Globalization of auditing

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Introduction

Global expansion by large providers of audit and accounting services began before the 1980s and continued steadily through the 1990s and into the twenty-first century, driven by factors such as national deregulation, privatisation of industries, integration of regional economies, liberalisation of world trade (including multilateral and bilateral agreements), the formation of the European common market, the shift from planned to market economies and privatisation of government assets. These factors have created additional demand for services provided by audit firms across a broader range of countries, cultures and languages. As product markets and financial markets become increasingly internationally integrated and the use of international accounting standards has become more widespread, the demand for related professional services on a global scale has also risen which has accelerated the globalization of the audit industry.

At the same time, decreases in cost and an increase in the availability of technology, telecommunications and travel have enabled providers of professional services to more readily overcome traditional barriers of time and location.

The audit industry underwent significant change over the period of the late 1980s and 1990s. Consolidation, resulting from overcapacity, saw the largest eight providers reduce to six by 1989 (Sullivan, 2002). Increasingly, audit services were viewed as undifferentiated commodities lacking value to purchasers, putting pressure on stock exchanges and corporate regulators to review the mandatory nature of financial statement audits. Increased price competition resulted between the audit firms (Carson et al., 2012) and additional services were included with the audit product in order to increase the perceived value of the audit. Costs were reduced by the introduction of technology, increases in partner/staff leverage and older partners being encouraged to retire early. Litigation and insurance costs increased during this period in many countries due to corporate collapses which were attributed to poor quality auditing (for example, the Savings and Loans crisis in the United States). During this time, there was a focus on increased audit quality through a reduction of risk (improved audit methodologies and more extensive client screening) and the provision of value-added services. This period was marked by internal firm tension between the consultants (high margin, high growth) and the audit partners (low margin and stable or declining revenues).
During the 1990s, significant consolidation also occurred within client industries, and the enhanced requirements of multinational clients dictated that audit firms also needed to consolidate to provide sufficient scale to service their largest clients. Relatively stagnant audit fee revenues during this period put pressure on firms to enhance profitability by increasing audit efficiency, or by increasing revenue through expansion and sale of other services (GAO, 2003). Restructuring of audit firms along industry lines facilitated increased overall efficiency as, once the initial investment was made in developing industry specialisations, audits were performed more efficiently and a more targeted approach to the design and sale of other services emerged. At the same time, audit methodologies evolved based on a broader understanding of industry risks, norms and practices stemming from the use of industry-based experts (Bell et al., 2005). In the early 2000s, a number of financial reporting and auditing failures (including Enron and the demise of Arthur Andersen) caused a collapse in confidence in financial reporting and in the integrity of the financial markets. In response, the Sarbanes-Oxley Act was passed in the United States in July 2002 creating a new audit regulator, PCAOB (Public Company Accounting Oversight Board), having substantial powers with the aim of restoring confidence in financial reporting and to improve the independence and quality of audits, with considerable changes in regulation impacting auditors adopted in other countries (J-SOX in Japan, Korea-SOX in South Korea, CLERP 9 in Australia, among others).

The recent financial crisis and its impact in varying degrees throughout the rest of the world demonstrated the interconnectedness of the global economy, particularly in relation to the tightness of credit markets. Investigations into the cause of the financial crisis and the role of auditors in providing early warning as to financial markets have been conducted in Europe (EC, 2010), the UK (House of Lords Economic Affairs Committee, 2011) among others and into the collapse of Lehmann Group in the United States (Jenner and Block, 2010). While government policy, investment banks and credit rating agencies have all been considered to have key roles in the root causes of the financial crisis, the role of auditors has also come under scrutiny. As a result, it seems likely that regulatory change will be demanded in a number of key economies, particularly in relation to audit firm tenure and the structure and content of the audit report. In a globalised profession, it would be likely that these changes would be seen to be adopted successively by other countries.

This chapter proceeds as follows, first describing the structure of the global audit market and the large audit firms that dominate the provision of audit services globally. The organisational form adopted by audit firms operating in multiple countries is discussed in detail, together with the research undertaken to address global issues in auditing, as well as opportunities for future research.

Global audit market structure

The audit industry is commonly described as having a tiered structure. The top tier (also referred to as ‘brand name auditors’) comprises the largest audit firms, which are structured as global firm networks. These global firm networks employ tens of thousands of employees worldwide to service their clients in a broad range of accounting, audit and other services. Until 1989, this group of brand name auditors was collectively referred to as the ‘Big 8’. During 1989, Arthur Young and Ernst & Whinney merged to form Ernst & Young, while Deloitte Haskins & Sells merged with Touche Ross to form Deloitte Touche Tohmatsu, forming the Big 6. In 1997, Price Waterhouse and Coopers & Lybrand merged, leaving a group of five large firms. The firm of Arthur Andersen, which collapsed in 2002, was the fifth member of the so-called Big 5. This collapse resulted from the firm’s involvement as auditors and consultants to Enron Corporation.
which was found to have misstated profits over an extended period of time. The current global Big 4 firm networks are Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers. Despite the important role played by these audit firm networks in enhancing the credibility of financial information, little is known about the structure and economics of these networks; however, regulators are making attempts for there to be greater disclosure of these issues. For example the European Union Eighth Directive (2006) requires large audit firms to issue transparency reports, although Deumes et al. (2012) do not find an association between disclosures in such reports and proxies for audit quality.

