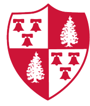
Montclair State University



MONTCLAIR STATE UNIVERSITY

Montclair State University Digital Commons

Department of Accounting and Finance Faculty Scholarship and Creative Works

Department of Accounting and Finance

1-1-2014

Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes

Gary Kleinman
Montclair State University, kleinmang@mail.montclair.edu

Beixin Lin
Montclair State University, linb@mail.montclair.edu

Dan Palmon
Rutgers - The State University of New Jersey, Newark

Follow this and additional works at: https://digitalcommons.montclair.edu/acctg-finance-facpubs

Part of the Accounting Commons, Corporate Finance Commons, and the Finance and Financial Management Commons

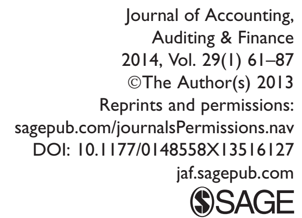
MSU Digital Commons Citation

Kleinman, Gary; Lin, Beixin; and Palmon, Dan, "Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes" (2014). *Department of Accounting and Finance Faculty Scholarship and Creative Works*. 29.
https://digitalcommons.montclair.edu/acctg-finance-facpubs/29

This Article is brought to you for free and open access by the Department of Accounting and Finance at Montclair State University Digital Commons. It has been accepted for inclusion in Department of Accounting and Finance Faculty Scholarship and Creative Works by an authorized administrator of Montclair State University Digital Commons. For more information, please contact digitalcommons@montclair.edu.

Check for updates

Tracks Paper


Journal of Accounting,
Auditing & Finance
2014, Vol. 29(1) 61–87
©The Author(s) 2013
Reprints and permissions:
sagepub.com/journalsPermissions.nav
DOI: 10.1177/0148558X13516127
jaf.sagepub.com

Audit Quality: A Cross-National Comparison of Audit Regulatory Regimes

Gary Kleinman[1], Beixin Betsy Lin[1], and Dan Palmon[2]

Abstract

The importance of fostering more accurate audits has been heightened by a series of high-profile accounting scandals at the beginning of the millennium. These scandals prompted more stringent regulations over corporate governance and financial reporting and the creation of audit oversight bodies as the Public Company Accounting Oversight Board (PCAOB) in the United States and the Public Oversight Board (POB) in the United Kingdom. In parallel, the growing globalization of business has brought forth calls for adherence to a common set of International Financial Reporting Standards (IFRS). Even if a common standard is promulgated, it will not lead to similar results if implementation differs across countries. Therefore, it is important to investigate the auditing regulatory regimes in different nations and the status of cross-border audit inspections. Accordingly, we begin by describing the cross-national institutions (e.g., the International Federation of Accountants [IFAC]) that impact national regulatory choices. Then we survey the audit regulatory practices of public company auditors of a select group of major economic powers and based on this analysis, we discuss the challenges and obstacles to engaging in intra-national audit, cross-national audit/inspections, and the challenges posed by differences in auditing standards used in various linked (e.g., by joint ventures, etc.) nations. We include in this discussion the effects of national culture, investor legal protection, economic development, and differing financial standard sources.

Keywords

auditing, regulation, PCAOB, international, audit quality, ISA

Introduction

The globalization of businesses has led to an attempt to have all financial accounting adhere to a common standard, IFRS (International Financial Reporting Standards). Rarely noted, however, is the growing globalization of audit practices as firms resident in one country open up operations and physical facilities in others. This globalization of audit

[1]Montclair State University, NJ, USA
[2]Rutgers-The State University of New Jersey, Newark, USA

Corresponding Author:
Gary Kleinman, Department of Accounting, Law and Taxation, School of Business, Montclair State University, c/o P.O. Box 468, Montclair, NJ 07043, USA.
Email: kleinmang@montclair.edu

practice suggests that it is increasingly important to help assure the quality of the audit functions being performed at the various locations.[1] Even in the absence of cross-border operations, the growing prevalence of cross-border investments itself highlights the importance of being able to evaluate the quality of financial statements attested to by non-domestic auditing firms.

The adequacy of intra-national auditing practice has been the subject of criticism for years. In the United States, for example, the Public Company Accounting Oversight Board (PCAOB; 2012) routinely publishes critiques of the performance of the audit firms that audit publicly owned companies, based on its inspections of selected audits during the, for larger auditing practices, annual inspection process.[2] Similar reviews of audit firm performance are conducted in the United Kingdom and elsewhere. It remains an open question as to whether auditing practice has improved as a result. Judgments cannot simply be made based on the annual reports of the PCAOB due to the methodology by which the PCAOB selects larger firm audits to inspect. The PCAOB, like the U.K.'s Audit Inspection Unit (AIU) and others, uses a risk-based methodology, but still selects a very small percentage of the audits to inspect. Similarly, judgments made based on the litigation literature are also problematic because litigation always takes place with a noticeable time lag due to the need to first discover a potentially litigable infraction, then the need to follow the legal process, with the latter often ending in settlements that are sealed by the court, with no admission of wrongdoing (McKenna, 2012a). Even lacking clear and incontrovertible evidence of systematic malfeasance or nonfeasance, the performance of auditing firms within the borders of the United States and other countries has come under harsh criticism. While the U.K.'s AIU noted some improvement, others have found a continuance of problems from year-to-year. According to Verschoor (2012), audit firm performance has not been improving in the post-Sarbanes–Oxley (SOX) era. PCAOB Chairman Doty noted in his 2012 report that ''Inspections continue to reveal an unacceptable level of deficiencies.''[3] Similar results were reported elsewhere. For example, the Canadian Public Accountability Board (CPAB), in its report on audit quality by inspected firms for 2011, found that there was no improvement in audit quality from year-to-year, and stated that other national inspection units found similar results.[4]

Despite the problems in evaluating the adequacy of auditor performance, and the capability of the constituted regulatory bodies to evaluate that performance, it is apparent that the growing globalization of business introduces a whole new order of complexity to the problem of regulating audit practice (see CPAB, 2011, for a listing of factors that should be taken into account). Specifically, we argue here that this situation calls for new attention to how audit regulation is undertaken. This is especially true when audits are performed by one firm extending its operations to foreign shores to carry out audits of non-domestically situated operations. We believe that it is important, therefore, to understand how key economic powers act to control the quality of the auditing services rendered within their jurisdictions so that comparative studies of regulatory effectiveness can be undertaken. This importance is underlined by the findings of the Working Group of the International Auditing Assurance Standards Board (2009) that user ''. . . perceptions of the scope and quality of audits and their perceptions of quality of audit report seem inextricably linked'' (p. 1). This is important, of course, because the Working Group also found that the auditor's report is valued by users.

The issues posed by globalization on the transparency of financial statements are heightened due to both the use of IFRS and its various flavors abroad, versus Generally Accepted Accounting Principles (GAAP) in the United States and other versions of GAAP

abroad, and the use of PCAOB standards to audit publicly owned companies in the United States versus International Standards on Auditing (ISA) in other countries, and other variants of auditing standards elsewhere. Given that both ISA and IFRS are more principles/judgment-based than are U.S. GAAP and PCAOB standards, there is a greater likelihood that conflating the work of audit teams trained in different sets of auditing rules to evaluate the implementation (and cross-financial statement standard translation) of different sets of financial reporting rules may lead to compounding of confusion as to what the results of the audit truly mean. This is true even assuming, as we do, that a consistent set of standards (financial, auditing) is used for each separate client. These issues are further compounded by the inevitable embedding of audit practices in different national cultures and legal environments resulting in differences in auditor perceptions and behavior (e.g., Endrawes & Monroe, 2012).

A Case Study of Contemporary Auditing and Accounting

In this section, we describe the practical implications of globalization on financial reporting and auditor judgment and practice, using the Hewlett Packard (HP)/Autonomy merger to illustrate the difficulties that may arise from different accounting standards and cross-national audit practice. HP bought Autonomy in 2011 for US$42.11 a share, US$11 billion total, or a 64% premium over the then current stock price for Autonomy stock. Autonomy was a British firm that sells infrastructure software to enterprises (see Slattery, 2011). Autonomy had been shopped before to other firms (e.g., Oracle), all of which had declined the purchase opportunity. On November 20, 2012, HP announced a massive charge of some US$8.8 billion to cover a write-down of goodwill and intangible assets in its software division (see Selling, 2012). Critically, HP's Form 8K (quoted in Selling, 2012), a form that U.S. registrants file with the U.S. Securities Exchange Commission upon the occurrence of significant events, stated that ''the majority of this impairment charge relates to accounting improprieties and disclosure failures at Autonomy that occurred prior to HP's acquisition'' and caused ''misrepresentation on the expected future financial performance.''

Selling (2012) and other sources cite differences in revenue recognition principles between IFRS—used by Autonomy because it was a British company—and U.S. GAAP as one source of HP's problem with Autonomy's reported revenue. The flexibility offered under IFRS with respect to revenue recognition, differences in how marketing expenses, downstream sales, and revenues generated from bundled products are reported under IFRS and U.S. GAAP, all contributed to confusion over Autonomy's reported revenue and profits. Norris (2012) specifically notes that with respect to software sale accounting,

> American rules . . . are much more specific on how to decide the relative values, while international rules tend to state principles the company should apply and offer limited examples to guide the decision. Similarly, the American rule aimed at preventing round trips has a lot more detail than the international one.

