' of a deontological sort may feel morally imperative, but they are justified only in so far as they produce morally desirable results. Very often this is so. Theft is wrong because it brings unhappiness to others, it doesn't produce unhappiness because it is wrong.

However, most theorists think there are limits to such consequentialist reductionism. It seems evident to them that there are some things you ought not to do (such as kill an innocent person) and some things you ought to do (such as treat people with respect), whatever the consequences. If it is these features of morality that are taken to delineate the scope of ethics, this is to relegate ethics to the periphery of practical fields such as accounting, with ethics being a constraining framework rather than an internal driving force.

Often these deontological imperatives are dignified with the title of 'rights', perhaps because they are seen as terminating in an affirmation of the value and intrinsic importance of all individual human beings, a grounding that enables them to be professed as moral trumps that take precedence over all other considerations in the moral game (Dworkin 1978). Again, no ethicists would exclude this type of moral consideration – there are some things that it is always wrong to do to other human beings – but a purely rights-based morality over-emphasises deontological morality at the expense of consequentialist moral reasoning. Not only are many such rights themselves evidently justified in part by consequentialist reasoning, but there is scarcely any right that cannot itself be trumped, not only by other rights, but by wider considerations of utility. This means that we cannot read off specific ethical obligations from a list of rights or assume that rights (such as the property rights of shareholders) are in an entirely different moral category from consequentialist morals. Hence we must expect that a lot of consequentialist reasoning, including technical auditing matters, must feature in determining the legitimate rights and duties of those involved in and affected by the outcome of the auditing process.

On the other hand, if accountants are to be fully involved in the process of ethical justification, they can never rest on affirmations, however empirically well-founded they may be, about the way in which things are done or statements about what practitioners and other participants believe ought to be done: the standing norms of the profession, or the respectable parts of it. They may have great epistemic authority on account of their knowledge of what will and what will not work in the real world of auditing, but they cannot justify any preferences within the range of workable alternatives without engaging in ethical debate. The message is, and it is not unfamiliar even if it is often forgotten, that what may be called 'critical accountancy' is routinely involved in ethical contestation, usually consequentialist but often broad enough to take into consideration those moral considerations, such as autonomy, fairness and equality, that escape the consequentialist net.

It follows from all this that both the consequentialist and the deontological dimensions of ethics draw us into deeply technical discussion into which most of us will be ill-equipped to enter. This means that it is impossible to say anything very specific and interesting about the ethical duties of auditors without engaging in at least a measure of such technicalities. It is simply not the case that applied ethics is a matter of insisting that professional groups, for instance, behave ethically and decently with respect to some self-evident deontological rules. Rather, what is needed is detailed and sophisticated discussion about the ethical duties of auditors that derive from what their role is, or ought to be, within a morally justified economic system. This is evidently a very open-ended enquiry.

Thus, in seeking to determine what preparers of external accounts ought to be required to put in their reports, it is hopelessly inadequate just to say that they should record the truth about the accounts – in other words, they should not lie. Even where there are objectively incontrovertible facts that can be ascertained, we are left with the issue of which facts to report, for they cannot all be reported. Where what is at stake is not misleading the reader of a report, the 'lie' cannot be identified without an idea of what it is that the reader wants to know or has a right to know. Without determining the legitimacy of the expectations involved, we do not know what counts as lying by omission, or what is a misleading statement. And, of course, an omission and a misleading statement cannot be considered lies – that is, deliberate falsehoods designed to deceive – unless there is a shared assumption as to what sort of information (and in what institutionalised form) is to be expected of a person in that situation.

So what is the role of the auditor? What service can auditors be legitimately expected to provide? This is a specific ethical question in a larger moral context that extends to a consideration of what constitutes a justified economic system within a justified political system. As such, it is not settled by any factual assertions about what auditors actually do, or about how our economic system actually operates, although any practical recommendations that arise out of such reflection must take off from and return to what is known about how the system currently performs and what sort of reform might work in practice.

This ethical scheme may be applied to the question of what place, if any, there is for the concept of a 'true and fair view' (TFV) in the auditing process and its regulation. The familiar line here is that the object of an external financial audit is to give an opinion that the reported accounts of a business give a true and fair view of its trading position and financial standing. In general terms this is often interpreted by saying that the auditor's role is to tell actual and potential shareholders whether they can trust the published accounts of the company as giving a reasonably accurate picture of its economic performance for the purpose of investment decisions (Mautz & Sharaf 1961, p. 158; Flint 1988).

This conception has its attractions because it presents a readily intelligible and clearly significant purpose for the auditing function: a financial audit is intended to provide reassurance that there is a valid informational basis for shareholders and others with an interest or potential interest in the performance of an organisation to carry out such roles as investors, owners and financial advisers, roles that are considered to be crucial to the performance of a liberal capitalist economic system in which it is important that funds are invested in the most efficient way – that is, the way that best enhances the production of desired goods and services at the lowest feasible price – the assumption being that this requires investors to make their investments on an economically-informed basis.

