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On the Independence of Auditors, with Special Regard to the Financial Sector

SUMMARY: The appearance of the joint stock company has made unlimited consolidation of capital possible, but capital ownership and capital operation became separated as a result. From the very beginning, the goal was to protect ownership interests and limit management interests. In order to better enforce ownership interests, the use of auditors became prevalent. The main argument for this was their independence. In recent decades, there has been increasing demand for enforcing the interests of parties beyond the owners within the operation of companies, particularly banks. The present paper draws conclusions after processing relevant literature and makes recommendations on how to improve auditor independence in the financial sector.

KEYWORDS: auditor, independence, bank, credibility of financial statements
JEL CODE: M42

The essence of a joint-stock company lies in the possibility of the consolidation of capital. Many capital owners establish a production or service provider company together, which have no size limitations resulting from a scarcity of capital. The result of the consolidation of capital is the separation of capital ownership and capital operation, because it is obvious that several hundred or several thousand shareholders cannot control the operation of the joint-stock company. Control and the operating decision must and should be left to the managers selected by the shareholders of the joint-stock company. With the separation of owner shareholders and CEOs and directors, entrusted with running the company, the information asymmetry and the different goals of the parties lead to a conflict. From the very beginning, the goal was to protect ownership interests and limit management interests. In the interest of better enforcing ownership interests, the use of auditors became prevalent.

The auditing of the content of the annual report, and of the related report is the pinnacle of the auditing of the economic operation of joint-stock companies. The most important conditions that need to be ensured are the independence of the auditor and public access to the auditor's report. Auditing can be evaluated along two specific lines, two cross-sections. Firstly, it provides protection from the tax authority by representing the interests of the shareholders and management, and secondly it represents the interests of the shareholders against management.

From the mid-19th century, in most Anglosphere countries, primarily in England and the United States of America, the appointment of an independent auditor by the general assembly became mandatory. This practice had not become immediately

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mandatory on the European continent (Germany, France, the Netherlands, Italy), nonetheless it spread quite far.

The independence of auditors was already debated in the 1930s. According to more moderate opinions, the independence of auditors had to be increased, while a more outspoken view was that auditors were not entirely independent, which needed to be changed. In the United States the SEC (Securities and Exchange Commission) recommended in 1940 that in the interest of increasing the independence of auditors, they should be nominated by the external members of the board of directors and approved by the general assembly.

INTERNATIONAL RESEARCH ON INDEPENDENT AUDITS[1]

According to *Jensen* and *Meckling* (1976) there is an information asymmetry between creditors and management as well, similarly to shareholders. Based on earlier studies (Chow, 1982; Francis and Wilson, 1988), the greater the capital gearing, the more probable that the company requires an audit to decrease information asymmetry. *Chow* (1982), *Abdel-Khalik* (1993), *Blackwell et al.* (1998) found a positive correlation between capital gearing and the demand for audits. According to *Watts* and *Zimmerman* (1986), the auditor's guarantee decreases the monitoring costs of creditors.

An independent auditor can reinforce the authenticity of financial statements, which is the basis of the operation of financial markets.[2] These markets are largely influenced by expectations, therefore, the independence of auditors must be unquestionable. There are many factors that strengthen or weaken the presumed or actual independence of auditors; media coverage is significant, and it is precisely for this reason that there has been and still is significant research on the subject, primarily in the US.

What does independence mean? According to the definition of the US Securities and Exchange Commission (SEC), independence is a mental state of objectivity and lack of bias (Rule 57; SEC, 2003). Rule 57 states: public confidence in the financial statements of companies depends on whether the given auditor is professionally independent or not. If investors were to view a given auditor as an advocate for the corporate client, the value of the audit might well be lost and the independence of the auditor brought into doubt (SEC 2003, Chapter III/A). *Levitt* (2000) determined that in more cases than not, audit firms behaved as 'attorneys' and not as auditors with their audited clients. The five largest audit firms at the time, the Big 5, considered themselves to be companies providing multidisciplinary professional services rather than auditors. It is difficult to ascertain whether their independence has been actually compromised during the audits, nevertheless, their independence can be questioned based on their own self-definition.