The key point here is that the U.K. segment of Deloitte and Touche's global practice had given Autonomy an unqualified opinion even though, by U.S. standards, they were not independent given that Deloitte and Touche provided non-auditing services that would be considered independence-impairing in the United States (Norris, 2012). As Selling (2012) notes, Deloitte and Touche continues to stand by that opinion. Thus, even in culturally similar nations—the United Kingdom and the United States—differences in audit rules and

financial accounting rules resulted in a non-comparable audit and financial statement results. How much more problematic, therefore, may audits conducted in countries with even less cultural similarity be? Another interesting angle in this HP/Autonomy battle is the involvement of all of the Big 4 accounting firms. Norris (2012) gives an excellent summary of their ''role playing'':

> Deloitte, the auditor that certified the Autonomy books, was doing a lot of non-audit work for the company, evidently including advising on how much the managers whose work it was checking should be paid. KPMG, which evidently found no problems at Autonomy last year, was hired by H.P. when it wanted to make the acquisition. PwC, which found major problems this year, was hired by H.P. when it believed that it had been defrauded. Ernst, the H.P. auditor, last year signed off on H.P.'s books that included the large amount of Autonomy good will. Now it will sign off on books that say much of the good will was fake.

''Perhaps coincidentally, the accounting firms tended to reach the conclusions desired by those who paid them.'' Norris concluded cynically. There are several implications from the HP-Autonomy imbroglio.

The first major implication is that differences in the quality and ''tightness'' of financial reporting standards lead to confusion when a company steeped in the use of one set of standards looks at acquisitions where the books are kept using a different set of standards. Clearly, HP could afford the expertise needed to reconcile financial statements created under IFRS to GAAP. The consulting auditor, KPMG, must certainly have had that expertise yet, as recounted by Norris, found no issue. Whether one set of standards is inferior to another is not a key point here. What is important is that differences in standards may lead to undesirable outcomes when they are not fully taken into account by key stakeholders. A second major implication of the HP/Autonomy imbroglio is that auditing standards may differ in quality. An important instance of differing standards lies in the definition of independence used in the United Kingdom versus the United States. In the United Kingdom, as Norris points out, it is acceptable for the auditor who is hired, paid, and potentially fired by the client to audit that client even though the auditor, Deloitte, was being paid to audit Autonomy by the very management whose compensation package was in some part a product of Deloitte's non-audit service (NAS) advice to Autonomy's board. In the United States, the auditor would be barred from performing this service, but not the United Kingdom. One can infer from this, because a restriction is present in one auditing venue but not another, that on this particular issue, U.S. auditing standards were more restrictive than in the United Kingdom. As will be described below, U.K. auditing standards are a subset of ISA. Accordingly, even if accounting standards among different venues were the same, having what some may consider poorer quality auditing standards may result in poorer audits and poorer quality opinions.

A third major implication from the HP/Autonomy case is related to the work being divided between the Big 4 audit firms. The Big 4 audit firms thoroughly dominate the global audit markets. This could be a positive feature of the market for audit services because as Han, Kang, and Yoo (2012) note, larger size audit firms are often considered to provide higher quality audit services as measured by restatements, discretionary accruals, disclosure transparency, and so on. The audit firms, with their global presence, have the opportunity to provide guidance to their national components with respect to best audit practice and methods of achieving high-quality control over the auditing process. But that control is exercised and mediated by local circumstances. That said, though, the fact that

all of the Big 4 firms are involved in this case shows the extent of concentration in the auditing market. The problems of Big 4 dominance include an unlevel playing field, too few to fail, clients finding it hard to switch auditors, and so on. Its implications and risks are discussed later in the article.

A final major implication of the HP/Autonomy case is that it presents telling evidence of how differences in accounting and auditing standards, even when the audit is performed by the purportedly highest quality audit firms, may result in untoward results. Auditors in different nations, even though they belong to the same global audit firm may pursue their professional responsibilities in adherence to their respective standards and regulations, but the combination of different approaches, could fail to achieve a high-quality end result. Therefore, it becomes critical to have some type of overall cross-country control if audited reports are to be meaningful to all potential stakeholders. We discuss this issue in the next section.

Survey of Audit Regulatory Regimes

One important means of narrowing the variance of outcomes between different sets/sources and mechanisms of standards is to look at the nature of the regulatory regimes under which auditors work. Presumably, better regulatory schemes betoken more auditor effort in seeing that the statements report fairly the client's underlying economic status. The problems with international auditing regulation have been noted in the popular and other literatures (e.g., Norris, 2011). In this article, therefore, we look first at the sources of international auditing and U.S. standards (ISA, PCAOB, others as appropriate), and also describe the efforts of well-respected international organizations, organizations that set an overarching framework for the regulation process, a process that occurs—to date—at the national level. We then briefly examine the auditing regulatory regimes in countries that are major economic powers on almost every continent. The nations involved were selected because the International Monetary Fund (IMF) reported their gross domestic products (GDPs) as among the highest on the planet.[5] In addition, however, to having among the highest GDPs on the planet, we imposed the additional restriction that every major continent be included in the survey of regulatory regimes, except for Australia. The latter is excluded because it is tied very closely to the United Kingdom both historically and culturally. Our goal is to answer questions that provide a solid glimpse of national audit regulatory practice and the consequences of audit laxity or malfeasance. Table 1 provides a list of problems developed by the Private Sector Taskforce of Regulated Professions and Industries (PSTRPIs) that are caused by the lack of standardization of regulation cross-nationally. The PSTRPI (2011) reports note that attempts at cross-national regulation are hampered when one jurisdiction's oversight body does not recognize another's inspections or when confidentiality considerations come into play.

Next, we describe international auditing-related regulatory organizations. Then, we will discuss the impact of judgment breadth allowable within different financial statement rules (i.e., U.S. GAAP vs. IFRS). Subsequently, we will describe the regulatory organizations and systems of nine major nations, and discuss the impact of national culture and legal framework on auditor behavior. In the end, we will make suggestions for further work in this area.

Cross-National Regulatory Institutions

International regulatory institutions in accounting and auditing are created to help assure consistent quality of audit services across national boundaries. Such concordance of quality

Table 1. PSTRPI Listing of Problems Caused by Current Arrangements.

Raises business costs due to the need to respond to different national reporting requirements;
May slow or obstruct progress toward effective oversight of multinational firms;
Promotes such game playing as searching for jurisdictions with the most permissive regulatory structure;
Raises cost of financial statement audits, especially for multinationals where auditors must comply with different national standards;
Raises audit oversight and regulation costs due to the licensing, registration, and reporting differences auditors face;
Financial reporting and audit outcome reports lack comparability;
The inability to easily transfer accounting services between markets, for example, through the contemplated "European Passport," has a negative effect on the provision of those services;
There is a high administrative burden for audit oversight bodies, which currently must maintain their own registration, reporting, and oversight systems;
Establish bilateral arrangements with other, non-domestic, regulatory bodies;
Audit firms must develop their own information search routines to enable them to satisfy local market legal and registration requirements.

Source. Private Sector Taskforce of Regulated Professions and Industries (PSTRPI; 2011).

is difficult to assure, however, given that each nation continues to have its own national audit regulatory apparatus as well as distinct legal and cultural norms. In consequence, efforts to achieve capital market transparency and audit consistency face difficulties even when standards for practice are stated similarly.[6] According to International Federation of Accountants' (IFAC; 2011) Policy Position 1 on the regulation of the accounting profession, effective regulation requires transparency, proportionality, fair, and consistent implementation in a non-discriminatory manner, and should be subject to regular review.[7] Furthermore, it should aim to ensure that professional services provide match, in efficiency and effectiveness, what society and the economy demand. Accordingly, there is a need for enforced ethical, technical, and professional standards to assure that professional providers will enjoy the necessary competence and willingness to meet professional standards in doing their work. The importance of these efforts was underlined by the financial crisis of 2007 and onward. This resulted in various initiatives to address flaws in audit regulation.

The European Union (EU), for example, published a 2010 Green Paper on audit policy, as part of a set of initiatives aimed at restoring financial stability.[8] As the Green Paper states,

> The fact that numerous banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet raises not only the question of how auditors could give clean audit reports to their clients for those periods but also about the suitability and adequacy of the current legislative framework. (p. 3)

Importantly for our effort, it argues that ''audit opinions should focus on 'substance over form,' which includes ensuring that there is no arbitrage of the differences in regulatory frameworks between jurisdictions'' (p. 6). They further argue that there should also be an increased emphasis on substantive as opposed to control testing.[9]

While the Green Paper is provocative, its proposals are not law. Law, as it currently stands in the EU pending adoption or rejection of audit market reform proposals set out by European Commissioner Michel Barnier in November 2011, is set out in the EU Directive

on Statutory Audit (2006/43/EC). This directive sets out professional ethics requirements, auditor independence principles, ownership considerations, audit fees, auditor rotation, and client company governance considerations. Furthermore, the Directive states that audit partners, not firms, must be rotated. With respect to NAS fees, the Directive forbids the provision of audit services if ''an objective, reasonable and informed third party would conclude that the statutory auditor's independence would be impaired'' (Directive 2006/43/EC, p. 18).[10]

The EU as a collective entity, the European Commission and the European Parliament are all important actors in setting overall policy that may impact the behavior of individual nations within the EU. Two of the nine nations of interest to our effort are in the EU, Germany, and the United Kingdom. Given the size and current economic performance of the EU, and the ability of member nations to influence EU actions, as well as the ability of the EU to influence member actions, it is important to understand the regulatory agencies that exist in the EU itself. While the EU can act directly, through the parliament for example, it can also act through agents more closely connected to the profession or market of interest. One such agent is the European Group of Auditors' Oversight Bodies (EGAOB; see http://ec.europa.eu/internal_market/auditing/egaob/index_en.htm).