Interestingly, this gives auditors a dramatic and explicit ethical role, on any definition of 'ethical', since they are in the business of creating or destroying the trust on which business relationships largely depend, something that is generally regarded as, other things being equal, a desirable moral relationship in itself and is, in many circumstances, essential for mutually beneficial human cooperation. It follows that any failure in carrying out the audit role, if due to incompetence or negligence, is morally wrong, and if deliberate, is highly immoral, not only because of its adverse consequences, but also because it destroys a relationship that is valuable in itself. No wonder shareholders who are let down by auditors are angry and resentful as well as hurt: not only have they lost money on their investment but their trust has been betrayed.

Moreover, in creating, sustaining or undermining trust between other parties (the shareholder and the company being audited), auditors are relying on the assumption of others that they themselves are trustworthy, in that they can be relied upon to give an honest and reliable judgment as to the accuracy of the accounts and thus the trustworthiness of the company. Auditors depend on being trusted to sustain trust in others. They must therefore present themselves as honest and capable persons, for if they are not, then their services are valueless in economic terms and hence morally defective as well.

From the economic point of view there is, of course, a market in trust, and in this market, if it is in working order, auditors who are generally believed to be untrustworthy go to the wall, since they will not be hired. The market value of an auditing firm depends on its being trusted (although not necessarily on its being trustworthy). But markets are not perfect, especially in the short term, and many auditing failures never come to light publicly, and in the meantime the market remains, in consequence, less efficient, and the shareholders remain aggrieved or simply duped. Arthur Andersen rode high in reputational terms until their rapid demise following on their part in the Enron scandal (Toffler & Reingold 2003).

And the injury goes wider than that, for any discovered breaches of auditors' trust will make investors less likely to risk their funds in future, thus retarding the effective working of the economic system to the detriment of others who might otherwise benefit from the success of the system. Auditing is thus crucial to the creation and sustenance of trust as a public good, through the stimulating effect of a general belief in an economic community that there is available reliable information as to the performance of public companies.

The systemic need for reliable audits goes some way to explaining the (now tarnished) public image of auditors as reliable and honest people who use their special status as monopolists of accounting legitimation for the benefit of others, and sets the scene for the abuse of such high public esteem of the sort that has been shown in the arrogance and greed of senior partners in the now defunct Arthur Andersen, and is thereby inevitably suspected to occur in other comparable companies.

Leaving to one side, for the moment, whether the TVF is either a necessary or sufficient statement of the justifying objectives of the audit (and there are clearly other objectives and other audiences beyond shareholders that need to be considered), this chapter examines the TFV concept and its different actual and possible interpretations, before going on to consider how it might be deployed and sustained in the auditing process. With this in mind two sorts of question are raised: (1) what are the competing functions of the TFV, and (2) what are the competing meanings of the TFV? This then leads on to topic (3), how might or ought the function and the content of the TFV relate to each other?

Functions and meaning of the TFV

An examination of some of the literature on the TFV reveals a number of distinct but sometimes overlapping uses or functions for the concept. We may label them

(1) *the override function*, (2) *the supplementation function*, (3) *the interpretive function*, (4) *the legitimation function*, and (5) *the justifying function*.

1. *The override function* takes the TFV to be part of a working external accounting and auditing principle that is used to trump accounting and auditing rules or standards in that the preparer of financial statements is permitted (or required) to avoid conformity to such norms if this is necessary in order to present a TFV.[1] This may be applied to preparers, auditors, standard-setting bodies or courts.[2]

The override function represents the legal position in the United Kingdom (although even there accounting standards as set by the Accounting Standards Board do not permit an override with respect to its standards), Hong Kong and Singapore, and perhaps in the European Union (Nobes 1993), but not (any more) in Australia or the United States, where strict conformity to accounting standards, usually expressed in terms of determinate rules, is required. Where the override principle does hold, systems vary as to how far the circumstances of the override are specified and the extent to which an auditor is obliged to draw attention to such departures and give some explanation for them.

2. *The supplementation function* is related to the override function with respect to the circumstances of its use, but instead of overriding the rule in question, it requires that the preparers provide such additional information as will give a true and fair view.[3] This provides an opportunity for the exercise of the responsibility often ascribed to auditors to act as some sort of watch-dog (or even investigator or police) over the accounting practices of companies, drawing attention to 'irregularities' or concerns over practices that may be strictly legal, but are unusual and likely to give rise to a misleading picture of the company's financial situation. It feeds particularly on the idea that an auditor gives an 'opinion' that the prepared accounts give a true and fair view.

[1]The UK Companies Act 1948 as amended in 1981 introduced the idea that matters to be included in a company's accounts and notes be overridden if this is necessary to give a true and fair view. For example, Mautz and Sharaf (1961), p. 160: 'Thus the auditor borrows generally accepted accounting principles from accounting but he accepts them with reservations. If they do not meet the needs of the case at hand he must reject them and develop what in his judgment is a proper solution'. And op. cit., p. 167, an auditor 'must decide whether they [accounting presentations] are fair in the circumstances'. In 1983 the Companies Act was amended to require compliance with the accounting standards authorised by the Accounting Review Board, together with an override provision enabling directors to depart from these standards so as to give a true and fair view. The Act was amended in 1991 to permit only the provision of additional information.