In their 2003 study, *Jenkins* and *Krawczyk* were measuring the independence of auditors when they examined the effects of six various consulting services on the auditors' verdicts. According to certified, but not practising auditors, participating in the survey, the provision of accounting and legal consulting services could decrease the independence of auditors. Based on *Mauldin's* (2003) questionnaire survey, in the opinion of institutional investors, auditor independence is compromised if auditors provide consulting services besides auditing to clients, particularly if said consulting services are related to internal audits, mergers or acquisitions.

The relevant literature usually uses auditors' consulting fees and mandate duration to

measure actual independence. In *Ashbaugh's* (2004) view, the consulting fee creates a tighter economic bond between the auditor and the client than the mandate duration, therefore, it can be more useful to measure the extent of auditor independence. This issue was studied by *Beck et al.* (1988) over a period of two years (1978 and 1979). The separate examination of the two years in question brought different results: in one, consulting fees proved to be better variables to measure auditor independence, while in the other mandate duration. The majority of research uses consulting fees as variables, they are, however, limited by access to data. The change was brought on by the SEC's 2003 rules as they prohibited certified audit firms to provide audit and certain consulting services at the same time. Prior to this, SEC already required auditing firms to make available their auditing fees and other consulting fees to the public. Based on public data, the view of *Frankel et al. (2002)* was that the median of consulting fees was almost equal to the auditing fees, and therefore the consulting fees can be used to assess the independence of the auditors. I would like to note that even today most studies use the consulting fees instead of the auditing fees to assess auditor independence.

The 2001 Enron scandal and the subsequent passing of the Sarbanes–Oxley Act (SOX) in 2002 brought further profound changes in auditing. The simultaneous provision of certain consulting services and audits was prohibited. Such consulting services included the development and installation of accounting IT systems, appraisal services, actuarial services, internal audit services, management or human resources services, investment services, legal services, and expert services that are not related to auditing. In 2003, the SEC required quoted companies to make their auditing and consulting related service costs public, detailing specifically the auditing fees, the costs of services related to auditing, costs related to tax consulting, and all other costs related to consulting, not limited by the SOX. Considering that consulting data are public in the United States, they continue to hold relevance for the assessment of auditor independence, although the types of services that can be provided have been significantly curtailed by the SOX. However, it did not limit the income that can be earned on the authorised services.

Examining the impact of SOX, *Dopuch et al.* (2003) made a surprising discovery, namely that the assessment of auditor independence remains unbroken even in the case of more significant consulting service provision. *Zhang* (2003), however, was critical of these statements, saying that Dopuch et al. allowed access to survey participants which could have affected final results. *Gaynor et al.* (2005) asked board of directors members to play the role of investors. The results: after SOX, board of directors members did not consider that auditor independence was compromised if the auditors also provided consulting to their clients. It has to be noted, however, that their past decisions had an effect on the behaviour of the members of the board of directors, if for example they had approved consulting agreements provided by an auditor. It is possible that they did not want to acknowledge that auditor independence might be compromised as a result of consulting services provided by the same auditor.

Thornton et al. (2006) came to different conclusion when they asked bankers and accountants to play the role of investors. According to the opinion of bankers and accountants, auditor independence was compromised by the provision of extensive consultancy services, including the ones authorised by the SOX. Having assessed the results of earlier research, *Beaulieu* and

Reinstein (2006) have established that only those accountants were influenced by research findings published in academic periodicals, who did not work in auditing. Those, however, who did work in auditing, held a completely different view of consultancy, because they had an opposing opinion altogether based on their practice.

Kinney et al. (2004) examined the correlation between various consulting services and adjustments of financial statements outside the reporting period. The results did not show a positive correlation between the fees of accounting IT systems, services related to internal auditing and the adjustment of financial statements. These results contradict other studies, but they are interesting in that both types of consulting services are forbidden for auditors under the SOX.

The studies mentioned fail to reach unanimous results in connection with whether the other services provided by auditors influence their independence, and whether consulting fees constitute the best measure of assessing their independence. While certain authors concluded that consulting services distorted the objectivity of auditors (Jenkins and Krawczyk, 2003; Maudlin, 2003; Thornton et al., 2006), others did not find these assertions to be proven (Dopuch et al., 2003; Gaynor et al., 2005). However, the opinion of the market and the investors may not be disregarded, according to whom non-auditing fees may have a negative effect on auditor independence. Although the SOX covers overlapping auditing and consultancy activities, the dilemma remains: can auditors be independent when they already know during their audit that a new consulting engagement is awaiting them from their client once the audit is completed.