The EGAOB's public oversight powers are similar to that of the PCAOB, although the PCAOB standards have no *direct* impact on continuous education. In this role, the EGAOB has the opportunity to provide technical advice and information to assist the EC in creating and carrying out its possibilities. The remit of its advice includes endorsing ISAs and the assessment of third countries' public oversight systems. As such, it carries a great deal of power because the EU, as a collective economic power, is still the greatest such on the planet (see Appendix A). The ability of the EGAOB to assess third countries' public oversight systems plays an important part in our scheme because it provides auditors in approved jurisdictions the ability to claim quality of product, that is, if they do indeed receive seals of approval from their own national entities that have been approved by the EGAOB.

In contrast to the EU and its entities (e.g., the EGAOB), the *Public Interest Oversight Board* (PIOB; www.ipiob.org) is a high-level group, which is extra-territorial in that it has no links to specific nations, but makes its products available for adoption by all. The PIOB is an umbrella organization that has oversight responsibilities over the aforementioned IFAC, International Auditing and Assurance Standards Board (IAASB), International Accounting Ethics Standards Board (IAESB), and other international groups (see Figure 1) that influence the audit standard setting environment. The PIOB describes its own objective as being to ''increase the confidence of investors and others that the public interest activities of the International Federation of Accountants . . . are properly responsive to the public interest'' (http://www.ipiob.org). Figure 1 shows the relationship of the PIOB to its constituent parts, illustrating the mechanisms of oversight, control, and advisement that are possible in such a structure.[11]

The EGAOB and PIOB fulfill oversight functions, with the EGAOB playing a gatekeeping function as well in that it can deny the use of standards formulated. The PIOB, however, has a monitoring function with respect to the very body that does set the ISAs—IAASB (ifac.org/iaasb). The self-proclaimed goal of IAASB is to improve the quality and uniformity of auditing practice through its standard setting process. Unlike the PCAOB, however, it has no enforcement powers and its standards do not have the force of law. Given the need for sovereign nations to balance the need for domestic sovereignty with the development of uniform practice, and the instances wherein ISAs (like IFRS) are

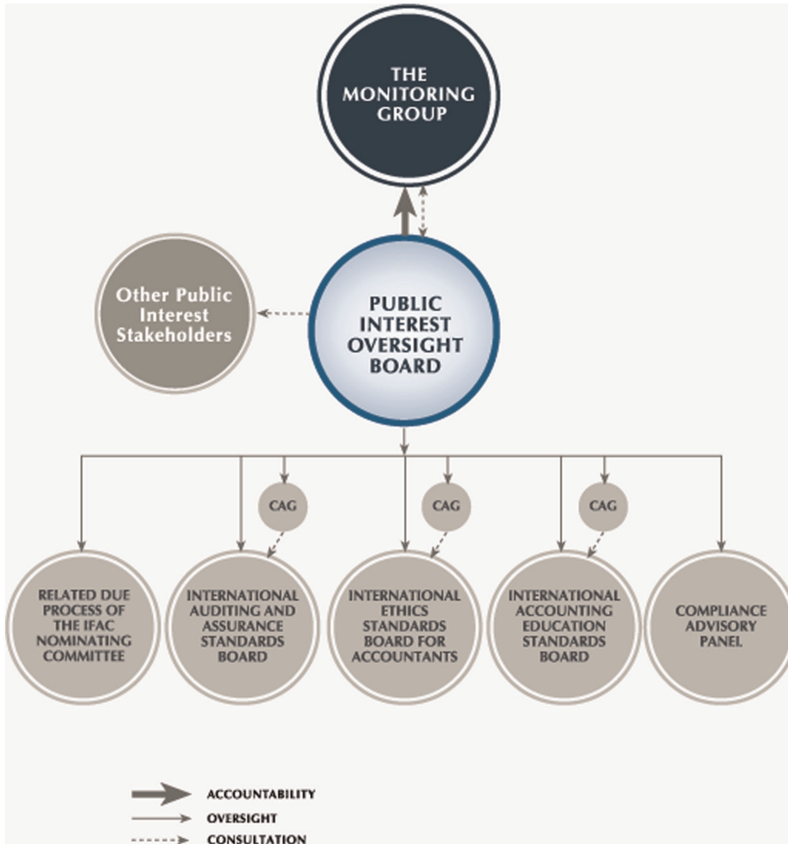


Figure 1. Relationship of PIOB to constituent parts.
Note. PIOB = Public Interest Oversight Board; CAG = Consultative Advisory Group; IFAC = International Federation of Accountants.
Source: This figure was found at ipiob.org/about/what-piob on 6/30/2012.

adapted to meet local needs, the value of the standards is in question. This is especially noteworthy given the higher level of professional judgment allowed to auditors in the use of ISAs as compared with the *comparatively* more structured auditing standards promulgated by the U.S.'s PCAOB.

Exchanges of information between regulatory organizations are important in keeping each from reinventing wheels developed by others. The *International Forum of Independent Audit Regulators* is an organization that enables regulators to compare notes (https://www.ifiar.org/Home.aspx). It sees its function as enabling sharing knowledge of the audit market environment, practical experiences of regulators, promoting regulatory agency collaboration, and fostering communication with other international organizations that support development of audit quality. To the extent that it successfully enacts its functions, the pseudo-Darwinian struggle that would allow the best standard extant to survive can be enacted, unless perceptions of what works best are impaired or completely invisible given the incomplete observability of the relationship of a particular auditing standard to particular audit outcomes, as well as the difficulties in observing with what fidelity to the letter and spirit of a standard the standard was actually followed. These

issues become more complex given differences in national cultures that may impact both the perception of the requirements of a particular auditing standard and the willingness to implement a standard's requirements objectively and accurately perceived due to local exchange inhibitions unique to specific auditor–client relationships (e.g., Kleinman & Palmon, 2001; Kleinman, Palmon, & Lee, 2003; in an internal auditing context, see also Sarens & Abdolmohammadi, 2009, and for an external auditing context, see Endrawes & Monroe, 2012). The expectation of legal consequences for failure to enact faithfully a standard's behavioral requirements is also a problem.

The existence and operation of international organizations that seek to regulate, or at least influence the regulation of, auditing organizations demonstrate the current process for sharing information between national regulatory agencies and standard setters. Information sharing, however, is not equivalent to the creation of supranational organizations to actually regulate the practice of auditing. Such regulation remains in the hands of national regulators and is subject to the vicissitudes that the United States and Hong Kong, for example, face in trying to acquire information from portions of group audits conducted in other countries.[12] Given this, such regulatory behavior is subject to local preferences with regard to the severity or laxity of the same. Local behavior, even at the national level, is affected by local traditions and cultural and legal norms, as well as preferences with regard to interacting with other extra-national entities (e.g., Jaggi & Low, 2000). Even in the EU, of course, despite the existence of the European Parliament and the latter's capacity to issue or cause to be issued directives regarding the audit market within the EU, national entities still choose the auditing standards to adopt, or adapt if first set elsewhere, and then choose the regulatory mix to monitor audit firm employment of those standards. Accordingly, we turn next to the sources of national auditing standards. Subsequently, we will describe national regulatory systems within our nine countries.

Sources of National Auditing Standards

To understand the strength of regulations, especially when we are comparing auditing regulations cross-nationally, one must understand the criteria by which regulated performances are judged. In the United States, the criterion standards for publicly owned corporations—the focus here—are set by the PCAOB. Many of these standards still reflect the standards set forth by the American Institute of Certified Public Accountants (AICPA) prior to April 16, 2003, although these older standards are slowly being swept away as the PCAOB issues new, risk-based, auditing standards of its own. In the United States, the PCAOB standards reflect more of a check-the-box quality than do the AICPA standards, which are currently applicable to audits of privately owned companies in the United States. The AICPA standards are more akin to the IFAC's ISAs and, like them, are more judgment-based. IFAC is an important international audit standard setting body with its standards adopted as a whole, or in part, by many nations. Through the IAASB, it sets ISAs and International Standards on Quality Control (ISQC) for participating nations' audit firms. Other important international organizations exist as well.

The use of ISAs is widespread. The IFAC reports that 126 jurisdictions worldwide have adopted ISAs, at least in part. In 11, the use of the ISAs is required by law or regulation. In another 32, the ISAs are adopted. In another 28, IFAC reports, national standards are the ISAs. The IFAC lists ''other'' as consisting of 55 jurisdictions (see http://www.ifac.org/about-ifac/membership/compliance-program/basis-isa-adoption; see also http://www.ifac.org/about-ifac/membership/compliance-program/basis-isa-adoption).[13]

Regulatory bodies may, and do, choose to monitor the behavior of auditing firms to ensure compliance with standards, but the choice of those standards is that of the regulatory body alone. The choice of standards, assuming compliance, is intended to shape the behavior of auditing professionals faced with the concrete reality of client financial and internal control systems, client practice in complying with financial accounting standards, and so on. Standards set by different regulatory bodies, even with respect to the same subject matter, may differ in levels of specificity and judgment left to the auditing professional. National cultures and practices may also impact the ability of an auditing professional to apply standards as he or she sees fit (e.g., Endrawes & Monroe, 2012; Sarens & Abdolmohammadi, 2009). Indeed, national culture and practices may very well shape the way the professional sees fit to apply a given auditing standard. While some nations adopt, say, the ISAs as written by the IAASB, others modify the standard to suit their own national preferences and perceived needs (e.g., Germany and China). Restoy (2011), for example, notes that a delicate balancing act must be struck between regulatory sovereignty and standard universality. Accordingly, we next look at the choice of standards of the nine nations of interest here (from the same IFAC source noted above).