[2]See Arden (1997), p. 677, for the TFV as a 'stop gap'. Compare McBarnet and Whelan (1999): 'The true and fair override is an express licence in the Companies Act to depart from, rather than comply with, specific legal requirements in "special circumstances".'

[3]Thus, the Australian *Corporations Act 2001*, s. 296: 'If the financial statements and notes prepared in compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements …' See also the European Community's Fourth Directive on Company Law, Articles 2.4 and 2.5.

3. *The interpretative function* takes the TFV to be part of a principle or set of principles for use in interpreting the rules and standards laid down for external accounting and auditing when the meaning and import of these are in doubt through ambiguity, lack of specificity or unclarity.[4] This applies particularly to the interpretation of the rule-defined categories that are set by the rules to determine what falls under which heading when using the terms in which accounting standards are expressed – the sphere in which creative accounting flourishes. This function may extend to filling in gaps where there are no existing rules to cover novel situations but not, in theory, to altering rules that are clear and unambiguous.

The interpretive function can be viewed as embodying a certain attitude to rules, seeing them as attempts to give a particular concrete form to the overall objective of presenting a TFV, rather than as formal restrictions that a 'good' accountant should be able to manipulate to best serve the interests of the company whose accounts are under audit. A genuine and good-faith respect for rules, often referred to in terms of following the 'spirit' rather than the 'letter' of the rules, does not mean departing from the rules when it suits those involved, but, when there is doubt as to their meaning, interpreting the rules in the light of their evident purpose, rather than scheming how to get round them by thinking up clever but often dishonest 'misreadings' of the rules in question.

4. *The legitimation function*: this approach sees the TFV as bearing on the duty of an auditor to offer, in addition to assurance that accounting standards have been observed, an opinion that the audited material does represent a TFV of the financial situation of the company. This is seen as having the social function of legitimating the enterprise.[5]

The legitimation function operates independently of (1) to (3) above in so far as it requires that they provide a professional opinion as to whether the proffered accounts provide a broadly accurate view of the company's trading position, although it may be seen as a broad extension of the supplementation function. This legitimating or validating function may involve requiring preparers to make further disclosures or commenting

[4]Nobes (1993), p. 45: 'TFV is used by directors/auditors in interpreting the law and standards or where there is no law or standard …' This is sometimes put in terms of the TFV being used in the exercise of 'judgment' (Gearin & Khandelwal 1995; Moroney & Sidhu 2001).

[5]Michael Power (1997), p. 9: 'Audit has become a benchmark for securing the legitimacy of an organisational action in which auditable standards of performance have been erected not only to provide for substantive internal improvements and the quality of service but to make these improvements externally verifiable via acts of certification'. Also Peter Miller, cited in Hopwood and Miller (1994), p. 11: 'One could study modern accounting as a ceremonial function that legitimates organizations with the mythical 'users' of accounting information: internal participants, stockholders, the public, and with agencies such as the Securities Exchange Commission'.

on whether conformity to existing accounting standards does provide an accurate enough view of the financial state of the company in question, but it serves primarily to legitimate the financial statements by affirming their general reliability and validity. This function has to do with the social function of the audit as giving assurance not only to investors but to the economic system as a whole, thus contributing to the social and political standing of business.

5. *The justifying function*: unlike the above three functions which take the TFV to be operative within the auditing process, the justifying function sees the TFV to be primarily applicable to determination of what accounting standards and legal rules bearing on such standards and processes ought to be adopted.[6] This is a matter of justifying and criticising the rules, not overriding, interpreting or supplementing them. The justifying function uses the TFV to justify (or not) the rules and standards that are authoritatively adopted as governing the presentation of accounts for audit, either in framing professional accounting standards or in drawing up the legislation within which such standards operate. On this approach, a TFV does not necessarily feature in the working processes of these rule-governed processes but provides the basis for a justification or critique of the processes and the rules that are involved in them.

Rather misleadingly, the justificatory function is sometimes identified in the literature with the override function, perhaps because standard-setters can use the TFV to establish standards that are in conflict with (but in practice 'override') existing legal requirements.[7] This conflict as to whose rules should take priority in practice is quite a distinct matter from the use of discretion by preparers and auditors with respect to departing from authoritative accounting rules, whatever the origin of these rules might be. Clearly, the use by standard- or rule-setters of the TFV to create auditing standards and laws is a justificatory function of a TFV very different from the function of enabling preparers and auditors to depart from such standards and rules as have been made.

Turning to the contending contents or meanings of the idea of a TFV, a sample of these would have to include:

[6]Nobes (1993), p. 47: 'In particular, in some countries (e.g. France and Spain) it (TFV) seems to have been used by regulators as a philosophy to accompany reform to the rules'. See also Alexander (1999), p. 252, and CLERP 9, Proposal 16.
[7]Thus Alexander (1999), p. 250: '… if the regulation is going to be changed – as it must and will be – then some overriding criterion greater than that enshrined within the regulation itself must, as a matter of logical necessity, be employed in order to decide on the changes and developments needed'.

