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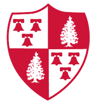

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Auditor independence: third party hiring and paying auditors

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Abstract

Purpose – Although the Sarbanes Oxley Act (SOX) has introduced rules to avoid auditor independence impairment, there are still issues that are not sufficiently solved. The purpose of this paper is to discuss the problems of auditor independence that arise by auditors being hired and paid by the auditee, and by SOX requiring rotation of only the lead audit partner.

Design/methodology/approach – The paper takes the form of a discussion paper, exploring alternatives to overcome the mentioned issues of independence.

Findings – The paper presents an alternative where auditors are hired and paid by an external third party. Besides this change, it also proposes a quality control system including the extension of the CPE program. A private entity in representation of the investors (e.g. Stock exchange) and an oversight board (e.g. PCAOB) as alternatives to hire, pay and control audit quality are discussed.

Practical implications – This paper has implications for regulators, since it presents a new alternative for hiring and paying auditors that requires an active involvement of an independent third party. It also has implications for professional bodies by increasing their participation in monitoring and training its members.

Originality/value – The paper presents an original alternative for avoiding independence issues derived by auditors being hired and paid by the auditee, and opens a discussion in a new solution to an old problem.

Keywords Auditors, Outsourcing, Auditor's fees, United States of America, Europe

Paper type Viewpoint

1. Introduction

Auditors certify that Financial Statements are reasonably accurate and provide adequate disclosure. Since different users rely on this information for their decision-making, the issue of independence of the auditor has been a fundamental one for regulators, practitioners and researchers. As stated by Moore *et al.* (2006):

> Independence is the only justification for the existence of accounting firms that provide outside audits; if it were not for the claim of independence, there would be no reason for outside auditors to exist, since their function would be redundant with that of a firm's inside auditors.

In order to ensure independence, the only relationship between the company and the auditor has to be the audit task. The European Union has established a set of directives that provide accounting rules that have to be followed by the members. The objective of these directives is "to require companies in the jurisdiction of the Member States to fulfill a minimum set of common obligations to further the establishment of an undistorted system of competition, to ensure in all the Member States some protection for people in business relations with companies and thus assist the companies' economic development" (European Union Fact Sheets, 2001). The International

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Federation of Accountants (IFAC, 2009), through the International Auditing and Assurance Standards Board (IAASB) develops the International Standards on Assurance Engagements (ISAEs), with the purpose of serving "the public interest by setting high quality auditing, assurance, quality control and related services standards and by facilitating the convergence of international and national standards . . . " Section 290 of the Code of Ethics released in July 2009 requires the rotation of the partner of the audit team every seven years with two years time-out, unless exempt by the independent regulator, and the non provision of some non-audit services. It also requires the review of an accountant that is not member of the firm if the audit fees exceed 15 percent of the total fees of the firm for two years, and the prohibition of compensation or evaluation of auditors based on the success in selling non-audit services.

After the 2000 scandals of Enron, WorldCom, etc. the Sarbanes-Oxley Act (SOX) of 2002 introduced rules to increase independence. These rules include the prohibition to provide other services in conjunction with the audit, the rotation of the auditors, and conflicts of interest resulting from employment relationships. However, some of them do not seem to be strong enough. For example, SOX requires the rotation of auditors every five years, but only of the lead audit partner, which is not protective enough because of inter group membership relations and behavior, as will be discussed in section 2.2. Other rules in SOX seem to be more effective in increasing the degree of independence, for example the prohibition of non-auditing services like systems design and implementation, provided simultaneously with auditing services. Finally, there are threats to independence that are completely ignored in the act, for example, the fact that auditors are paid by the auditee, which creates incentives to issue favorable reports to keep the client.

In 2009, auditors have been involved in new scandals. In the Bernard Madoff fraud, the auditor is investigated for conducting sham audits (Efrati, 2009). In the New Century investigation, the lawsuit alleges that the auditors were negligent trying to protect the business relationship and the audit fees (Kardos, 2009). These and other scandals provide evidence of the limitations of SOX in terms of auditor independence. If the auditors were regularly rotated and paid by someone other than the client, the incentives to conceal schemas to keep the client might disappear.

In this paper these two issues are addressed, rotation of the audit team and who pays for the audit, and a new structure to avoid these factors of risk of independence impairment is proposed.