According to the information collected and published by IFAC, the United Kingdom and South Africa have adopted ISAs as the national auditing standards and there are no separate local auditing standards. China, Germany, and India have adopted ISAs as the basis from which to develop national auditing standards and to move toward convergence with the clarified ISAs. There may be national modifications to ISAs due to legal or regulatory requirements or country-specific circumstances. In Brazil, Generally Accepted Auditing Standards were developed and issued by the CFC (Federal Accounting Council) in cooperation with IBRACON (Institute of Independent Auditors). CFC and IBRACON indicated that their standards are based on ISAs and they agree on the need to eliminate differences. A comparison of the Brazilian auditing standards (Normas Brasileiras de Contabilidade) to IFAC standards was performed, with the desired convergence completed by the end of 2009. Japanese Generally Accepted Auditing Standards consist of the Auditing Standards codified by the Business Accounting Council (BAC), with the implementation guidance (Auditing Standards Committee Statements) itself being issued by Japanese Institute of Certified Public Accountants (JICPA). To respond to the clarity project of the IAASB, JICPA is rewriting its Implementation Guidance to accelerate ISA convergence (*Source.* http://www.hp.jicpa.or.jp/english/about/publications/pdf/PUBLICATION-Overview2010.pdf). The Russian Federation adopted legal requirements (Article 7 of the Federal Law on Auditing Activity) that require its standards to be in accordance with the ISAs. This process began in December 31, 2008. The standards themselves are set by the Audit Council. Beginning on January 1, 2012, Russian Federal Standards on Auditing Activity were required to be promulgated in accordance with the ISA. The Russian Federation itself is not a member of the EU, accordingly there are fewer pressures from the bureaucratic and legal structure of the EU to force the Russian Federation to conform its standards to the IFAC's ISAs. The United States uses PCAOB standards for publicly owned firms. PCAOB standards are set by the PCAOB under the authority granted to the PCAOB in the SOX Act of 2002, with all standards subject to review and approval by the U.S. Securities Exchange Commission. These are generally considered rule-based, less judgmental than ISAs.

Discussion. The description of the sources and nature of the auditing standards that exist in each of the nine nations of interest here, as well as in the EU as a whole, demonstrates that

the nature of auditing standards differs between nations. We found that with the exception of the United States, most of the countries surveyed had adopted ISAs in whole or in part, often adapting ISAs to accommodate local concerns. These local concerns may reflect cultural norms and practices, legal code, tax law, or other considerations. Accordingly, while the International Auditing Assurance Standards Board ISAs are used widely, the standards are not used in ''as adopted by the IAASB'' form. The greater the differences between implementations of ISAs, the more difficult it is to assert that most economic powers follow the same auditing standards. We do not pursue a taxonomic analysis of ISAs here, that is, we neither attempt to differentiate between the degree of pure implementation in one country versus another nor look at particular regions of the standards that are particularized in one country or another. Our point is that it is not legitimate to infer that just because nations have adopted ISAs, or pledged convergence with local adaptations to the ISAs, that these nations are following the same auditing standards. Accordingly, individuals who are perusing financial statements[14] produced in different countries, each accompanied by what, in the United States, would be called a ''clean or unqualified audit report,'' cannot assume that the same report would have been produced in another country using that country's auditing standards.

On another note, ISAs have the reputation of requiring more auditor judgment than do such comparatively more rule-based standards such as the U.S.'s PCAOB. A consideration with more, as opposed to less, judgmental standards is that the auditor has more leeway to come to agree with his or her client, thus leading to less independence of judgment and poorer quality audits.[15] For example, according to the inspection reports published by the PCAOB, it seems that audit quality is not improving and that audit problems cluster heavily, but not exclusively, in areas where judgment needs to be applied by the auditor. Judgmental areas include the amount to set aside for loan loss reserves and fair value estimates. In this regard, the PCAOB, like other audit regulatory bodies overseas, often chides the auditors for failing to collect enough evidence to enable it to effectively support or refute management reporting preferences. The U.K.'s Public Oversight Board (POB) audit inspection reports also cite the exercise of professional skepticism as a repeatedly identified problem. Greater judgment implies more room for auditors to respond to challenges with claims that ''in their judgment,'' X, Y, and Z were done correctly. Greater specificity of requirements provides the regulatory body with a greater opportunity to ask whether prescribed procedures were followed. And, if they were followed, why the auditor believed X was a correct conclusion rather than Y.

Accordingly, we choose to examine here two parts of the institutional and regulatory boundaries that we presume impact auditor behavior: the sets of standards that auditors are required to implement during the auditing process, and the regulatory requirements and characteristics of the setting within which these standards are implemented. This effectively narrows the decision space of the auditor. With more specificity of required task performance, the auditor's judgment arena narrows down to why he or she came to Conclusion A versus Conclusion B. Auditor behavior that is acceptable to the national regulatory inspector, of course, may also be acceptable to the domestic courts of law. National regulatory agencies will only be of use, of course, if they can garner knowledge of the quality of work done by auditors under their aegis. Accordingly, for each of the nine countries, we addressed the questions of what the auditing regulator was and whether they used peer review of audit firm activities or whether the regulatory agency inspected the audit firm by itself.[16]

National Audit Regulatory Regimes

In the immediately preceding section, we described the source of auditing standards in different nations and noted that the international standards are often tailored to suit individual national circumstances. We inferred from that that uniformity of an auditing outcome cannot be presumed, even though each auditor faced identical clients.[17] Here, we describe the auditing regulatory systems in the nine selected nations, nations that collectively generate over half of the global GDP. We describe these regulatory systems to shed light on the existence of potential pressures on auditors to resist the calls of avarice and lassitude, and therefore to expend the necessary effort to accomplish their work well.

We isolated the following questions as valuable to answer:

- What standards does each national regulator use: ISA? PCAOB (here)? Other?
- Does the extant literature say these are principles or rule-based?
  - Legal framework used in nation?
- Who is the national regulator?
- How is regulation enacted?
- Regulator inspections?
  - Non-regulator inspections that count (e.g., peer review)?
  - How often are the inspections conducted?
  - What are the consequences of found problems? Fines? Disciplinary actions?
  - What public reports, if any, are made available—allowing potential clients to see ''auditor quality''?
  - Are there cross-national agreements? And what criteria govern the willingness of Country A's willingness to accept audit inspections conducted by Country B (e.g., the EU might say something like ''That country's domestic inspection routine is rigorous enough to be acceptable as sufficient for our own purposes.'')?

Collectively, these questions suggest the judgmental nature, and therefore the disputability, of auditor judgment, allowing auditors to argue the use of professional judgment in making decisions with which others disagree; the observability of auditor behavior, with that observability generated through characteristics of the national auditor inspection regime (by the regulator, by peers, and how frequent), and the potential consequences of found problems (fines, disciplinary actions, public disclosure of purported turpitude, whether moral, efficient, or effectiveness-related).

National regulator. In the wake of a series of high-profile corporate accounting scandals and auditing failures in the early 2000s, many countries have passed or amended laws to strengthen financial reporting systems and tighten regulatory oversight over public companies and their auditors, such as the SOX Act (2002) in the United States, the Government's Review of Audit Regulation (2003) in the United Kingdom, Auditor Oversight Act (2004) in Germany, the Amended Certified Public Accountant (CPA) Act (2003) in Japan, and the Auditing Profession Act (2005) in South Africa, just to name a few. These legislatures have enacted laws resulting in the establishment of independent oversight board such as the PCAOB (the United States), POB's AIU (the United Kingdom, replaced by the Conduct Committee under the Financial Reporting Council [FRC] in July 2012), Auditor Oversight Commission (AOC, Germany), Certified Public Accountants and Auditors Oversight Board

(CPAAOB, Japan), and the Independent Regulatory Board for Auditors (IRBA, South Africa) in developed countries. In comparison, though the BRIC (Brazil, Russian Federation, India, and China) countries are also taking steps to conform to international norms and standards concerning corporate financial reporting, auditing, and regulations, an independent audit oversight body has not yet been established. The national regulators in these countries are usually the Ministry of Finance (MOF) and the Securities and Exchanges Commission.

How is auditor regulation effected?

Auditing regulatory bodies. Our study shows that out of the nine countries surveyed, Germany, South Africa, the United Kingdom, and the United States have direct regulator inspection of auditors of public interest entities. The accounting firms are inspected on a cycle basis depending on the number of clients audited, the number of audit engagements, or the classification of a practitioner's attest portfolio (in the case of South Africa). The selection approach of audits is risk-based. The U.S. PCAOB publishes on its website the inspection reports of each individual auditing firm inspected. In Germany, the AOC and the Wirtschaftsprüferkammer (WPK) cannot make the inspection reports publicly available due to legal restrictions. However, the AOC issues an annual report that provides general information regarding the overall inspection results. The U.K.'s POB also publishes the overall inspection results annually. In contrast, the audit oversight body of Japan does not directly inspect auditors but relies on peer review reports to determine whether on-site inspection is necessary. In Japan, the JICPA created a Quality Control Committee consisting of predominantly JICPA council members, and other highly experienced members that plan quality control reviews and direct the Quality Control Review Team that executes reviews. The Quality Control Review Team is independent of other JICPA organizations and reports directly to the Quality Control Committee.

For the BRIC countries, the oversight of auditors of publicly listed entities relies primarily on peer review systems as a self-regulatory mechanism. The peer review system in Brazil is managed by the External Review Committee (CRE), which consists of representatives of two other organizations. The reviewed firm can choose its reviewer but the latter must be a firm of similar size. The review's results are sent to CFC and to Comissão de Valores Mobiliários (CVM) (i.e., Securities and Exchange Commission). Both entities have authority to punish the firms or the accountants. However, a 2005 World Bank (Report on the Observance of Standards and Codes [ROSC]) report stated that Brazilian regulators stated that they rarely apply appropriate sanctions. As might be expected, the ROSC report stated, ''This has led some regulators to question the usefulness of the quality control system as a whole.'' Given noted failures throughout the auditing world, these are words that may resonate elsewhere.