1. *The positivist meaning*: the positivist approach to the meaning of the TFV equates the content of the TFV with conformity to existing authoritative (or 'positive') accounting norms, legal and otherwise.[8] Here the TFV is a summation of all the rules and standards that are authoritatively required.[9] It is a TFV if the accounts are in compliance with accepted auditing standards. The term 'positivist' is less applicable when these norms consist of general principles couched in evaluative terms and more applicable when they consist of rules, conformity to which can be objectively determined. As with respect to the idea of 'positive law', the model here is of rules with empirical content that can be scientifically applied to observable situations, rather than unspecific standards which require those who use them to make subjective judgments in order to understand and follow them.

2. *The economic reality meaning*: the economic reality approach assumes that the external financial statements are intended to be an accurate, or at least not misleading, picture or representation of the economic position of the company.[10] In a weaker form, the TFV is one that reflects 'economic relevance' (Tweedie & Whittington 1990, pp. 87-8).

Drawing primarily on 'true' rather than 'fair', an economic reality TFV is one that makes no demonstrably false factual claims about the economic circumstances of the company, and does not mislead the reader by giving an erroneous impression concerning the profitability, economic performance and, by implication, the prospects of the company. While the facts involved in accounting are largely institutional facts whose existence is dependent on social meanings and institutions, the idea here is that a TFV is one that is in accordance with such institutional facts as are relevant to a clear understanding of the company's economic position. This involves going behind the accounts to check their external rather than their internal validity and reliability as representations of economic

[8]Thus, in the United States financial statements are required to 'present fairly in conformity with generally accepted accounting principles'. The assumption is that the rules and principles adopted by standard-setting bodies that are independent of the accounting and auditing professional associations have a quasi-legal status in that they are routinely used by the professions and the courts as determining the legal responsibilities of accountants and auditors.
[9]McBarnet and Whelan (1999), p. 88: 'When and how should a true and fair view be equated with specific rules, when and how should it override them?'
[10]Thus, Fourth EC Directive on Company Law, Article 2:

> 3.The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.
> 4. Where the application of the provisions of this Directive would not be sufficient to give a true and fair view within the meaning of paragraph 3, additional information must be given.
> 5. Where in exceptional cases the application of a provision of the Directive is incompatible with the obligation laid down in paragraph 3, that provision must be departed from in order to give and true and fair view within the meaning of paragraph 3. Any such departure must be disclosed in the notes on the accounts together with an explanation for the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules.

realities. On this approach, a TFV is one that correctly reflects economic reality.

3. *The ordinary and natural meaning*: this approach treats the TFV as an abstract legal term that gains such meaning as it has from its general intelligibility and use amongst ordinary speakers of the language, outside of any technical definitions or attempts to fasten it to specific criteria of meaning. This is the meaning that can be derived from the ordinary and natural meaning of the words 'true and fair', either construed separately or together. In practice this involves courts drawing on, but not being determined by, the way in which the concept is operationalised by those involved in the processes of accounting and auditing.[11] This may be described as a 'contextual plain meaning' in that it is plain to those with some knowledge and experience of accounting and auditing practice.

Some of these functions and meanings might be struck out as manifestly inadequate or insufficient. Thus, we might seek to exclude the override function as being incompatible with the rule of law in that it gives unacceptable discretion to accountants and auditors, permitting all sorts of unfairnesses, uncertainties and biases (unless, that is, one of the other alternative meanings can be used to provide an objective and precise way of determining the proper use of the override function according to specific rules: none would seem to be convincing candidates for this role). This is the prime reason why the override function was removed from the corporate law of Australia.

However, there is a lively debate about the rival attractions of precise rules and general principles in governing conduct generally. It would be unwise to exclude the provision of extensive discretion in auditing. There are many well-rehearsed reasons for encouraging flexibility with respect to rules in areas where there is difficulty in formulating rules that are adequate to meet all the circumstances that arise. This is particularly the case when participants have strong incentives to find ways around rules that are put in place to guide and control their conduct (Griffiths 1986).

The familiar paradox here is that an override function makes it more feasible for honest preparers and auditors to give an accurate picture of the economic position of a company by looking to the substance rather than the form of economic transactions, but, at the same time, it makes it much easier to indulge in the sort of creative accounting that is concerned to present a more favourable economic picture than is actually warranted (McBarnet & Whelan 1999, Chapter 9). Here

[11]Arden (1997), p. 676: 'I will now make some general points about the true and fair view. I believe that it cannot be defined and that synonyms cannot be found for it. However I can define a number of features of the true and fair view'. Justice Arden then goes on to say how courts use the concept by drawing on its contemporaneous meaning and take account of the 'authoritative and generally accepted views of expert accountants and the views of the UK Accounting Standards Board'. The lack of a legal definition of TFV in the Australian context has been used to explain the difficulty of taking legal action on the grounds that accounts do not represent a TFV (Deegan, Kent & Lin 1994).

one thing is clear: the override function places proportionately greater reliance on the honesty of those involved than does a tighter, more rule-based regime. This does not, of course, in itself determine which approach is the more effective.