The dilemma of independence could also arise in connection with audit fees. The SOX does not regulate (maximise) audit fees. It does require auditing partners to rotate, but it does not cap the assignment period of an audit firm. The question arises that in the event that there are no ongoing consultancy engagements (including those sanctioned by the SOX) and there are no plans for such engagements in the future, but the given company pays a relatively high rate for the auditing service and the auditor expects to remain the auditor of the company in the future as well – can it be said with absolute certainty that the auditor will not be partial during the audit for the given period in order to ensure that the company will commission his services in the future as well, especially if the auditor's margin on the audit fee is quite sizeable? How can one measure the "ethical" content of the margin? Studying the question is quite complex. No such papers have been written until this point. There are, however, studies which assess the independence of auditors on the basis of the duration their appointment.

Iyer and Rama (2004) conducted a questionnaire survey with corporate executives (CEOs, Managing Directors, CFOs, etc.) to establish the factors that influenced the decisions of the auditor according to the respondents. The authors were looking to find cases of differences of opinions, where auditors were likely to adjust their findings to the client's opinion or compromise their own opinion to favour that of the client. According to the respondents, the assignment period of auditing partners was a relevant factor, while using non-audit services was not. In addition, contrary to general opinion, respondents said that auditors appointed for the short term were much easier to influence than those with long-term contracts. The research also revealed that as opposed to consulting services, the assignment period of auditors provided a much better approach to measure auditor independence. *Ghosh* and *Moon's* 2005

empirical study showed a significant positive correlation between the duration of the auditor's appointment and the income earned from consulting services. The study suggests that the duration of the auditor's appointment might be just as good an indicator to measure the reduction in the independence of auditors than the fees charged for consultancy.

Some studies conducted before the SOX (De Angelo, 1981; quoted by Kleinman et al., 1998) explain that the longer someone employs an auditor, the smaller the per-unit cost of the audit becomes, as the auditor is already familiar with the company, therefore needs less time to conduct the audit. This effect increases the auditing profit margin, but it might also have a negative effect where auditors might become interested in trying to win the assignment for the next period, which can curtail their independence. This could also mean that since the auditor is more familiar with the given company, the managers of the company are more likely to extend the auditor's appointment, and also count on the opinion of the auditor beyond the scope of the audit, therefore they will ask for additional services from them. Whichever the case, auditors becomes increasingly dependent on their clients economically, which can compromise their independence. It is also possible that the clients become increasingly dependent on auditors because of their expertise, which could strengthen the auditors' position over the years, further increasing their independence. Therefore, the effect of the duration of the auditor's appointment is not clear.

The purpose of the above studies was to establish how auditor independence can be measured. Studies that also examined the independence or lack thereof on the veracity of financial statements went even further. The research conducted by *Frankel et al.* (2002) triggered a heated debate. In their study, they examined the relationship between the auditor independence – assessed on the basis of consultancy services – and profit manipulation. Profit manipulation was measured by individually established profit reducing or profit increasing items. Their observation was that the profit manipulation of companies increases, i.e., the credibility of the financial statements is reduced in proportion with the increase in the amounts paid for consulting services. The authors concede that the weakness of their study is that there might be a third variable in addition to the ones they examined, which was not considered, but could have an effect on both of the variables examined. Consequently, it is conceivable that only an indirect relationship exists between profit manipulation and consulting services, but both variables depend on the same criterion.

Ashbaugh et al. (2003) repeated Frankel et al.'s study after changing some of the variables involved. Ashbaugh et al. criticised Frankel's methodology, saying that the discretionary profit modifying items estimated from total expenditure might distort the model, and so they used the expenditure figures from the preceding year; moreover discretionary profit modifying items do not necessarily follow normal distribution, therefore, they used their natural logarithm. Based on the results, generated after these modifications, there is no evidence that auditors' consulting services have any effect on the reliability of financial statements. The results contradict Frankel et al.'s research results. *Schneider et al.* (2006) on the other hand criticise Ashbaugh's study. According to the authors, the model is restricted by the fact that it uses the expenditures of the preceding year as opposed to the current year, however, they agree with Ashbaugh in that Frankel's findings are the result of effects outside their model. Despite the weakness in Frankel's study, *Chung* and

Kallapur (2003) repeated the experiment, filtering the industrial, corporate governance effects as well as the effects of auditor expertise, but they failed to find a significant correlation between extraordinary profit modifying items and the reduction in auditor independence as measured on the basis of consulting services.