The Russian Federation passed a law on auditing activity (Federal Law on Auditing No. 307-FZ) in 2008, which became effective in January 2010. The new Audit Law requires mandatory membership of Russian auditors in one of the resulting six accredited Self-Regulated Organizations (SROs) of Auditors and registration with the MOF. The SROs are allowed to recruit some auditing firms to participate in external quality assurance reviews of other auditing firms that belong to the organization. The standard of measurement for these reviews, however, is the requirements of the Federal Law, auditing standards, professional ethics codes, and independence rules. The SROs themselves bear the responsibility

for setting deadlines and review frequency. A Russian federal agency, however, sets the procedure for the appointment and performance of the audit firm review.

The Institute of Chartered Accountants of India (ICAI) introduced the Peer Review Mechanism, the first of its kind for any profession in India in 2002 by issuing Statement on Peer Review. The peer review system is managed by the Peer Review Board (the Board), which comprises Council members of ICAI and representatives from Ministry of Corporate Affairs, Comptroller and Auditor General of India (C&AG), and Securities and Exchange Board of India (SEBI). The SEBI has mandated that the auditors of listed entities should be subject to a peer review process and hold a valid certificate issued by the Board. Furthermore, individual reviewers are required to meet certain requirements set out by ICAI and follow instructions presented in a comprehensive Peer Review Manual furnished by the Board. Reviewers are permitted to choose from using a compliance or a substantive approach to doing the review, or a combination of the two. The inspections follow a cycle approach, with Stage I firms subject to triennial review and others subject to less frequent reviews.

China's auditing profession regulatory system is managed by the Chinese Institute of Certified Public Accountants (CICPA) and supervised by the MOF. The CICPA uses a peer review system to conduct the quality assurance review of accounting firms. The MOF is entitled to (a) monitor the performances of accounting firms and (b) impose administrative sanctions as warranted. In addition, the Chinese Securities Regulatory Commission (CSRC) reviews the audit practices of firms that audit publicly listed companies. The CSRC requires these firms to be reviewed at least once in every 3 years. According to the World Bank's (2009) ROSC, ''The CICPA should work for continuously strengthening the procedure for reviewing the audit practice and focusing more on the quality assurance of accounting firms.'' In addition, the report stated that ''many stakeholders expressed concern that new accountancy professionals lack adequate exposure to the practical application of accounting standards, appropriate level of communication skills, and aptitude in forming judgment in applying accounting policies concerning complex recognition and measurement issues.''

Discussion. Our discussion on the nine nation regulatory regime notes the circumstances attendant upon peer review processes, including whether reciprocal reviews are permitted, to the extent that information is currently available. Understanding these circumstances is important in helping develop an understanding of the integrity of the review process. An inspected firm for Year 1 that becomes the inspector of the inspector firm in Year 2 may be able to trade favors with their counterpart firm. Trading favors, or even the perceived possibility of trading favors, reduces the credibility of a peer reviewing system. We take the position, therefore, that regulator review is probably a better way of assuring the credibility of an inspection program rather than a peer review process even though there is the possibility of ''regulatory capture'' (see, for example, Barofsky, 2012).

Another facet of the inspection process relates to the frequency of inspections. In the United States, the PCAOB inspects audit firms with at least 100 audit clients annually, with the inspectees being chosen based on the PCAOB's risk-based methodology. Audit firms with fewer than 100 clients may be audited every 3 years. Frequency of inspections by other, non-U.S., regulatory agencies ranges from 1 to 5 years. Some increase the frequency of the inspection rate based on the prior year's inspection findings for particular audit firms. The value of inspections, of course, rests with (a) the ability of the inspection team to provide effective feedback to the inspected auditor with regard to its audit performance; (b) the deterrent effect that knowledge that one is to be inspected has with regard

to taking due care during the audit; and, of course, (c) the willingness of the inspectee firm to make changes given that its purported failures have been identified to it. The extremely small percentages of audits inspected, of course, mitigates against (b) above becoming a consideration in the mind of audit teams, managers, and partners. Certainly one would expect the high level of litigation against auditors to also militate against auditors engaging in sloppy, reckless, or grossly negligent audits. This, of course, goes to point (c). Having learned of a deficiency in its practice, one would expect the audit firms to reform those practices to avoid potential liability from future failures of that sort. An interesting question, though, is whether this happens. Evidence adduced by the Canadian CPAB and the PCAOB (both cited above) suggests they do not.

Legal problems for auditors come in two large varieties—through regulatory authorities and through litigation regulatory sanctions may include imprisonment, fines, disciplinary suspensions, and license loss. We also present information with respect to non-pecuniary economic sanctions. Making public the results of inspections, for example, threatens auditors with a reduction of his or her client list should current clients leave and/or potential clients avoid that auditor.[18] However, in practice, such sanctions fail to create a significant impact—Big 4 auditing firms have suffered several high-profile audit failures, but continue to dominate the market for public audits. Another factor weakening regulatory action is the reluctance to sanction any of the Big 4 heavily enough to cause firm failure. KPMG, for example, faced severe sanction for its role in selling inappropriate tax shelters several years ago. Had the U.S. Department of Justice (DOJ) chosen to indict the firm for the systematically inappropriate behavior that took place within it, KPMG may have collapsed just as did Arthur Andersen. Regulatory forbearance may have restrained the U.S. DOJ's hand in this case because a government agency has some responsibility to see how its powers fit with broader public policy objectives. Whether the hand of the law should be stayed to fit other policy objectives, however, is a matter for legal and political science, not accounting, scholars.

The plaintiffs' bar, however, need follow no such constraint. It has the potential to act as an enforcer of auditor quality, using national legal processes as the tools by which to discover alleged professional malpractice and to punish it. It has been argued elsewhere (e.g., Francis & Wang, 2008; Han et al., 2012; Wingate, 1997) that legal code type (whether the common law type code found in Anglo-Saxon heritage countries or the civil code found elsewhere, for example, Germany, Taiwan) affects the level of investor protection afforded to investors. The argument in favor of legal code follows La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) in stating that common law codes afford greater investor protection than do civil law codes. However, Callen, Morel, and Richardson (2011) argue that once national culture is accounted for, the relationship disappears. Equally critical is the existence of sophisticated, large law firms that have the resources to effectively sue well-heeled Big 4 auditors. In the absence of such law firms, enforcement through private lawsuits is ineffective and the actions of regulators become doubly important.

Appendix B presents information on each of the nine countries sources of GAAP and culture.

Cross-border audit oversight. The globalization of business has resulted in many firms having physical presences overseas and doing business from these locations. Accordingly, the auditor must audit not only domestic locations but also those situated far afield. We begin our discussion with the EU's practices with respect to recognizing the work of auditors in other jurisdictions (ec.europa.eu/internal_market/auditing/docs/info-letter/

2011_05_en.pdf). The EU's practices are important because, collectively, they represent the largest share of the global economy of any power otherwise mentioned here. Accordingly, their regulatory stance on which other nation's regulatory apparatuses are equivalent to their own sheds a great deal of light on which other nation's regulatory apparatus is equivalently ''tough'' or ''lenient,'' as their own. Mutual recognition of audit regulatory activities is important because it helps avoid ''duplication of supervisory work, unnecessary burdens on audit firms, and above all, [it] promotes a high degree of investor protection by ensuring high quality audits.'' In that way, it serves as an indicator of what regulatory qualities promote audit quality.

On January 19, 2011, the EU Commission Decision 2011/30/EU1 stated that the following 10 audit oversight regimes were equivalent to those of the EU's. The 10 nations named were Australia, Canada, *China*, Croatia, *Japan*, Singapore, *South Africa*, South Korea, Switzerland, and the *United States* (the names of the nations of interest here are italicized). Given this finding, EU national audit oversight bodies were allowed to treat audits carried out by these nations' auditors as equivalent to those carried out by an EU auditor. Reciprocal treatment by the non-EU state, however, was required. The EU also has a transitional regime category. Under it, auditors from 20 other non-EU jurisdictions have been granted, through July 31, 2012, permission to conduct audits without EU oversight.[19] Furthermore, they are not required to register with EU authorities given a showing that adequate investor protections existed in their home countries. Brazil, India, and Russia are among the 20 identified. The EU's model is based on mutual reliance among audit regulators not only inside but also outside Europe. For the countries where the audit oversight bodies are considered as ''equivalent'' to the EU's, European public oversight bodies can rely on the inspections carried out by their counterparts, expecting the same treatment for EU audit firms. To this, the U.S. PCAOB had a cautious reaction. PCAOB spokesperson Colleen Brennan stated,

> While the PCAOB certainly has no objection to other regulators relying on its [the PCAOB's] oversight of registered firms, the PCAOB has long maintained that foreign audit regulators are welcome to come to the United States to inspect U.S. firms that are within their regulatory jurisdiction and that the PCAOB stands ready to assist them to the extent of its authority if they so desire. (http://www.accountingtoday.com/news/Europe- Cooperate-Audit-Firm-Inspections-56983-1.html)

While the EU may choose to rely on the audit inspections of the PCAOB, it did not mean that the PCAOB will necessarily rely on the work of EU audit inspectors.

As is evident, reliance on the work of other audit regulators is an important issue. The process of identifying which regulator's work should be relied on, however, is an important one. Avoiding duplication of effort preserves scarce regulatory resources for other things. However, accrediting through acceptance the work of problematic other regulators may cloak serious quality issues. In this regard, therefore, it should be noted that it is somewhat surprising that China is among the 10 countries being recognized as having an equivalent audit oversight system despite the recent accounting scandals involving several U.S.-listed Chinese firms, scandals that caught worldwide attention. Japan, in contrast, has adopted a model of cooperation and mutual reliance similar to the EU's. In July 2012, Japan's Financial Services Agency (FSA) and CPAAOB published ''Guidance on Equivalency Assessment on Audit and Public Oversight Systems of Foreign Jurisdictions.'' Essentially, Japan's regulatory bodies are going to rely on inspections of third country auditors carried

out by competent counterparts in foreign jurisdictions instead of conducting direct inspections. In addition, Japan has signed cooperation agreements with the Canadian and U.S. authorities.