As regards the meaning alternatives, it may be possible to exclude (4) (the ordinary and natural meaning) as leading to contents so vague and indeterminate as to be useless for any of the functions listed. But this also may be thought to show an as yet unjustified bias towards an ideal of rule-governance that neglects the interacting impacts of ideology, authority and discretionary power. Thus on one view of the legitimating function of the audit, there is need for a grand-sounding ideal through which to affirm that people can have confidence to participate eagerly in and politically endorse an economic system that requires their support. Similarly, the capacity of the courts to intervene where things seem to have gone wrong in the business world is enhanced, not diminished, by the existence of an ill-defined concept on which they can draw to justify whatever decision they consider it best to make.[12] Indeed, some may argue that an ordinary and natural meaning is best suited to enabling the wisdom of experienced auditors to exercise their discretion in respect to the override function.

Assuming, then, that all the functions and meanings are at least feasible alternatives, we may note that some of the competing functions go better with some of the competing meanings of the TFV. Thus, the override function does not go well with positivist meaning (conformity to accounting standards). If a TFV is a summary of the norms that apply, it can hardly be used to trump those norms. In fact, it can be argued that positivist meaning cannot serve any of the possible functions, except perhaps a limited interpretive one in which some authoritative norms interpret others analogically. For this reason, positivist meaning might be discarded as tantamount to a declaration of redundancy for the TFV. And, indeed, strict adherence to current rules and standards is often opposed to a TFV approach.

However, to discard the positivist meaning entirely fails to recognise the different meanings that the TFV may have with respect to its different functions and how the positive meaning may feature in a more complicated scenario. Thus, the positivist meaning may have a subordinate role with respect to the uses to which the economic reality sense of the TFV is put. For instance, the economic reality meaning for the TFV is a good starting point for the justificatory function, since accounting standards and auditing criteria should, it may seem evident, be designed so that conformity to them will make the economic reality of the company concerned transparent. Further, having a set of such agreed rules to which all

[12]Alexander (1999), p. 246:

> One of the perceived problems with the Type A approach in general, and with TFV in particular, is the lack of any formal definition. It can be argued, persuasively in the author's view, that the indefinable nature of such a concept is its strength. Like 'justice', for example, it is a concept inherently greater than its precision in terms of any one particular time and place could possibly encapsulate.

companies must conform is a necessary requirement for making comparisons between companies, thus fostering efficiency and fairness in financial market competition. A positivist meaning of the TFV plays a necessary part in a justificatory function that includes the provision of information in a form in which the economic realities of companies can be compared.

If accounting standards do in fact serve to provide a TFV in the sense of economic reality, then it follows that an auditing process that requires these standards to be met is thereby serving the achievement of a TFV in the economic reality sense. In these circumstances, the positivist meaning indirectly serves the goals expressed through the economic reality meaning.

It may appear that the economic reality meaning is in general central and pervasive in that it features in all the listed functions. It seems particularly appropriate for use in the override function, which serves to meet the difficulty that no set of rules can always work out as their designers expect, so that exceptions have to be made if the justificatory aims are to be achieved. Similarly, the generally favoured purposive approach to interpretation enables rules to be read in a way that best serves the justificatory aims of the accounting standards. Legitimation, it may be argued, is best achieved by an affirmation in terms of economic reality. And we have already seen that it is a plausible basis for the justificatory function.

Yet this apparent clean sweep for the economic reality approach to the meaning of the TFV comes up against several difficulties. The chief of these difficulties is that, if the justificatory function is best served by creating appropriate rules, it makes little sense to undermine the role of these rules by allowing for overrides and interpretations that have the effect of making conformity to such rules optional. This is to invite open season for the creative accounting that positive standards are meant to control. In this situation, we need a much more precise meaning for the TFV with respect to the override and interpretive functions than is useful in stating the values and objectives of having the standards and rules in the first place. Indeed, accounting standards cannot simply be seen as having an instrumental role in requiring the provision of information relevant to exhibiting a pre-existing economic reality, for they serve in part to determine what economic reality is taken to be. Accounting standards partly constitute what counts as the real economic position of the company.

This line cannot be taken too far. Any feasible conception of economic reality has to include reference to empirically verifiable and unavoidable realities, such as the capacity of an enterprise to meet its liabilities and provide dividends to its shareholders, but there is considerable scope for identifying softer constituents of 'economic reality' that depend on little more than the general acceptance that certain criteria have a bearing on the sort of economic standing that leads investors to invest.

To the extent that accounting standards determine what counts as economic reality, the idea of justifying these standards by reference to their usefulness for reflecting an independent economic reality undermines the idea that the economic reality meaning of the TFV can operate in the justifying function. However, it also undermines the override function in the same way, in that what would then be happening is a redefinition of economic reality, not a judgment that observance of the standards does not in this instance serve to exhibit that reality.