2. Background

2.1 The role of auditing

Although accounting can be traced over 70,000 years back in Africa, and to 3,000 BC with Mesopotamians keeping records of their business transactions (Tinker and Sy, 2006), the origin of auditing is to be linked to the Egypt, Greece and Rome ancient empires. Boyd (1968) explains that it developed as a need to control that officials worked for the empire insted of enriching themselves. A report by the Instituto de Censores Jurados de Cuentas de España (1976, p. 14) indicates that there are tasks that can be related to auditing in Italy in the Middle Age, and that England had reviewers as early as the XIII Century. Similarly to the ancient empires, this report explains that

the role of the controller in Kingdoms and Courts in Europe developed as a need to control collections and payments as well as revenues and expenses.

Auditing, as a regulated profession, starts much later after industrialization and the birth of corporations. As described in the forementioned report, during the first half of the XIX Century in England, railroad companies without solvency as well as cooperatives created without financial guarantees, started to go into bankruptcy. To avoid the damage produced in working people's wealth, the government hired accoutants to overview the bankruptcies and liquidations. The especialization of these reviewers led to the development of auditing as a profession (p. 16), regulated by the Companies Act of 1929. Montgomery (1949, p. 9) state that when the businessmen found that the value received from the work of an experienced auditor exceeded the cost of the servies, that relation became a continuing one. The Companies Act of 1948 introduced competence requirements for auditors. In France, the auditor and the accountant professions are organized separatelly. In 1867 the "Institution du commissariat aux comptes" was created in corporations, and an audit report on the Financial Statements was required, but auditing was regulated by law in 1935 and 1936. Other countries like Germany had the first regulation of auditing and accounting in the 1930s as well, while Spain regulated the profession in 1945, although it was not fully developed until the 1970s.

Similarly, in the United States, auditing was introduced as a necessity after the Great Depression. At that time, "Regulations and laws were viewed as necessary for survival because it could alleviate public criticism by providing a (sometimes false) assurance that corporations would be held accountable for their actions". (Lehman, 1992) President Franklin Roosevelt's administration proposed legislation to protect investors and other external parties, by requiring the disclosure of relevant and material facts about public companies. Furthermore, other rules were directed to prohibit deceit and misrepresentations of the information disclosed. In this direction, the Securities Act of 1933 and the Securities Exchange Act of 1934 established the SEC, and required publicly traded firms to file financial reports reviewed by independent outside auditors.

The second section of the Securities Act of 1934 fundaments the necessity for regulation indicating that:

> [. . .] transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto [. . .].

By regulating, the legislators try to resolve the conflict of interest of different parties in the community, assuming the role of a neutral party committed to common interest. The independent review turns auditors into public watchdogs, according to the definition given by Warren Burger on behalf of a unanimous US Supreme Court (*United States* v. *Arthur Young & Co.*, 1984).

The evolution of technology has changed what is expected from auditing. For example, the availability of computer networking makes it possible to redesign the auditing architecture around online auditing (Vasarhelyi, 2002). It is also possible to perform a type of auditing which produces audit results simultaneously with or a short period of time after the occurrence of relevant events, (Continuous Auditing (CA) as defined by Vasarhelyi (2002)). In this paper, Vasarhelyi states that it would be

more accurate to call it instant rather than continuous auditing, and that it will turn the audit process to an audit by exception. If auditors control instantaneously, they could produce an evergreen report and notify conditions that affect that report when they occur. Although it is desirable to have assurance on information disclosed to guarantee user's protection, this reporting structure might originate new independence issues. While auditors controlling continuously have more knowledge of the strengths and weaknesses of the controls and reporting mechanisms of the company, by participating in this process, their independence might be compromised. If auditors produce an evergreen report, how independent can they be at the time of the annual audit report? Can they produce an unfavorable report if they are not satisfied with the company's book closing after they have been giving the evergreen? We can certainly think of some structure in which annual reports are no longer required, but as long as they are, the information they contain includes accruals added at the time of the close, that affect the corporation's income and need to be included in the auditor's report.

2.2 Auditor independence

Montgomery (1949) presents a summary of duties and liabilities that apply to auditors based on the English decisions and the principles of the common law in force in the USA Among them, he states that the auditor's relation with the client has to be confidential, but "if his position as auditor becomes incompatible with honesty, he may withdraw at any time", which indicates a requirement of independence of the auditor. There are different definitions of auditor independence as well as different variables used to measure independence. The AICPA (2006) provides one that relates independence with ethics and expertise by establishing that

> Independence implies one's ability to act with integrity and exercise objectivity and professional skepticism. Therefore, independence is critical to promote ethical behavior and reliable financial reporting.