The companies examined by Franker et al. came from the textile industry, printing industry, and durable goods producers, as well as transport companies and retail chain stores. In contrast, *Reynolds et al.* (2004) examined fast-growing small-, and medium-sized enterprises, as well as online commerce, bio-pharmaceutical, telecommunication and pharmaceutical companies. Despite the different research sample, they came to the same conclusion, i.e., companies that used more consulting services usually engaged in creative book-keeping much more intensively, which was made possible, according to their assertions, by the reduction of auditor independence. *Elder et al.* (2004) take the research further, extending the scope of their research to include commercial banks and industries, which have not been included in the previous studies. They found a positive correlation between consultancy services, and total and discretional credit risk provisioning. They drew the conclusion that when auditor independence decreases (which was measured through an increase in consulting services) auditors allow their clients greater freedom in creative book-keeping.

Kanagaretnam et al. (2010) also examined the relationship between profit influence and the independence of the auditors in the banking sector. The authors measured the auditor independence by the overall fees paid to them and profit manipulation by the credit risk provisioning of banks. Earlier studies (Wahlen, 1994; Collins et al., 1995; Kanagaretnam et al., 2003; Kanagaretnam et al., 2004) argue that credit risk provisions represent the largest profit modifying item for banks. As a result, bank managers are motivated to make discretionary decisions with regard to provisioning, meaning that they might adjust the Capital Adequacy Ratio or profit to improve their own remuneration prospects or might signal the market by way of provisioning. Kanagaretnam et al. (2010) came to the conclusion that the extra remuneration paid by large banks to auditors did not correlate with influencing profit, whereas in the case of small banks they found a strong positive correlation between profit increasing (smaller scale) provisioning and the amount paid to auditors as well as the extra remuneration paid to auditors in exchange for non-audit related services. Their results were diminished by the fact that fees paid to auditors should be examined at the level of banking groups, because an "extra" service provided at one of the banks may be compensated by extra fees paid by another bank within the banking group, since members of banking groups usually use the same auditor.

In addition to the above studies, *Myers et al.* (2003) assessed the relationship between auditor independence and creative book-keeping, using the duration of the auditor's appointment to assess the independence of the auditor. It was their observation that the longer an auditor was hired, the fewer extraordinary profit modifying items there were in the financial statements. In their opinion, longer term auditor-client relationships increase the auditors' room to manoeuvre during their discussions with the client, as a result of which the number of extraordinary profit modifying items is reduced.

Summarising the findings of the studies that assess the relationship between auditor independence and creative book-keeping, there is no uniform conclusion to be drawn.

Another group of research efforts examined the correlations between market reactions and

the consultancy income earned by auditors. *Krishnan et al.* (2005) found a negative correlation between consultancy income and market reactions, i.e., when consultancy fee income is higher, which signifies a reduction in the independence of the auditor, the market's reaction to the profit increase of the company is weaker. This observation is in line with the final conclusion drawn by Frankel et al. (2002), namely that the investors' perception of the drop in independence is accompanied by the weakened credibility of results. Ghosh and Moon (2005) also supported this conclusion with auditor independence measured by mandate duration. According to their conclusion, in a longer term auditor-client relationship market reactions are stronger, i.e., the increase in the trust in auditor independence is accompanied by the market's greater faith in profit forecasts.

One study (Chaney and Philipich, 2002) examined how the stock exchange reacted to the collapse of Arthur Andersen after Andersen admitted destroying documents related to Enron. Surprisingly, the authors found no significant market reaction in the case of listed companies that received both auditing and consulting services from Arthur Andersen. This led them to conclude that markets are not affected if the auditor also provides consulting services to the client. Let me note, however, that contrary to this conclusion, it is also possible that the markets have already priced in the risks related to Andersen even before the wrongdoing was admitted.