However, both functions are not undermined to the same extent. The justifying function includes a requirement to make to some extent arbitrary decisions about what standards are to be authoritative in order to achieve the conceptual order required for judging performance and making inter-company comparisons. The override function has no such goal, even though it may actually be used to foster a change in what counts as economic reality.

One way out of this conundrum is to develop the economic reality meaning of a TFV into a more specific theory about what constitutes acceptable indicators of economic reality and how this can be reflected in accounting standards. While I doubt whether this can be refined with a degree of precision that will render the override and interpretive function safe from the dangers of special pleading and self-serving manipulation, it is a task that has to be undertaken anyway for the justificatory function to work.

Making a justifying theory out of the TFV concept is clearly an immense task of great technical and moral complexity, but it is one that must be undertaken if the justificatory function of the TFV has credibility, and it would seem that this function is the only one that will save the TFV from association with a purely rhetorical form of legitimation which does no more than invite the public to 'trust us' (the auditors), or provide courts with a vague principle to legitimate their discretionary power to deal with what they see as unacceptably creative accounting on the grounds that this does not provide a true and fair view in the ordinary and natural meaning of those words. (In practice, courts take the easy way out and fill in the content of the TFV by reference to current accounting practice.)

For whom?

This final section of the chapter is directed at just one aspect of what is involved in developing the idea of a TFV into a justificatory theory of external accounting and auditing: if external accounts should provide a TFV, from whose perspectives are we to consider whether the view in question is true and fair? (See Gaa 1986.) The answer suggested is that the public interest served by auditing must be mediated through considering the interests of a much wider range of users than the traditional investor/shareholder model suggests.

The standard line is that audits are for users (Tweedie & Whittington 1990, p. 87) and these are equated primarily with shareholders, actual and potential. Theory of the audit centres around what these shareholders either want to know or – not the same thing – what they have a right to be told. This assumption is sometimes grounded in the fact that the shareholders are the owners of the company, and are therefore ultimately the persons who are paying the auditors and with whom the auditors have a contract. In short, the audit is one way in which the owners of a company check up on how its managers and workforce are making use of the shareholders' investments. It is a matter of accountability of the agent to the principal.[13]

Given such property and contractual rights, it would certainly seem difficult to deny that shareholders are one major audience for an audit. However, it would be a dubious deontological intuition concerning property rights to say they are the sole group with a legitimate interest in the nature and content of an audit. Ownership does readily imply that there is a right of the owner to exclude others from accessing that property, but this is a right that is routinely qualified by the interests of others in what happens in and with that property.

Nor is the situation necessarily changed by the fact that the shareholders are ultimately paying the auditors. Again, it is a familiar feature of a polity characterised by the rule of law that people can be required to pay for services that are in and for the public interest, such as third-party insurance. It may be the case that companies are required to conduct and pay for audits because of their wider social and economic significance. Indeed, this would seem to be the case, as shareholders are not legally entitled to waive their right to an audit.

This is also clear from the fact that an acceptable theory of the audit cannot terminate in finding out what shareholders want from an audit. Rather, the theories concentrate on what shareholders have the right to get from an audit. But this is not an intuited right, rather it is a deduction from a view of the proper role of the shareholder in a liberal market economy. This is captured in the theory of the rational investor: the person who is committed to investing her money in whatever enterprise will return most by way of dividends and share value.

The model of the rational investor is capable of being interpreted in terms of deontological rights. It can be seen as a fundamental liberty that a person can invest their funds in any way and on any terms they choose and others voluntarily accept, and that right may be seen as including the right to commission an audit for such purposes as they desire. This may indeed be accepted at least as a prima facie right – that is, a right that stands unless good reason is given for its limitation – and harm to others is a standard reason that may be used to

[13]David Flint (1988): 'An audit is a form of checking which is demanded when agents expose principals to "moral hazards", because they may act against the principals' interests, and to "information asymmetrics" because they know more than the principals'.

limit such prima facie liberty rights. But it is, at the very least, also an instrumental or consequentialist right due to the role of shareholder investment in the model of an efficient capitalist market economy, which works at its best only when resources are utilised efficiently. On this approach not only are shareholder rights determined by what the rational shareholders need to know to play their part, but the required audience is at the same time extended to include potential investors whose decisions are equally significant for the efficient capitalist economy. And this, of course, explains, or is at least one reason, why audits of public companies are not private documents. This in itself is enough to free up the normative definition of the audit from the determination of shareholders' interests alone. The clients of the audit are at least the investing community as a whole. This is the current orthodoxy.

However, once we allow this extension of audience to potential shareholders and include in the articulation of 'entitlement' what they need to know in order to fulfil a specific role in a market capitalist economy, then we are on a slippery slope towards the inclusion of multiple audiences. Creditors and suppliers can hardly be excluded, given their part in the underwriting of any business activity. Employees too have a role in such economies, in that they should take up and leave employment in the light of their rational calculation of where they can make most money for least work. This leads to the efficient deployment of labour. Employees also require, to play their role, information that is relevant to their determination of what sort of contract to enter into with their employer or potential employer, even if they are not also interested parties through the share ownership they have through their company pension schemes.