Antle (1984) defines auditor independence with consideration of conflict of interests produced when an auditor's personal interest affects the auditing outcome; requiring non-cooperative behavior for independence. The Sarbanes Oxley Act (SOX) does not include a definition of auditor independence, but in section 2, it determines rules to guarantee such independence. These rules refer to non audit activities that cannot be performed by auditors for their clients in order to reduce conflict of interest (like bookkeeping, actuarial services, information systems design, management), rotation of partners every five years, and reporting to the audit committee.

The requirement of independence of the auditor is present in Europe as well. The European Union has established a set of directives that provide accounting rules that have to be followed by the members. The objective of these directives (European Union Fact Sheets, 2001) is:

> [. . .] to require companies in the jurisdiction of the Member States to fulfill a minimum set of common obligations to further the establishment of an undistorted system of competition, to ensure in all the Member States some protection for people in business relations with companies and thus assist the companies' economic development.

While the fifth directive regulates the structure of public limited liability companies and the powers of their management, the eighth council directive (84/253/EEC of April

1984) regulates the audit profession. The requirements imposed by the directive are that the auditor has to be a person of good repute with professional competence, who is not involved in an incompatible activity; thus, it requires independence of the auditor. The Directive 2006/43/EC of the European Parliament and of the council of 17 May 2006 amends the Council Directive 84/253/EEC (European Parliament, 2006). This directive requires that all approved auditors should be included in a register accessible to the public (European Parliament, 2006).

The International Federation of Accountants (IFAC), through the International Auditing and Assurance Standards Board (IAASB) develops the International Standards on Assurance Engagements (ISAEs), with the purpose of serving "the public interest by setting high quality auditing, assurance, quality control and related services standards and by facilitating the convergence of international and national standards..." Section 290 of the Code of Ethics released in July 2009 requires the rotation of the partner of the audit team every seven years with two years time-out, unless exempt by the independent regulator, and the non provision of some non audit services. It also requires the review of an accountant that is not member of the firm if the audit fees exceed 15 percent of the total fees of the firm for two years, and the prohibition of compensation or evaluation of auditors based on the success in selling non-audit services.

Among the variables considered in research as determinants of auditor independence, these are the most extensively used:

- *Firm size:* Since a big firm is expected to have more clients, each client is expected to affect less its income; therefore, the auditor has less incentives to report favorably to keep the client (Reynolds and Francis, 2000; Mautz and Sharaf, 1961; Gul, 1991; McKinley *et al.*, 1985; DeAngelo, 1981), This variable does not consider the number of clients of the audit firm or its importance. A big firm may have many clients but if one of them accounts for a large percentage of its income, the incentive to report to keep the client still exists. There is no attempt to avoid this threat in the US, but in Europe the Code of Ethics requires special controls in case of audit fees being more than 15 percent of total fees of the firm for two years.
- *Audit and Non-audit fees:* The combination of audit and non-audit fees, especially when the second exceeds the first, as used to happen in many companies, gives incentives to auditors to report favorably to keep the client. Besides, when auditors have participated in consulting services like the development of information systems, the evaluation of those systems might be affected by their participation in the design (Palmrose, 1986; Parkash and Venable, 1993), Both the US and Europe have measures in place to control for the provision of simultaneous services to the client.
- *Identification with the client and long-term relationships between auditee and auditor:* This issue has generated a long debate with studies finding that audit quality decreases as auditor tenure increases (Deis and Giroux, 1992; Dopuch *et al.*, 2001). Tenure may result in friendships developed with the auditee, which might impair independence if the auditor feels he belongs to the auditee's group. Also, the auditor might rely in previous years' auditing and relax his evaluation without detecting new events that might change his assessment. Moore *et al.*

(2006) develop a theory of moral seduction proposing that violations might occur without any conscious intention, and that ethical lapses occur gradually, therefore increasing the probability of occurrence with tenured auditors.

- *Managers hiring and firing auditors:* "This client/auditor relationship is probably a larger source of lack of independence than many of the issues extensively discussed in the literature" (Vasarhelyi, 2002).

The focus of this paper is on the problem of rotation of audit teams, as well as auditors being hired, fired and paid by the auditee. An alternative structure to avoid this independence issue is proposed as well.