During the Enron scandal and the current subprime mortgage crisis, the independence of credit rating agencies i.e. the reliability of their ratings was called into question, as these credit ratings are paid for by the same companies whose bonds are being rated. In their 2004 paper, *Brandon et al.* – although instead of examining the consultancy agreements of credit rating agencies, they looked at the relationship between auditor independence measured in fees paid in excess of audit fees and bond ratings—came to the conclusion that there is no significant relationship between the two. It was their observation that credit rating agencies were not affected by simultaneous audit and consulting mandates (i.e. the potential drop in auditor independence).

Also noteworthy are the researches that examine whether the decrease of independence impacts the audit opinion issued. According to the study by *Kornish* and *Levine* (2004), higher audit fees may motivate auditors to issue clean opinions even when there are certain signs at the company that indicate problems, which could even endanger its operation in the year following the audit. The authors expanded their investigation to cover several years, but in this case were unable to show this correlation. *Reckers* and *Robinson* (2007) came to a conclusion, which contradicts the findings of the one-year study. According to their empirical research, the audit result was not affected by the auditors' consulting income. In their case study based research, they included senior auditors from the Big 4, who participated in advanced training and were asked to write an auditor's opinion on the basis of a typical audit scenario. The case study (audit script) contained manipulated variables: significant consulting agreements exist (or do not exist) with the client, internally evaluated client risk is high or low. The answers provided by participants did not reflect the authors' expectations, who were of the opinion that higher consulting fee revenues would motivate respondents to issue clean audit opinions. A possible explanation to this surprising outcome: the participants in the case study are at a low level in the Big 4 hierarchy, thus are not motivated to make "political decisions" when issuing audit opinions, furthermore, participants were most

probably influenced by the fact that the case study was conducted as part of an advanced training on audits and was no more than a simulated audit report.

Koch et al. (2009) conducted research based on another case study to determine whether SOX amendments concerning the accountability of auditors had any impact on auditor behaviour. Prior to SOX, auditors of companies listed on the US stock exchange had no accounting obligations to the management, and it was the management which appointed auditors and determined their fees. SOX made audit committees mandatory for listed companies and delegated all auditor-related activities (appointment, determination of fees, settlement) to their competence. By involving auditors from two of the Big 4, the authors came to the conclusion, based on the case studies, that auditors are not influenced by having a management with aggressive accounting aspirations as clients or the audit committee with a conservative accounting approach. They did, however, determine that: if auditors have a stake in holding onto their client, they are more inclined to be partial, regardless of whether this client is the management or the audit committee. According to the study, the risk to auditor independence is not the client type, but the stake the auditor has in winning the assignment for the next period.

There is an ongoing debate in the relevant literature, particularly since the 2008 subprime crisis, regarding the fact that auditors are unable to recognise system-level risks affecting companies or it is not in their interest to make such findings public. In the majority of cases, these are risks that have been accumulating for years, therefore no imminent "explosion" is expected and auditors have to give assurance that the company will be operational in the following one year. "Negotiating" with management, therefore, has room to manoeuvre. *Doogar et al.* (2012) examine the auditing of American banks prior to the 2008 crisis on the basis of empirical data. Taking the total fees given to auditors as the measurement of auditor attention, the authors came to the conclusion that auditors were aware of the increase in audit risks due to the rise in economic risks. The authors themselves mention that the adequacy of auditor responses to risks is a different matter. As *Lukács* put it as a self-criticism of the auditing profession: "it is true that in some cases they did not call attention in time to the risks in banks' balance sheets or the problems in regulations; they were not vocal enough when discovering the rate of indebtedness, lack of equity capital, the complexity or opacity of transactions; and were afraid to be adequately brave when issuing qualified reports" (Lukács, 2011, p. 129).

We should end with studies that dealt with how investors' confidence in company value was influenced by the supposed drop in auditor independence or their willingness to file suits against the auditor in question. In their 1984 paper, *St. Pierre* and *Andersen* determined that the bankruptcy of a company is an indication to investors, as at that point they see proof that the given firm's auditor did not perform the audit task adequately. *Church* and Zhang (2005) studied how the drop in auditor independence, measured on the basis of consulting services, affected the confidence of investors in company value and their willingness to file suits for damages. Their answer: investors are more willing to file lawsuits against the auditor if he has a high-value consulting agreement with the given firm, i.e. the investors felt the auditor was not independent. We must, however, also note that in the case of bankruptcy, lawsuits brought against the auditor are usually the very last measure taken by investors. Such lawsuits usually end with settlement, and

it is impossible to know to what extent the biased opinions of auditors contributed to the companies' bankruptcies. Lukács (2011) approaches the accountability of auditors from another angle and argues for the limiting of auditors' unlimited civil and criminal liability to enable them to provide extra information on clients in their report.