Indeed, managers themselves have a legitimate economic interest in an audit that alerts them to inefficiencies or dishonesty in the organisation. Although some of these may be matters more of internal than external audit, others relate to the more personal market decisions that managerial employers have to make, especially when they have artificial incentives to maximise the company's profitability, as is increasingly the case with performance-based pay.

On the other hand, it is clear that one of the major economic and moral issues of corporate governance today is curbing the way in which senior managers are able to treat the resources of their company as if they owned them. Thus, senior management, themselves often without a major investment stake in a company, seem able to reward themselves to excess in the often brief period in which they are effectively in charge of the organisation. Clearly, senior management has an illegitimate interest in disguising the extent of their personal gain as it might emerge in the company's accounts and exaggerating its profitability.

Going in the other direction, towards external interests in the audit – that is, the interests of those who have a particular commercial relationship to the company in question – there are many facets of a public interest in the nature of the economic competition between businesses. The health of the capitalist system depends not only on the existence of competition between manufacturers and service providers, but competition based on adequate information being available to the competitors as well as to the shareholders and potential shareholders.

This model of market efficiency is closely linked to the associated ideal of fair equality of opportunity. It is considered not only inefficient but unfair if opportunities are given to some players in the market economy but not to others, perhaps as a result of insider-trading, selective release of market-related information, legal restrictions on ownership rights or non-discriminatory hiring practices.

Further, given that the profitability of business depends on shareholder confidence in the system generally, this means that all those with a stake in the productivity of an economy have a stake in the prevalence of audits that investors can trust. This is clearly of most direct relevance to financial institutions, including stock exchanges, merchant bankers and investment services generally. And this extends to the interests of the State as regulator of an economy with respect to protecting and fostering economic competition. That interest has economic legitimacy in so far as such regulation is necessary for a free market, and is politically justified to the extent that the State provides infrastructure for business operations and grants privileges to companies with respect to such matters as limited liability.

Fairness may feature here as no more than a synonym for the sort of formal equality of opportunity that maximises market efficiency. Or, more powerfully, fairness may be used to bring in issues of the just distribution of the wealth that is to be maximised, in proportion, for instance, to the value added by the work of those involved. In the latter case, society as a whole has a legitimate interest in the sort of audit that public companies are required to undergo.

In canvassing the range of audiences that might reasonably claim to have a right to true and fair financial reports and trustworthy audits, I have endeavoured to remain within the parameters of a financial audit and to economic justifications that are incontrovertible and draw on purely economic criteria. Clearly, still further audiences enter the picture when we broaden the scope of the audit to take in other social and environmental responsibilities, many of which have, of course, financial implications, for both the business being audited and the financial sustainability of an economy as a whole. As triple bottom lines overlap, so do potential audit audiences, particularly if we depart from the rational investor model to a 'what the actual investor wants to know' model, since actual investors have non-economic as well as economic interests.

It is not possible to follow through all the ramifications of what follows from the admission of multiple audit audiences. All will have different actual expectations and different justified entitlements. This in turn means that what is relevant for one audience may not be so relevant to another, and what one audience needs to know for reasons of economic efficiency may not be necessary for another audience. To some extent this could be met by extending the scope of the information required, or even multiplying the types of audits to suit the different audiences and their roles.

Yet the interests and needs of the audiences are not only different, they are actually in conflict, at least with respect to some matters. Thus, it is in the interests of current shareholders to have a rosy picture of the company's performance made public and legitimated, since this will enhance the value of their shares. But potential investors have an interest in a more accurate picture or they may lose money by investing in the company in the light of its financial reports. Potential creditors may have a similar point of view, but actual creditors may have an outlook similar to existing investors. Employees are likely to have more of an interest in long-term profitability over short-term gain than either shareholders or senior management. And so on.

Of course, these may be conflicts of wants rather than legitimate requirements, and a neutral economic efficiency standpoint might serve to harmonise their legitimate interests in the audit. Thus, actual shareholders may want inside information about the company in which they have invested, but to give them that might render the economy less efficient by distorting the market in those shares. However, it is clear that not all differences between even legitimate audience requirements can be so harmonised, in which case we have a standard political situation in which there is a need to resolve conflicting points of view in a morally acceptable manner – in other words, an issue of fairness, and one to which a TFV may be considered at least linguistically relevant.

This is where we might draw on the ordinary and natural meaning of a TFV, according to which accounts should be presented so as to foster fair equality of opportunity. Here we enter a realm where we cannot simply interpret such terms in a purely aggregative economic dimension that ignores the distributional consequences of any favoured solution.

Applied philosophy can suggest various devices at this point. One of these derives from the famous theory of justice expounded by John Rawls, according to which justice is a form of fairness in which the basic institutions of our society are justified in so far as they approximate to those arrangements that all persons would agree to behind a veil of ignorance – that is, without the knowledge of what particular role or position they would have in society. This is a decision-procedure designed to give equal weight to the preferences of each individual and at the same time to exclude the bias that derives in actual contracts from inequalities and calculations of individual benefit (Rawls 1971).