2.2.1 Auditors hired, fired and paid by the auditee. When the auditor is hired, fired and paid by the auditee, the client can choose the auditor who will most likely deliver a favorable audit opinion. The auditor will use his professional judgment and accept or not the engagement, but as found in previous research, the outcome of the audit will affect the relationship between auditors and clients (Levinthal and Fichman, 1988; Seabright *et al.*, 1992; DeFond and Subramanyam, 1998; Chow and Rice, 1982). Therefore, if the auditee does not hire and pay the auditors, the auditor does not need to produce a report that matches the auditee's expectation to keep the client.

Different countries require that every public company must have an audit committee composed of members of the board of directors, which has a function of oversight over the financial reporting system, the internal controls and the independent auditors (SEC, 2003). When there is no designated body, the whole board of directors has the responsibility of the committee. In terms of external audit, this committee is in charge of the appointment, compensation, retention and oversight of the auditors, who have to report to the committee as well. It is also a forum the auditors have to discuss concerns related to their duties without the intervention of the managers, with the purpose of guaranteeing that "the management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices". The Combined Code on Corporate Governance (UK, July 2003) requires two to three independent non-executive directors. Among its functions, it is the role of the audit committee to appoint, re-appoint, remove and pay the auditor, to monitor the external auditor's independence, and to develop a policy in terms of provision of non-audit services by auditors. In many cases the committee proved not to be effective in its mandate given the fraudulent events involving managers and auditors in the beginning of the XXI Century both in Europe and the USA.

The Sarbanes Oxley Act introduced new rules in order to improve its effectiveness and among them it requires independence of the members of the committee. These independence requirements prohibit the members to act as consultants of the company, and to be affiliated with the company or a subsidiary. As stated in the SEC final rule, "an independent audit committee with adequate resources helps to overcome this problem and to align corporate interests with those of the shareholders". This means that even when the audit committee is involved in the process of hiring, firing, and paying for the audit, their interests could be biased towards those of the stockholders, which might affect the interest of other stakeholders, as will be discussed in section 3.

2.2.2 Rotating only the lead audit partner. In the European Union, Section 209 of the Code of Ethics released in July 2009 (IFAC) requires the rotation of the partner of the audit team every seven years with two years time-out unless exempted by the independent regulator. The exemption may be granted when the firm has only a few people with the required skills to serve as an audit partner, and the independent regulator has provided safeguards. The Sarbanes-Oxley Act (SOX) requires the rotation of the audit partner every five years.

Section 208-4 of the SOX, explains the rotation of audit partner by "balancing the need to bring a 'fresh look' to the audit engagement with the need to maintain continuity and audit quality". This requirement tries to avoid the identification of the auditor with the client produced by familiarity or close relationships. Moore *et al.* (2006) extensively discuss how economic and social incentives influence auditor's decisions. Some of these incentives can be explained by the social identity theory developed by Henri Tajfel and John Turner (Tajfel and Turner, 1979, 1986). According to this theory, individuals identify themselves with a group due to their membership, and they feel identical to the people in that group. Studies in inter group behavior indicate that individuals within a group hold positive perceptions about other group members, give higher acceptance of their outcomes regardless of the message quality, and are willing to protect them and cooperate with them (Brewer, 1979; Brewer and Kramer, 1985; Kramer and Brewer, 1984; Levine *et al.*, 2002; Abrams *et al.*, 1990; Mackie *et al.* 1992). On the other hand, research found that individuals distrust or are suspicious of members of other groups (Kramer, 1994, Kramer and Messick, 1998). If the auditor has strong relationships with the client, he/she might feel part of the client's group and bias the audit to protect the interests of the client, while they are expected to act with suspicion. Montgomery (1949, p. 8) states that:

> [...] the general rule of the common law, that all men are considered honest until proved dishonest, may be observed by an auditor with respect to the staff of the client; but he is charged with an exceptional degree of diligence in recognizing indications of dishonesty on the part of those who occupy responsible positions.

SOX and the European regulations assume that by rotating the audit partner, those ties of familiarity and membership do not develop, but new auditing leaders might try to protect the results of previous engagements because of their membership to the same audit firm, and the bonds they have created as in-group members.