In summary: studies dealing with the independence of auditors cannot draw a unified conclusion either. There is also no unified position on whether the term of consulting agreements or the duration of auditor mandates is an appropriate gauge of auditor independence, particularly if we take into account that nowadays the consulting services provided by auditors to clients are significantly more restricted than in the past. The law does not prohibit the provision of consulting services if the audit is completed and this could decrease auditor objectivity just as much as the existence of consulting agreements while audits are in progress. This means that the mutually exclusive regulation of auditing and consulting for the given year does not necessarily resolve the problem of independence; consequently the results of studies that compare the consulting revenues of auditors for a given year, thereby drawing conclusions regarding auditor independence should also be handled with caution. On the other hand, there is no standard rule to determine audit fees, therefore there is no way of knowing whether the fees offered to auditors contain funds aimed at 'securing goodwill' or not.

Finally, I would like to note that the results of simulated case studies should be accepted with strong reservations. In theory, auditors are definitely aware of their obligations and the objective of audit work, therefore, why would they not give the answer expected of them as participants of the experiment? Do they think and act in the same manner though in real-life situations? Are they not influenced by other circumstances? Are they not influenced by their own firm? We will never know the answer to these questions.

AUDITORS AND SUPERVISORY AUTHORITIES

In most countries, including Hungary, auditors of banks have to send audit reports as well as other special reports (e.g. reports on the efficiency of bank control or IT systems) to the bank supervisory authority. In certain countries, the bank act sets out the auditors' obligation to notify the bank supervisory authority if they find a significant risk or irregularities in the bank's operation. Furthermore, in Albania for instance, auditors are only allowed to perform audits in the banking sector with the prior authorisation of the bank supervisory authority, but to date there have been no cases (at least I do not know of any) where the authority has revoked the mandate of any auditors when their work was debatable and could be called into question. In her studies, *Ojo* (2005, 2006a, 2006b, 2007) deals with how the bank supervisory authority could cooperate more closely with the auditor in the interest of the more efficient regulation of banks. In her opinion, the responsibility and accountability of auditors should be increased. She raises that the accountability of auditors with respect to omissions or deficiencies should perhaps be a principle of even greater significance than their independence. Lukács (2011) also argues for the closer relationship of auditors and supervisory authorities.

In agreement with those proposing a closer relationship between auditors and supervisory authorities (Ojo, 2005, 2006a, 2006b, 2007; Lukács, 2011), in my opinion there is a solution that could be introduced,

where auditors would have to request prior approval from the supervisory authority to accept engagements in the banking sector. Supervision within the system would be active; if the omission or deficiency of an auditor were to be uncovered, his/her audit mandate for the banking sector would be revoked and his/her independence with respect to the given bank would be under constant monitoring. If independence is called into question in the auditor-bank relationship, the auditor's mandate could be revoked. The auditor would have accounting obligations not just to the bank's management and owners, but also to the supervisory authority, and thus would have a stake in maintaining independence.

AUDIT LIMITS

Two additional sets of problems should be highlighted with respect to auditors. One of these concerns professional competency, for instance: during a bank audit, it is difficult to realistically believe that an auditor would be able to recognise and comprehend (though this can and should be an expectation) the true risk of certain products, which can only be developed with such in-depth expertise in the given field that only a few persons possess such expertise at the bank in question, or even worse, only the actual person who developed the given product. Over the course of financial innovation, specific professional knowledge in the case of bank employees has risen to a level that is difficult to follow for both auditors and supervisory authorities alike, turning this into a sort of cat-and-mouse game. Difficult to follow, but not impossible. Adaptation, however, would require repricing (fee increase) in the case of audit fees, or otherwise would cause audit profit margins to drop (involving experts would raise the costs of the audit firm, while the audit fee would remain the same). The latter would only be possible in the case of the amendment of the regulations, where the auditing profession or companies involved in auditing would be forced to expand competition, i.e. break out of the circle formed by the magic four, the Big 4[3] which in turn leads us to the other set of problems that has at least the same significance as the issue of the professional competency of auditors.