The U.S. PCAOB has held cooperation discussions with foreign regulators and has reached agreements with a dozen countries including Japan, Germany, the United Kingdom, and a few others. The SOX Act requires all the registered audit firms, U.S. and non-U.S., to be inspected by PCAOB. Clients of non-inspected auditors may face delisting from U.S. stock exchanges as a result of using a non-inspected auditor. Given that the United States still has the largest and most liquid capital markets, loss of access to the same may severely impact the ability of the client firms to raise capital here. Despite this, as of June 2012, there were still 16 jurisdictions denying PCAOB access to the information necessary to conduct inspections of registered firms: Austria, Belgium, China, Cyprus, the Czech Republic, Denmark, Finland, France, Greece, Hungary, Ireland, Italy, Luxembourg, Poland, Portugal, and Sweden (see http://pcaobus.org/International/Inspections/Documents/06302012_international_inspections_information.pdf). The ability of the PCAOB to ''force'' others to allow the provision of information to it is in some doubt. While the PCAOB publishes the names of registered audit firms for whom the inspection fieldwork has not yet been completed, and also publishes the names of the U.S.-listed issuers audited by a PCAOB-registered firm located in a jurisdiction where obstacles to PCAOB inspections still exist, these efforts have not yet borne fruit—most notably with respect to China.

Germany and the United Kingdom, being EU member states, comply with its EU Statutory Audit Directive (''Directive 2006/43/EC''). The latter sets minimum regulatory requirements for statutory audits across the EU/European Economic Area (EEA) to ensure that third country auditors meet high standards in their audit work. Accordingly, third country auditors are entered on a public register and subject to the same minimum level of regulation imposed on EU/EEA auditors. As mentioned earlier, both Germany and the United Kingdom have signed cooperation agreements with U.S. PCAOB on joint inspections.

The EU does not accept the Brazilian, Russian Federation's and Indian regulatory oversight systems as equivalent to its own. As mentioned earlier, they are considered as ''transitional nations.'' Nor does the PCAOB have a cooperation agreement with any of them. The regulatory bodies of these countries make no mention of international cooperation with others.

Discussion. Achieving cross-national regulatory agreements on oversight is very difficult. It is very tough to gain an understanding of just how high quality is the inspection program implemented by a non-domestic audit regulator without in effect auditing the auditor's auditor. Issues of national prestige and reputation, as well as the institutional pride—or protectiveness—felt by the national regulator are very likely to affect the level of cooperation that they will provide to other agencies that seek to evaluate their own performance of their inspections. The consequences for a suspect national regulatory agency could include the same loss of funding that might occur to a corporation receiving a suspect audit opinion. While a corporation might be frozen out of the capital markets or indeed might be made a target in the market for corporate control, a national regulator may have its budget reduced or have its administrative elite displaced from their positions should they be found lacking in competence. Furthermore, auditing regulation is a relatively arcane field, one which the public is unlikely to understand. Accordingly, national regulators could if they wished wave the national flag and complain of the unfairness of

extra-national bodies that seek to impinge on national sovereignty to influence the domestic regulatory process.

Cultural Considerations in International Auditing Regulation

There is a growing literature on the impact of national culture on accounting practice and auditing professionalism (e.g., Endrawes & Monroe, 2012; Sarens & Abdolmohammadi, 2009; Wingate, 1997). For example, using the cultural dimensions identified by Hofstede (1980) and then expanded by House, Hanges, Javidan, Dorfman, and Gupta (2004), Sarens and Abdolmohammadi (2009) find that the degree of professionalism in internal auditing is higher in countries with lower level of uncertainty avoidance, collectivism, and assertiveness using a sample of 45 countries, and the degree of uniformity in internal auditing is higher in countries with lower level of power distance and collectivism using a sample of 32 countries. In a less sweeping experimental study in the context of external auditing, Endrawes and Monroe (2012) examine the effect of culture on auditors' professional skepticism by comparing auditors from two cultures that are sharply different—Egypt and Australia. Both groups of auditors work in the same Big 4 audit firms. Using culture dimensions of individualism/collectivism and power distance developed by Hofstede (1980), the culture of Egypt is characterized as high power distance and collectivist while Australia is characterized as the opposite. As Endrawes and Monroe (2012) point out,

> The similarity of judgment between auditors in a collectivist culture is likely to be higher than auditors in an individualism/autonomy culture, where they are more flexible and independent and have the right to pursue their own intellectual directions and decisions. In a collectivistic society, such as Egypt and China, individuals ''lose face'' by not meeting the social needs of the group. This suggests that auditors' judgment is a function of individualism/collectivism. (p. 11)

Their study found that Egyptian auditors tend to use more non-confrontational audit procedures and rely less on confrontational audit procedures, while Australian auditors score higher in terms of confrontational audit procedures. Furthermore, they found accountability has a greater effect on Egyptian auditors due to their high power distance cultural background. Therefore, the Endrawes and Monroe (2012) study lent support to the argument that auditors' professional skepticism is affected by cultural factors. Auditors from a collectivist, high power distance country tend to form their judgment more on ''norms, situations, and social structures,'' whereas auditors from an individualistic, low power distance country tend to depend more on beliefs, values, and pursuits of ''truth'' (Endrawes & Monroe, 2012, pp. 10-11).

We argue here that the findings of Sarens and Abdolmohammadi's (2009) and Endrawes and Monroe's (2012) studies may shed interesting light on additional forces, beyond national regulatory apparatuses, that may impact professional external auditor behavior. Professionalism provides an anchor to thinking and behavior in uncertain times. Clinging to it and the behavior believed to stem from it, may be conducive to more ethical and professional external auditor behavior as well. As Kleinman and Palmon (2001) argue, auditors are enmeshed in webs of work sites, professional organizations, family and communities, and culture and religion, with the strands of these webs potentially pulling the individual in different directions. As noted previously, Callen et al. (2011) find that the cultural metrics of individualism (uncertainty avoidance) are significantly

negatively (positively) associated with earnings management but that religiosity or religious denomination is unrelated to earnings management at the country level. Another interesting finding of this study is that legal enforcement is found to have no effect on earnings management after controlling for culture, but this result has to be treated with caution as many countries do not have a well-developed plaintiff's bar that can successfully challenge large audit firms. To sum up, differences in audit practice arising from cultural and legal norms are pervasive, highlighting the need for strengthening cross-border regulatory arrangements.

Discussion

The fundamental problem of auditor–client relationships (e.g., Anandarajan, Kleinman, & Palmon, 2012; Kleinman & Palmon, 2001) is that the client hires, pays, and fires the auditor in all of our sample countries. Absent a strong basis for litigation, culture and regulatory action may need to act to foster better auditor behavior.[20] If Sarens and Abdolmohammadi's (2009) results can be generalized to auditor behavior, then perhaps culture can act as a counterweight to low litigation risk. It may be that more assertive cultures will empower the auditor to insist on appropriate adjustments to the financial statements. Similar issues may pertain to the cultural construct of power distance. In cultures with greater power distance, should auditors believe themselves to be less powerful, they may be more inhibited in addressing problems with the client than otherwise, with the other elements we have discussed impacting the relationship in the same way as it did assertiveness. Therefore, international auditing standards should consider the effect of cultural differences on auditors' professionalism, judgment, and uniformity.

Conclusion

Our review of the current intra-national and cross-national arrangements for audit inspections suggests that there are many difficulties involved. There is, as yet, no convincing evidence that intra-national audit inspections are improving audit quality. Furthermore, while there are a number of commonalities between audit inspection regimes, such as the frequency and target of the more frequent audits, there is little that suggests that these inspection regimes are rigorous. The key issue is that auditors do not challenge the client's management sufficiently in areas which involve professional judgment. Given the wide variety of accounting principles used (e.g., GAAP in the United States, IFRS in its various national incarnations elsewhere, as well as other versions of GAAP), difference in how professional judgment is exercised and regulated as well as the different legal and cultural contexts within which these decisions are carried out, it is difficult to be optimistic about obtaining uniform audit quality. The key issue for audit regulators, therefore, may not just be to ''check the box'' of inspection procedures, but to develop tools for evaluating and controlling audit failures. Accordingly, we suggest that there is a need for a systematic program of research to better understand how audit quality is impacted by the interactions between relevant facets of national culture, legal systems, accounting standards, auditing standards, and auditing enforcement regimes. Certainly the proposition that many varieties of audit regulation should be allowed to bloom in search of the variety that best serves the public interest is a proposition that perhaps should be considered—for now.

Appendix A

Chosen Countries and Their International Monetary Fund GDP Data.

Rank GDP	Entity	GDP	% global GDP (rounded)
	World	74,384,980	
	European Union	15,203,145	20.4
1	The United States	14,526,550	19.5
2	China	10,119,896	13.6
3	Japan	4,323,504	5.8
4	India	4,000,002	5.4
5	Germany	2,944,352	4.0
6	Russia	2,230,954	3.0
7	The United Kingdom	2,181,456	2.9
8	Brazil	2,178,529	2.9
25	South Africa	528,806	0.7
	Total individual states	58,234,194	57.85

Note. GDP = gross domestic products.

Appendix B

Compendium of Information on Nations' Legal System, GAAP Source, and Culture.