3. Previous solutions to the independence issue in literature

Different alternatives have been proposed to avoid this risk of independence impairment. Moore *et al.* (2006) suggest that auditors should be hired not by the managers but by the audit committee of the board of directors, and that within a period of five years, the client should not be able to fire the auditor. The advantages of this proposed solution is that it would eliminate the incentives to please the client with a positive opinion during the five years of the contract, after which auditors should be changed (not the partner but the firm) to avoid the identification with the client. However, as discussed by Nelson (2006), this alternative might result in a company unable to switch a poor quality auditor. A second drawback of this solution is that it looks at the traditional role of auditors as watchdogs of investors in an era in which the number of stakeholders has increased. Employees, customers, vendors, creditors, even

the comunities in which the company is settled have to be protected. If the auditor is hired by the Board of Directors, the auditor needs to be aligned only with the owners' interests, and other external stakeholders are completely unprotected. For example, if the company is involved in tax evasion, or does not comply with environmental rules and the auditor oversees those facts, owners might have better returns, but the community's interests are affected. The lack of protection of some stakeholders is not apparent due to the structure of the current reporting model, which requires different reports without audit certification for different purposes; for example taxes or environmental reports are produced independently of financial statements. If the current reporting model evolves as expected (Vasarhelyi and Alles, 2006), meaningful reports will be provided based on a unique database, and auditors will have to assess on them.

Other alternatives to deal with this independence issue were proposed in literature. Ronen (2002), Elliott (2002) and Bhattacharjee *et al.* (2005) propose a model where public companies purchase financial statement insurance from insurance companies in order to indemnify against misstatements. Ronen (2002) proposes that before setting the premium, the insurance company hires auditors to assess the risk of misstatements. The board of directors decides how much insurance to buy, and the premium acts as an indicator. Similarly, Bhattacharjee *et al.* (2005) propose a framework where regulators require public companies to purchase insurance to indemnify their financial statements against material misstatements, and the insurance company hires an auditor as an underwriter to assess the risk of material misstatement. Elliott (2002) presents an online reporting model in which the users pay for the assurance. He states that since online reports make it possible to identify what information was used and by whom, an online contract can be established. In this insurance transaction model the insured is paid for the losses caused by faulty information. The advantage of the insurance model solution is the change in the agency relationship to the insurance company acting as the principal, so that auditors do not need to please the managers in order to keep their future income. However, as in Moore's solution, it only looks for the protection of the shareholders, since the board of directors decides how much insurance to buy. The desired level of risk of other stakeholders is not included in the decision since they do not have representation in the board of directors. Another drawback of this solution is that since there is a promise to indemnify against the cost of a wrong decision, the quality of information is not important as long as there is financial capacity to meet the contract obligations.

Vasarhelyi (2002) analyzes different alternatives of payment for Continuous Assurance, and presents a new model in which clients of continuous assurance pay for it. He proposes investors paying a fee for an "evergreen" report, banks paying for continuous monitoring, banks charging lower mortgage/loan fees for continuously monitored clients, insurance companies paying for certain assurances, insurance firms charging lower fees for continuous monitoring, and customers and creditors paying for continuous assurance of the health of the organization. This model of users of financial and non-financial information, paying for it and indirectly paying for its assurance, is supported by Elliott (2002) as well. Going further, the alternative of investors paying for assurance can be associated to the stock exchange paying for assurance. The problems and benefits of this alternative are discussed in section 4.3.

4. Proposed solution

Two questions have to be addressed when suggesting alternatives to the current payment structure: who pays for the audit and who selects or hires the auditors. Hence, some of the solutions mentioned in the previous section are incomplete. Moore *et al.* (2006) address the second issue, while Vasarhelyi (2002) addresses only the first one. The alternative of paying insurance is the only one that considers both components; the insurance company hires and pays the auditors, while the client pays the premium. However, this model has the drawbacks mentioned in the previous section.

4.1 Who hires and pays auditors? – Theoretical framework

As discussed in section 2.2, there is an independence issue produced by auditors being hired and paid by the auditee. Ronen (2002) posits that there is an inherent conflict of interest between the management (principal) and the auditor (agent) because the "former structures the financial relation with the auditor to induce a clean opinion on the financial statements even when it is not justified". This conflict can be resolved by creating a principal-agent relationship with a principal aligned with the interests of the parties affected by the audited information. In the existing solutions to address this conflict, shareholders are considered the only intended beneficiaries of the auditor's attestation. However, it is proposed in this paper that not only the shareholders, but the stakeholders, have to be considered as principals in this relationship.