Ninety per cent of quoted companies are audited by one of the Big 4, (Deloitte, PricewaterhouseCoopers, Ernst & Young and KPMG), meaning that the audit market is practically divided up between the four largest players. These are also the firms that rotate during the mandatory rotation of auditors. So far, smaller firms have been unable to break this magic circle. Just to avoid confusion, I have no desire to lobby for the smaller audit firms, but as *Bánfi et al.* (2011) so succinctly put it: "audit firms live their lives of several decades in close symbiosis with the firms to be audited", which is clearly not something that would reinforce the independence and objectivity of auditing.

In the past, attempts were made to resolve the issue of independence by separating audit and non-audit (consulting) services, which did somewhat alleviate the problem, but failed to resolve it. Even today, there are non-audit services that are allowed to be provided at the same time as audits, such as tax consultancy, which, besides independence, also raises an ethical problem regarding tax evasion. Taking advantage of the opportunity of international tax optimisation, the four major audit firms do not simply provide assistance in decreasing companies' tax liabilities through offshore companies, but at times use this same technique to decrease the payment of taxes due after their own activities. The analysis and elaboration of the offshore issue, however, goes beyond the limits of this paper.[4]

Another reason why the problem of auditor

independence cannot be resolved even through the complete separation of audit and advisory services is that it is impossible to measure to what extent the 'extra fees" given for the services (in this case specifically for auditing) of the preceding period influenced the pricing of consulting fees received at the end of the audit cycle. We can assume that a stricter regulation of auditors would help matters along, prohibiting the two activities within a company or company group.

CONCLUSIONS AND RECOMMENDATIONS

The financial crisis, that has been ongoing since 2008, has already made a deep impact on banks and the process is far from over. This is particularly true for the Mediterranean region; however, bank bailouts were and are still necessary in certain Scandinavian countries as well. In the European Union, and the euro area in particular, the planned bank union could bring about a stricter regulation of the financial sector than what is currently practised by national supervisory authorities. New institutional solutions are needed, however, replacing the institutions and tools applied until this point would not be expedient; instead we must strive to perfect these. This applies to auditing and auditors as well.

Widespread international research allows us to formulate certain recommendations that could improve audit efficiency.

The first of these is: the bank assignment of auditors should be approved by the bank supervisory authority in advance. This has already been introduced in certain countries, but has yet to become general practice.

The second: the audit fees of financial institutions should be defined on the basis of pre-define parameters, deviation from which should be approved by the financial supervisory authority. This would allow the prohibiting or at least the limiting of 'extra' fees provided to auditors. The possibility of 'extra' remuneration should be eliminated in order to prevent clients (banks) attempting to secure the 'goodwill' of auditors.

The third: the supervisory authority should actively monitor the independence of auditors from specific bank clients. Should any suspicions arise with regard to independence, after deliberation the supervisory authority could revoke the permit for the audit of the given bank. This particular rule would help to maintain auditor independence, and through this, would improve the credibility of financial statements that are significant for money and capital markets. The examination of the supervisory authority could extend to whether any conflicts of interest exist beyond the subsidiary level, at the bank group level, that could impact the results of the audit of the subsidiary.

We could raise a number of questions with debatable answers that would not at all make further research and practical experimentation unnecessary, but in fact obligatory.

NOTES

[1] International literature rarely separates the financial sector from other sectors when examining audit independence. I shall indicate if the research in question was directed specifically at the financial sector, in all other cases, there shall be no such specification.

[2] I owe special thanks to my anonymous proofreader who, in connection to this particular statement, called my attention to the fact that financial statements can be credible even without audits. We have to accept that in the standard case scenario, accountants do their job correctly and honestly, but

as fraud cannot be ruled out or 'adjustments' that are lighter than fraud may also occur, the role of the auditor should not be ruled out.

[3] Accepting and at the same time thanking the comment made by my anonymous proofreader, we could also raise the issue of a need in Europe for audit firms with European ties to spring up besides the Big 4 (of equivalent size), which of course would also mean that the size (market share) of the Big 4 would drop and the new audit firms would not have to match the current size of the Big 4.

[4] For more details, see Péli (2011) and Brother Layman (2011)

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