	Country	Country audit standards	Country GAAP	Culture-based description
1	The United States	PCAOB	U.S. GAAP	Uncertainty avoidance: 4.00 Power: 4.88 Institutional: 4.17 In-group: 4.25 Assertiveness: 4.55
2	China	ISA-based domestic standards	On February 15, 2006, the Ministry of Finance of the People's Republic of China issued a new set of ASBEs, comprising a basic standard and 38 specific standards. Mandatory as of January 1, 2007	Uncertainty avoidance: 5.28 Power: 5.04 Institutional: 4.56 In-group: 5.80 Assertiveness: 3.76
3	Japan	Domestically set standards moving to ISA convergence	Listed entities—IFRS Unlisted entities—Japanese GAAP	Uncertainty avoidance: 4.33 Power: 5.11 Institutional: 3.99 In-group: 4.63 Assertiveness: 3.59
4	India	ISA-based domestic standards	Ind AS have largely been converged to IFRS but not identical. Goal is to make Ind AS compatible to IFRS by April 2013	Uncertainty avoidance: 4.73 Power: 5.47 Institutional: 4.71 In-group: 5.92 Assertiveness: 3.73
5	Germany	ISA-based domestic standards	Listed entities: IFRS Non-listed entities: Option of IFRS and HGB	Uncertainty avoidance: 3.94 Power: 5.40 Institutional: 4.75 In-group: 4.52 Assertiveness: 4.67
6	Russia	ISA-based standards	Public interest entities—IFRS (adopted in 2011 for years-ended in 2012) Converging Russian Accounting Standards to IFRS (target date 2013)	Uncertainty avoidance: 5.07 Power: 5.52 (higher) Institutional: 3.89 In-group: 5.63 Assertiveness: 3.68

(continued)

Appendix B (continued)

	Country	Country audit standards	Country GAAP	Culture-based description
7	The United Kingdom	ISA	Listed entities: IFRS Unlisted entities other than small companies must follow other standard sources	Uncertainty avoidance: 4.07 Power: 5.15 Institutional: 4.45 In-group: 4.61 Assertiveness: 4.04
8	Brazil	ISA-based standards, with differences but moving toward convergence	Listed entities must publish consolidated financial statements according to IFRS (per Rule 457)	Uncertainty avoidance: 4.99 Power: 5.33 Institutional: 5.62 In-group: 5.18 Assertiveness: 4.20
9	South Africa	ISA	Under 2011 regulations, entities in South Africa are permitted to use either IFRS, IFRS for SMEs, or SA GAAP, depending on an entity's "public interest score" SA GAAP will be withdrawn and cease to apply in respect of financial years commencing on or after December 1, 2012	Uncertainty avoidance: 4.73 Power: 4.64 Institutional: 4.34 In-group: 4.80 Assertiveness: 4.48

Source. www.iasplus.com by Deloitte.

Note. The higher scores indicate the greater uncertainty avoidance, power distance, institutional collectivism, in-group collectivism, or assertiveness based on a 7-point Likert-type scale. Refer to Sarens and Abdolmohammadi (2009) for description of these cultural dimensions. Range (low to high) of 45 sample countries: uncertainty avoidance: 3.24-5.61, power distance: 3.89-5.80, institutional collectivism: 3.89-5.60, in-group collectivism: 3.53-6.36, and assertiveness: 3.38-4.79. GAAP = Generally Accepted Accounting Principles; PCAOB = Public Company Accounting Oversight Board; ISA = International Standards on Auditing; ASBEs = Accounting Standards for Business Enterprises; IFRS = International Financial Reporting Standards; SMEs = small and medium-sized enterprises; HGB = Handelsgesetzbuch; Ind AS = Indian Accounting Standards; SA GAAP = South African Statements of Generally Accepted Accounting Practice.

Declaration of Conflicting Interests

The author(s) declared no potential conflicts of interest with respect to the research, authorship, and/or publication of this article.

Funding

The author(s) received no financial support for the research, authorship, and/or publication of this article.

Notes

1. The European Union's (EU) Green Paper (2010) notes, ''Audits of large groups which operate in multiple jurisdictions are usually carried out by large global networks in view of the high level of resources such audits require. The Commission shares the concerns of a number of audit oversight bodies around the world which consider that the role of the group auditor needs to be reinforced. Arrangements need to be put in place to allow the group auditor to assume its role and responsibilities. Group auditors should have access to the reports and other documentation of all auditors reviewing sub-entities of the group. Group auditors should be involved in and have a clear overview of the complete audit process to be able to support and defend the group audit opinion'' (European Commission, 2010, p. 13).
2. The Public Company Accounting Oversight Board's (PCAOB) inspection requirements and rules are set out at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_4.aspx as of March 26, 2012.
3. See http://pcaobus.org/News/Speech/Pages/05312012_DotyAuditsInvestors.aspx
4. See http://www.cpab-ccrc.ca/EN/content/2011Public_Report_EN.pdf
5. The International Monetary Fund (IMF) and the Central Intelligence Agency (CIA) World Factbook were largely in agreement on the gross domestic product (GDP) levels and rankings of these nine countries. They differed from the World Bank's listing. Given the agreement between the IMF and the CIA World Factbook, we chose to use the IMF list as the source of the GDP information, and not the World Bank. The 2010 GDP data are shown in Appendix A, in both dollar terms and as a percentage of global GDP. The GDP of the EU as a whole is also shown, as well as its percentage of global GDP.
6. A summary of the differences between International Standards on Auditing (ISAs) and then current PCAOB standards can be seen at http://www.accountingtoday.com/news/Auditing-Standards-Converge-51467-1.html
7. *The International Federation of Accountants* (ifac.org) is a support organization that provides support to other, standard setting boards, such as the International Auditing Assurances Standards Board (IAASB), the International Accounting Ethics Standards Board (IAESB), the International Ethics Standards Board for Accountants, and the International Public Sector Accounting Standards Board in their efforts to develop ''high-quality, internationally recognized standards for auditing and assurance, education, ethics, and public sector accounting'' (the statement can be found at answer 4 at the link http://www.ifac.org/about-ifac/organization-overview/faq). It also provides resources (guidance, tools, etc.) to assist constituent organizations and their members in their work.
8. Its intent was to ''open a debate on the role of the auditor, the governance and the independence of audit firms, the supervision of auditors, the configuration of the audit market, the creation of a single market for the provision of audit services . . . and . . . international co-operation for the supervision of global audit networks'' (European Commission, 2010, p. 5).
9. The Green Paper also briefly describes some differences in law/regulation-required practices between different European nations with respect to the content, and justification for, the audit report. On page 9, for example, it notes that ''UK has recently revised its model to render the auditors' reports more concise and is considering making them more informative. The French Commercial Code requires the auditors to publicly justify, together with their report on the

annual accounts, their audit opinion.'' On page 10, it states that ''. . . German legislation . . . requires the external auditor to submit a 'long-form report' to the supervisory board,'' a report containing much more detailed information discovered by the auditor during the audit.

10. The Green Paper notes that imposition of a cross-national law on non-audit services (NAS) provision does not guarantee similarity of interpretation or enforcement. Specifically, it notes of the Directive, ''Article 22 has so far been implemented in a very divergent manner across the EU. For example in France there is a total ban concerning the provision of non-audit services by the auditor to its clients as well as strong restrictions on the possibility for the members of the network of the auditor to provide services to the members of the group of the audited entity. In many other Member States, rules are less restrictive and the provision of non audit services by auditors to their audit clients remains a regular feature'' (European Commission, 2010, p. 12). Apparently, views as to what auditor–client relationships third parties may perceive as impairing auditor independence differ across national boundaries. Of course, as the Green Paper's Footnote 23 notes, the Sarbanes–Oxley Act's prohibition on the rendering of certain services has implications for European firms that are listed on U.S. Exchanges.
11. The definition of activities and outcomes that are deemed ''properly responsive to the public interest,'' of course, is in the eye of the beholder. Fernando Restoy, the vice chairman of the Public Interest Oversight Board (PIOB), spoke to these issues on June 30, 2011. In his speech, he argued for the importance of the harmonization of international audit regulation. Restoy noted that the auditing and financial markets are faced with several challenges. These challenges include the heavy concentration of auditing in the Big 4, the efficacy of audit firm rotations, and so on. With regard to ISAs, he recommends adoption through an endorsement system, similar to the one used in the EU for International Financial Reporting Standards (IFRS). This method, he states, balances the regulatory sovereignty of individual states and the delegation of some of the decision making to the auditing standard setting board. Such a system leaves in place, though, the problem of attaining uniformity of both audit expectations, and further, the cross-national auditor behavior we referenced above. See 3Restoy (2011).
12. See, for example, the problems the U.S. PCAOB faces in acquiring the right to inspect work product of Chinese accounting firms (for a summary of the problem, see Gillis, June 30, 2012: http://chinaaccountingblog.com/weblog/will-the-us-delist-chinese.html). Also, see Reuters (August 29, 2012: http://www.nytimes.com/2012/08/29/business/global/ernst-young-taken-to-court-over-records.html) with respect to Hong Kong's problems in acquiring audit firm work product.
13. These differences between the U.S. PCAOB and ISA were studied in a report by the Maastricht Accounting, Auditing and Information Management Research Center (MARC) for the European Commission. The report was titled ''Evaluation of the differences between ISA and the standards of the U.S. PCAOB.''
14. For simplicity's sake, we assume away differences in statements due to different ''flavors'' of IFRS, or the use in the United States of Generally Accepted Accounting Principles (GAAP) here. Differences in IFRS ''flavors'' between different adopters of IFRS, or the use of U.S. GAAP instead of other bases of accounting, will, of course, raise additional complications.
15. See Ojo (2010) for a contrary view, however. He notes, ''Such subjective element contributes to managers and auditors' abilities to influence or manipulate accruals based results, depending on the incentives of such managers and auditors. The prescriptive application of rules is considered disadvantageous from the perspective where it adequately fails to take into account the substance of the transactions being undertaken'' (p. 616).
16. The EU as a whole does not have an individual audit regulatory body that can administer punishment.
17. Kleinman and Palmon (2000, 2001) lay out a framework for analyzing environmental and regulatory pressures on auditor behavior that may give rise to wide variation in actual audit

performance. Their framework was within-a-nation. Raising their framework to an international level suggests even greater sources of variation in behavior.