The debate about which managers are accountable to for their actions has two confronting theories. One of them considers that managers are accountable only to shareholders, while the other surpasses the shareholders and includes the society in which the business operates. Dodd (1932) views business corporations as institutions with a social service as well as a profit making function. He differentiates companies in industries like railroads, gas, electricity, and telephone, which have limitations on unqualified pursuit private profit, from strictly private companies. These companies, outside the public utility field, do not provide protection to customers under the assumption that it is guaranteed through competition. However, he posits that a planned economy is needed to stabilize the system of production and employment, so that the system moves from one purely for the profit of the stockholders to one that includes the surrounding society. Aligned with this concept, Dodd transcribes Mr Owe D. Young's conception of what a business executive's attitude should be, and he mentions three groups of interests in a corporation: the owners, the employees, and the general public, in which he includes the customers. However, neither Young nor Dodd provide a definition of a stakeholder. Freeman (1984, p. 49) indicates that the origins of the term are difficult to track down. In his book "Strategic Management, A Stakeholder Approach", he includes the Stanford Research Institute (SRI) definition: "those groups without whose support the organization would cease to exist". Besides stockholders, these groups include employees, customers, suppliers, lenders and society. Freeman further explains that the idea of the SRI's researchers was that "unless executives understood the needs and concerns of these stakeholder groups, they could not formulate corporate objectives which would receive the necessary support for the continued survival of the firm". Hence, Dodd and the SRI agree in that besides the stockholders, other groups of interest are affected by the corporations' activities and therefore need to be protected, which has become apparent in the recent financial crisis, where the social effect of corporate failure has been especially harmful.

Based on the previous discussion and in order to create a new principal-agent relationship, the proposed solution introduces a third party in the game who acts as mediator hiring auditors and collecting money from companies to pay for the audits. This structure eliminates the incentives for the auditors to produce reports to keep the client, because it is the third party who decides the retention of the auditor. Also, by having a third party to pay for the audit, any monetary incentive for the auditor to compensate for the risk of a low quality report also disappears.

A payment strategy has to be appropriately determined, so that the mechanism does not affect economically the companies or the auditing firms.

Previous studies have looked at the composition of audit fees. Simunic (1980) includes:

- size of the auditee;
- complexity of the auditee's operations;
- auditing problems associated with certain financial statement components especially inventories and receivables;
- the industry of the auditee; and
- whether the auditee is a public or a private company.

Based on this, one alternative of payment for the audit may be determined by public companies being charged a fee based on firm size (assets and revenue). Since this alternative does not consider the benefits a good internal control system provides to the audit; a more refined schema could weight the fees companies pay by complexity of the engagement. These weights should be determined as function of historical relationships between audit fees and size measures of the company, and be modified each year with data pertaining to the new audit. Auditors are finally paid by the designated independent party based on the number of hours applied to the engagement.

In terms of hiring auditors, it is proposed that the audit firm is selected by the independent party and hired for a limited time to avoid the effect of inter-group behavior discussed in the section 2. The Sarbanes Oxley act asks for change every five years, like Moore *et al.* (2006). Nelson (2006) suggests it should be more frequent. Given that there is a trade-off between the benefits of specific knowledge of the company and the effect of long term relationships, a rotation of the whole auditing company every three to five years seems appropriate. The audit firm is assigned blindly based on firm characteristics like size and expertise in the auditee's industry.

4.2 How can quality be improved?

To improve audit quality, two strategies are proposed. First, the designated third party has to have access to the audit documentation, so that at any time, it can control the auditing engagement by itself or by peer review. Second, involve audit firms in continuous updating and modernization of their personnel and processes, by developing periodic quality enhancement certification programs. The respondents of a survey of firms with less than 100 clients (Oliverio and Newman, 2009) identify weakness in knowledge of relevant GAAP as a reason for deficiency reports. Since training is provided through the CPE credits program, the results of the survey suggest that this program needs to be updated. In an era of changes in rules and automation, it

seems necessary that an organization like the AICPA develop adequate training programs to guarantee that auditors are adequately trained to serve the users' interests. The training program might also enhance training of smaller firms so that they are prepared to enter the public auditing arena, which will also generate a broader competence in auditing firms.

In a Continuous Audit (CA) environment, Companies would hire a CA provider to produce the evergreen report proposed by Vasarhelyi, and independently, the annual audit would be assigned by a third party. Furthermore, companies with CA implemented would pay less for their annual audit, since auditors could rely on the results of the CA. Similar benefits would be expected for companies implementing continuous control monitoring.

4.3 Third player

The independent third party has to comply with requirements that guarantee its independence:

- be an intermediate organism interested in providing users with good quality reports;
- be independent from the audit firm and the company; and
- have no incentives to assign a specific auditor to a specific company.