Applying this model of justice to the fairness between auditing audiences, the decision-procedure would be for representatives of all relevant groups (or stakeholders), who would not know which group they represent. Given that they do not know whether they will be a shareholder, a potential investor, a manager, an employee or an auditor, what would they choose in the light of their general knowledge of how economies and polities work? Would that provide a fair balance on whether preparers are justified in manipulating the rules to minimise the extent of their apparent assets?

Such a model is, however, persuasive principally with respect to the determination of basic universal rights and duties, something in which each individual has an equal legitimate interest. This does apply to the general principles of fair or impartial equality of opportunity and these are not without relevance to the function of a financial audit in a capitalist system. There may indeed be grounds for arguing that, within such a system, individuals have a right to an equal opportunity to make informed investment decisions. But this method of reasoning is not so powerful with respect to the special interests of other players in such economic systems. How do we weigh the (perhaps legitimate) interests of a company not to reveal its commercial secrets and corporate plans, even to its own employees? How do we weigh the (perhaps legitimate) interests of institutional investors with special duties relating to the superannuation rights and hence the basic welfare of large numbers of citizens?

At this point a number of strategies can be adopted. One would be to apply the concept of stakeholders, now widely used in the field of business ethics (Roberts & Mahoney 2004). This has the advantage of pointing us towards the identification of those who have a stake in an enterprise in the sense that they are dependent on its success. We may consider the legitimacy of interests with respect to auditing information as related to the vulnerability of different groups to serious adverse consequences. This tends to shift our focus towards the interests of employees, and investors whose basic material well-being is crucially dependent on the success of their investments. However, the connotations of the idea of 'stakeholders' also points us towards the extent of financial commitment to an enterprise, suggesting that those with larger investments have larger rights to a greater say in all aspects of the company's affairs.

In fact, stakeholder theory is not sufficiently developed to take the issues much further than this. There are radically different relationships between a company of different sorts of 'stakeholders'. The usage of the term is such that it can cover those on whom a company is dependent rather than those who are dependent on the company. And the concept is flexible enough to take in the State, or even the public, amongst those with a legitimate interest in the organisation in question, thus making stakeholders of us all. This may be sound enough in view of the public interest in maintaining the operations of an efficient and fair economy, but it leaves us largely without specific guidance as to who counts when we are deciding what constitutes a TFV.

Another tack is to draw on the developing ideology of human rights as a system of thought that is designed to identify those interests that ought to be overriding in contentious situations of social, economic and political conflict and cooperation. To some extent, this simply takes us back to the question of how far basic rights enter into the identification of specific economic relationships, something which I raised in relation to the application of Rawls' methodology. But it may suggest the need to reconsider some of the priorities that are given to different perspectives, not only those of current and prospective employees, those affected by the operations of multinational corporations in developing countries, and consumers whose health and safety may be at risk as a result of buying or not having access to a company's goods or services.

All this may be viewed as taking us way beyond the scope of financial audits towards ideas of triple bottom lines and wider corporate responsibility for the social and political impact of their activities. Yet it is hard to see how these matters can be divorced from the availability of accurate information as to the financial operations of companies, and what is and what is not to be viewed as an externality from the financial point of view. Does a fair view of a company's financial operations omit the environmental damage that it does not itself have to pay for?

Conclusion

This normative discussion of the legitimate audiences to whom public audits ought to be addressed brings out both the potential and the challenge of developing the idea of a TFV into a comprehensive normative theory of the audit. Whatever the drawbacks of the concept when used for other purposes, it provides perhaps the best starting point for any comprehensive study of the ethics of auditing to draw on the TFV as an outline theory to be used by regulators and by standard-setters.

That said, the justificatory role is not incompatible with using a positivist conception of the TFV as the basis for a presenters' and practicing auditors' ethic that is focused on the accurate implementation of the rules prescribed by the relevant authorities with the objective of generating reliable and comparable measures of a TFV. This excludes using the TFV as a basis for departing from such standards on the basis of broad principles, and probably also excludes requiring auditors to exercise strong discretion by supplementing their reports on the basis of very general principles. But it requires an approach to accounting rules and standards that interprets them as instruments of achieving a TFV.

If accounting standards are well-thought out in terms of the justifying TFV and if they are approached by preparers, auditors and users in the spirit rather than the letter of such standards, then there can be a systemic basis for building trust in a practice that can no longer sustain such trust simply through appeals to the honesty and integrity of the individual auditor. An abandonment of pure commercialism and a return to the 'professional man' model (Reiter & Williams 2004) of the individual auditor cannot by itself restore trust in audits: that is something the system as a whole must regenerate. Yet at the core of the ethics of the audit practitioner must be a respect for and understanding of rules as part of a coordinated effort to provide a systematic approach to achieving the broad public interest objectives of the audit, something that is best captured by the idea of a TFV.

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