18. For instance, ''China does not permit class action lawsuits that can have a sobering impact on auditors' incentives to constrain firms against manipulating their financial statements (Ball, 2009; Mahoney, 2009). As far as we know, there have been no successful civil lawsuits against auditors of listed firms in China. More generally, minority investors in modern China have hardly any legal recourse against tunneling by insiders, who are frequently politically connected, and security regulators have minimal jurisdiction over controlling entities (e.g., Allen et al., 2005; Fan et al., 2007; Jiang et al., 2010),'' stated in He, Pittman, and Rui (2012). Their findings show that in the absence of strong legal enforcement, partners' concern over reputation damage of an audit failure can serve as a deterrent of inappropriate auditor behavior and engender higher audit quality.
19. The transitional nations are listed as follows: Abu Dhabi, Bermuda, *Brazil*, the Cayman Islands, The Dubai International Financial Centre, Egypt, Guernsey, Hong Kong, *India*, Indonesia, the Isle of Man, Israel, Jersey, Malaysia, Mauritius, New Zealand, *Russia*, Taiwan, Thailand, and Turkey. The names of the nations of interest here are italicized.
20. Even in the United States, the Stonebridge decision (Glater, 2012) and, earlier, the enactment of the Private Securities Litigation Reform Act of 1995 have increased the difficulty of suing auditors.

References

Anandarajan, A., Kleinman, G., & Palmon, D. (2012). Is non-audit services a suitable proxy for auditor independence in the post-SOX period? *Research in Accounting Regulation*, *24*, 105-111.

Allen, F., Qian, J., & Qian, M. (2005). Law, finance, and economic growth in China. *Journal of Financial Economics*, *77*, 57-116.

Ball, R. (2009). Market and political/regulatory perspectives on the recent accounting scandals. *Journal of Accounting Research*, *47*, 277-323.

Barofsky, N. (2012). *BAILOUT: An inside account of how Washington abandoned Main Street while rescuing Wall Street*. New York, NY: Free Press.

Callen, J., Morel, M., & Richardson, G. (2011). Do culture and religion mitigate earnings management? Evidence from a cross-country analysis. *International Journal of Disclosure and Governance*, *8*, 103-121.

Canadian Public Accountability Board. (2011). *Meeting the challenge: ''A call to action.''* Retrieved from www.cpab-ccrc.ca/EN/content/2011Public_Report_EN.pdf

European Parliament and of the Council. (2006). *Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.*

Doty, J. (2012, May 31). *The relevance of audits and the needs of investors*. Speech at the 31st Annual SEC and Financial Reporting Institute Conference. Retrieved from http://pcaobus.org/News/Speech/Pages/05312012_DotyAuditsInvestors.aspx

Endrawes, M., & Monroe, G. (2012, June). *Professional scepticism of auditors: A cross-cultural experiment* (Working Paper). Retrieved from http://www.unisa.edu.au/Global/business/centres/cags/docs/seminars/Medhat%20G%20Monroe%20paper%20June%2027%202012.pdf

European Commission. (2010). *Audit policy: Lessons from the crisis*. Retrieved from http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf

Fan, J., Wong, T. J., & Zhang, T. (2007). Politically connected CEOs, corporate governance and post-IPO performance of China's newly partially privatized firms. *Journal of Financial Economics*, *84*, 330-357.

Francis, J., & Wang, D. (2008). The joint effect of investor protection and Big 4 audits on earnings quality around the world. *Contemporary Accounting Research*, *25*, 157-191.

Gillis, P. (2012, June 30). *Will the U.S. delist Chinese stocks?* Retrieved from http://chinaaccountingblog.com/weblog/archives/06-2012.html

Glater, J. D. (2012, December 27). Accountants skirt shareholder lawsuits. *The New York Times*. Retrieved from http://dealbook.nytimes.com/2012/12/27/accountants-skirt-shareholder-lawsuits/

Han, S., Kang, T., & Yoo, Y. K. (2012). Governance role of auditors and legal environment: Evidence from corporate disclosure transparency. *European Accounting Review*, *21*, 29-50.

He, X., Pittman, J., & Rui, O. M. (2013). *Reputational implications for partners after a major audit failure: Evidence from China*. Retrieved from http://ssrn.com/abstract=2013104 or http://dx.doi.org/10.2139/ssrn.2013104

Hofstede, G. (1980). *Culture's consequences: International differences in work-related values*. Beverly Hills, CA: SAGE.

House, R. J., Hanges, P.J., Javidan, M., Dorfman, P. W., & Gupta, V. (Eds). (2004). *Culture, leadership, and organizations: The GLOBE study of 62 societies*. Thousand Oaks, CA: SAGE.

International Federation of Accountants. (2011, September). *Regulation of accountancy profession* (IFAC Policy Position 1). Retrieved from http://www.ifac.org/sites/default/files/publications/files/PPP1-Regulation-of-the-Accountancy-Profession.pdf

Jaggi, B., & Low, P. Y. (2000). Impact of culture, market forces, and legal system on financial disclosures. *The International Journal of Accounting*, *35*, 495-519.

Jiang, G. H., Lee, M. C., & Yue, H. (2010). Tunneling through inter-corporate loans: The China experience. *Journal of Financial Economics*, *98*, 1-20.

Kleinman, G., & Palmon, D. (2000). A negotiation-oriented model of auditor-client relationships. *Group Decisions and Negotiations*, *9*, 17-45.

Kleinman, G., & Palmon, D. (2001). *Understanding auditor-client relationships: A multi-faceted analysis*. Princeton, NJ: Markus Weiner Publications.

Kleinman, G., Palmon, D., & Lee, P. (2003). The effects of personal and group level factors on the outcomes of simulated auditor-client teams. *Group Decisions and Negotiations*, *12*, 57-84.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (1998). Law and finance. *Journal of Political Economy*, *106*, 1113-1155.

Mahoney, P. G. (2009). The development of securities law in the United States. *Journal of Accounting Research*, *47*, 325-347.

McKenna, F. (2012a, June 19). *Big four auditors and jury trials: Not in the U.S*. Retrieved from http://retheauditors.com/2012/06/19/big-four-auditors-and-jury-trials-not-in-the-u-s/

Norris, F. (2011, June 9). Troubled audit opinions. *The New York Times*. Retrieved from http://www.nytimes.com/2011/06/10/business/10norris.html?_r=1&tntemail0=

Norris, F. (2012, November 29). A clash of auditors in HP deal. *The New York Times*. Retrieved from http://www.nytimes.com/2012/11/30/business/auditors-clash-in-hp-deal-for-autonomy.html

Ojo, M. (2010). The role of the IASB and auditing standards in the aftermath of the 2008/20092 financial crisis. *European Law Journal*, *16*, 604-623.

Private Sector Taskforce of Regulated Professions and Industries. (2011, September). *Final report to G-20 deputies: Regulatory convergence in financial professions and industries*. Retrieved from https://www.ifac.org/sites/default/files/publications/files/PSTF%20Report.pdf

Public Company Accounting Oversight Board. (2012). *Regulatory cooperation*. Retrieved from pcaobus.org/International/Pages/RegulatoryCooperation.aspx

Restoy, F. (2011, November 16). *International standard setting: The governance challenge*. Speech given at Berlin's IFAC Council. Retrieved from http://www.ipiob.org/index.php/speeches

Reuters. (2012, August 29). Ernst & Young taken to court over records. *The New York Times*. Retrieved from http://www.nytimes.com/2012/08/29/business/global/ernst-young-taken-to-court-over-records.html

Sarens, G., & Abdolmohammadi, M. (2009). *Cultural dimension and professionalism and uniformity of internal auditing practice*. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1529033

Selling, T. (2012, December 2). Autonomy: Investors are entitled to know what HP's management knows—By new year's eve. *The Accounting Onion*. Retrieved from http://accountingonion.typepad.com/theaccountingonion/2012/12/hps-autonomy-debacle-what-investors-are-entitled-to-know-by-new-years-eve.html

Slattery, K. (2011, August 19). *Hewlett Packard (HP) to acquire autonomy corporation*. Retrieved from http://www.digitalreefinc.com/blog/bid/70418/Hewlett-Packard-HP-to-Acquire-Autonomy-Corporation

Verschoor, C. (2012). Has SOX been successful? *Strategic Finance*, *94*(3), 15-17.

Wingate, M. L. (1997). An examination of culture influence on audit environments. *Research in Accounting Regulation*, *12*(Suppl. 1), 129-148.

Working Group of the International Auditing Assurance Standards Board. (2009, December). *Auditor's report—IAASB working group report*. Retrieved from http://www.ifac.org/sites/default/files/meetings/files/5108.pdf

World Bank. (2005). *Report on the Observance of Standards and Codes (ROSC)—Accounting and auditing*. Brazil. Retrieved from http://www.worldbank.org/ifa/rosc_aa_bra.pdf

World Bank. (2009). *Report on the Observance of Standards and Codes (ROSC)—Accounting and auditing*. People's Republic of China. Retrieved from http://www.worldbank.org/ifa/rosc_aa_chn.pdf