Stock Exchanges have incentives to be the third party mediator. They are affected by disclosures from companies, with stock prices changing as a result of a chain effect when fraud in some company is detected. For example, when Enron collapsed the entire industry was shaken, particularly the marketing and power generating companies (Proctor, 2002). Chairman Oxley, in the opening statement of Enron's hearing expresses "thankfully, at this point there does not seem to be systemic threat to the financial markets as a result of Enron's collapse, but the damage the collapse has done to the financial position of thousands of Americans will be very difficult to quantify" (Oxley, 2001).

Besides the benefits produced by tax collection, governments are affected by the companies' activities in many ways (environment, employment levels, other services to the communities like support to libraries, hospitals, research, etc.). If a company is involved in fraud, the degree of the effect that its actions have on the public administration will vary according to the circumstances. For example, if the company is closed, it might leave towns with high levels of unemployment, and the government, with fewer collections in tax will be forced to intervene to provide residents at least with the minimum resources to survive until some solution to the unemployment level is found. The same could happen if the company is affecting the environment in a way that it needs to be closed or relocated. The damage affects people in other communities since there are a high number of other stakeholders besides the employees. In addition, the effect will comprise a long period of time. Vendors for example have to relocate their production, which also affects their stakeholders. If individuals have their saving in shares of the company that is being closed, their future is compromised. The same effect can be observed in employees who receive part of their salary in shares as a promise of wealth in the future.

This scenario can be recognized in many 2000 scandals. As presented by Chairman Oxley in the opening statement of the Enron hearing (page 2), Enron's collapse

produced thousands of employees lose their jobs, besides "11,000 employees who participated in the company's 401(k) plan have seen their retirement savings practically eliminated". Furthermore, "Enron's collapse has drained the investment savings of investors across the country who put their retirement and other investments into mutual funds, pension funds, and other vehicles that invested in Enron. As a consequence of this situation, expenses in Medicare/Medicaid increased as well as expenses in other welfare programs". A report on the state of the US health sector in 2003 (Hellander, 2003) shows that nearly 75 million US residents lacked insurance for part 2001/2002, while 18 million lacked insurance coverage for the entire period. While there are other factors like low income affecting lack of healthcare, unemployment is certainly one of them. In this report, 20 percent of the individuals with no coverage were unemployed. Hellander (2003) includes the Bethlehem Steel bankruptcy, where 95,000 employees lost their healthcare benefits, and were invited to purchase COBRA[1] for six months, but they did not have the funds for that purchase, therefore, increasing the governmental expenditure in Medicaid.

Unfortunately, this scenario is present in today's economy, with Ponzi schemas and the mortgage, financial and car companies' collapse. These events add to the general economic crisis, and besides requiring tax-payers money for bailout, put the jobless rate at its highest level in a quarter century. We can conclude that the failure of a company affects the expenditures that need to be done with tax collections, and therefore, the managers are accountable to more than the shareholders as stated by stakeholders' theory. Certainly, if this failure is due to malfeasance or fraud, and can be detected with a good audit, the level of expenditure will decrease.

Given the impact a good audit has in the community as a whole, and the effect of a bad audit in the federal funds, a government regulating entity in charge of assigning and paying for audits looks like the most appropriate. As described previously, this organism would not have any control on the companies, and its function would be only to assure the quality of the audit to protect all the stakeholders, which is consistent with the philosophy of the 1934 Act.

4.4 Public oversight boards

Both the European Union and the USA have created boards to oversight, rule and police the activities of auditors of public firms. Although some of their objectives and rules are common, others are different depending on the body. The 8th Company Law Directive of the European Commission requires the members to create public oversight systems of auditors. Since these systems need to combine the efforts of auditors in Europe, the European Group of Auditors' Oversight Bodies (EGAOB) was created to coordinate them. This body is composed of non-practitioners representative from the oversight boards in the Member States. According to the directives of the European Commission, the public oversight system has the responsibility of:

- approval and registration of auditors and audit firms;
- adoption of standards on ethics and internal quality control; and
- continuous education, quality assurance and disciplinary systems.

These objectives indicate an intention to protect users of financial information by providing a high quality audit. Among the oversight tasks, the Guidance paper on the cooperation between competent authorities within the EU, produced by the EGAOB,

distinguishes between inspections and investigations. Inspections are conducted regularly to guarantee audit quality, and can be considered preventive; while investigations are conducted under circumstances where there is suspicion of violation of laws or rules.

SOX (Section 101) created an oversight board (PCAOB), which federalizes the control of the auditors, to the extent that auditing firms must be registered in the board in order to provide audit services. Its mission is to "oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports".

The PCAOB is a private, non-profit corporation whose board consists of five full-time members appointed by the Securities and Exchange Commission (SEC) after consulting with the Chairman of the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury. Of the five members, two are required to be or have been certified public accountants. The duties of the board include the registration of public accounting firms, the regulation and control of the audit profession to guarantee independence, ethics and quality, conduct inspections and investigations, and enforce compliance to the law. According to Section 104, the PCAOB has to conduct a continuing program of inspections to assess compliance with the Act, the rules of the Board, the rules of the SEC, and professional standards, once a year for firms that provide reports for more than 100 issuers, and at least triennially for firms that provide reports for fewer issuers. SOX requires that the Board prepares a written report of each inspection which is distributed to regulatory authorities.

According to its Strategic Plan (PCAOB), the Board is committed to the following rules:

- *Public interest:* protecting investors and serving the public interest.
- *Integrity:* maintain the highest possible ethical standards.
- *Excellence:* high quality analysis and performance.
- *Effectiveness and efficiency:* responsibility in managing resources.
- *Fairness:* treating firms in fair, impartial and consistent manner.
- *Flexibility and innovation:* committed to forward thinking, anticipate risks, take action.
- *Accountability:* accept responsibility for the Board's actions.
- *Teamwork:* engage outstanding, highly qualified and experienced professionals.

The mission and legal mandates of these two oversight boards, make them a viable alternative as the proposed independent third party. They have a registry of audit firms, its size and competencies, and therefore they can assign them to different audits based on matching characteristics. To guarantee audit quality, two strategies were proposed in section 4.2. First, the designated third party has to have access to the audit documentation, so that at any time, it can control the auditing engagement by itself or by peer review, and both the European and the US boards have included in their mission an inspection and an investigation role. In the PCAOB it seems that the inspection process works as required for triennially inspected firms, since public companies are more likely to switch auditors when their audit firm receives a deficiency inspection report (Abbott *et al.*, 2008). However, respondents to a survey of

triennial firms with no-deficiency reports agree in that the inspection process should provide an overall measure of audit quality by including a sample of audits (Oliverio and Newman, 2009). Second, involve audit firms in continuous updating and modernization of their personnel and processes, by developing periodic quality enhancement certification programs. The European oversight boards are still appropriate candidates since they have training as an objective. The PCAOB does not have training in its mission, but in conjunction with an organization like the AICPA has to engage in permanent audit training. The respondents of the mentioned survey (Oliverio and Newman, 2009) identify weakness in knowledge of relevant GAAP as a reason identified for deficiency reports, while level of knowledge and skills of the total audit team was identified as critical factor for achieving the no-deficiency report.

5. Conclusions

In this paper, the problem of auditor independence produced by auditors hired and paid by companies was discussed. Different alternatives presented in literature to deal with this issue, which were shown to be incomplete, were presented as well. Finally, the paper introduces a new structure which is in accordance with the spirit of the Securities and Exchange Act of 1934, and the beginning of auditing in England, and involves the nomination of a third party in charge of collecting funds to pay auditors and assign audit firms to the different audit engagements. This schema would avoid the risk of auditors pleasing the company to keep the job by changing the principal-agency relationship. It also extends the concept of principal according to stakeholder theory. With the purpose of increasing audit quality, a training and recertification function is added to this organization. Since the European Commission and SOX created boards with the purpose to oversight audit firms in an effort to protect the public interest, these oversight boards were proposed for this function. Both of them have already being assigned some level of audit quality control, and have a registry of auditing firms, which allows the assignment of audit firms to clients. A second alternative was presented in which a private third party in representation of investors (stock exchange) is designated to this function. The final effect of the proposed change is an increase in the quality control function of the board, an increase in the training of participating auditors, and an increase of auditor independence by auditors not being hired and paid by the auditee.

Note

1. COBRA (Consolidated Omnibus Budget Reconciliation Act) is a continuation health coverage program that allows employees and retirees under certain circumstances, the continuation of the health coverage at group rates. The program is more expensive than the coverage for active employees, since the participant has to pay the entire premium (the employer does not pay anything), but less expensive than individual health plans, available at: www.dol.gov/ebsa/faqs/faq_consumer_cobra.HTML

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