The second tier comprises a more diverse group of firms. Commonly referred to as national firms, these often have relationships with firms in other countries. Examples of these second tier firms are BDO, Grant Thornton, Horwarth, RSM and Moores Rowland. Some second tier firms, for example, BDO and Grant Thornton, have established more extensive firm networks on a global scale compared to other second tier firms. Clients of these firms tend to be smaller than those of the Big 4. These firms offer a comprehensive, but narrower, range of accounting, auditing and taxation services to their clients. Particularly in countries outside the United States, these firms provide a significant portion of assurance services to small to medium-sized companies, as well as accounting and taxation services. The remainder of the global audit market is made up of smaller, primarily local single-office firms. These firms generally service one geographic locality, offering a niche speciality or a ‘one stop shop’. Clients of these firms tend to be small businesses and individuals. This group of firms is numerically large but the firms are not significant when examining the global audit market. Accordingly the remainder of this chapter will focus on the global audit firm networks and their role in the globalization of auditing.

**Global audit firm networks**

Global audit firm networks comprise individual audit firms operating together under the same brand name, sharing knowledge and resources on a global scale. They dominate the provision of audit services to publicly listed corporations globally and in key economies such as the United States and Europe. The network mode of organization permits audit firms operating multinationally to access the efficiency benefits of markets and integrated multinational corporations simultaneously while maintaining individual legal structures (Lenz and James, 2007). In a network, authority and control are not tightly centralised, and in theory, the network is not dependent on any single member for its viability or survival. This is not to suggest that the global firm networks are necessarily homogeneous. For example, the Arthur Andersen ‘one-firm’ network structure was considered to be tighter than other global firm networks, which may provide an explanation for the dissolution of the firm globally rather than just the US firm. One of the advantages of a network structure is the ability to externalise risks throughout the network rather than internalising such risks within a hierarchical structure. This risk diversification strategy is important in a high litigation environment such as auditing and provides one explanation for this choice of operating structure by the key participants in the global audit market.

Firms in a global network have the dual advantage of being both global and local. Other strategic advantages arising from the use of network structures may include economies of scale, learning and access to knowledge, and better management of risk. Additionally, less capital is required by original network members to fund expansion into new environments. This is particularly relevant for audit firms which are generally structured as partnerships and are unable to access equity markets for financing. The existence of a global network enables choices as to how future expansion of economic activities will occur. For example, will the entire network
or specific network members sponsor expansion into a new market? The choice of a network structure allows members to access the disciplinary benefits of markets in that there is a credible threat that a network member could utilise the services of audit firms outside the network, as network members are encouraged, but not necessarily compelled, to use network partners. Costs of participating in a network structure include costs of coordination with network partners, potential erosion of competitive position by other members of the network, and creation of an adverse bargaining situation within the network (if leaving the network is not a credible threat).

There are benefits from the use of these network structures enabling this group of firms to expand efficiently in the global audit market. This results in raised barriers to entry for other firms. This has important implications for the competitiveness of the global audit market and for the regulation of audit providers. Global firm networks are found to have increased their concentration in the global audit market to levels which generally concern regulators, particularly if there were to be any future reduction in the current number of large audit providers whether by merger or collapse. The market share of the four largest firms based on audit fees of publicly listed companies in many countries is over 80 per cent, suggesting a highly concentrated market (Carson, 2009).

However, some of the benefits from a network structure are eroded when global audit network firms fail to maintain consistent quality control across the network, which has been implicated in recent corporate collapses such as Parmalat in Italy, Ahold in the Netherlands and Satyam in India. This has fuelled concerns by regulators as to the consistency of quality of audit services provided in multiple locations by networked audit firms, for example Goelzer of the PCAOB said in 2011: ‘We know from our inspections that firm quality varies from country to country, even when the firms in question have the same name and are part of the same global network’ (PCAOB, 2011b).

Regulators in national financial markets have responded to shareholder demands for greater regulation and accountability by corporations by imposing higher standards of transparency on global audit firms. Outside the United States, the European Commission (EC) also had concerns that there may have been a discrepancy between the image of global firm networks and the real level of control exercised over individual member firms (EC, 2003). The European Union (EU) also has noted the risk of an expectation gap arising from the belief that a brand name implies a universally high level of audit quality for all audits undertaken by that brand throughout the world. As a result of these concerns the EU initiated requirements for audit firm networks to be more transparent about individual member firms, their networks and their relationship to the network, requiring disclosure of information about internal quality assurance systems designed to ensure an equivalent audit quality across the member firms. Specifically, ‘the Commission views transparency as a natural requirement for audit firms which fundamentally operate to ensure the transparent financial reporting by companies’ (EC, 2003: 13). Accordingly, the EU requires that global firm networks provide assurance that quality control policies and procedures are complied with throughout the network. These may include periodic inter-firm reviews, tests of operating policies and procedures and review of workpapers of selected audits. Other controls may include common policies on recruitment, training, advancement, audit methodology and audit independence.

**Multinational audit clients**

The benefits of purchasing audit services from global firm networks are most apparent for multinational companies that require delivery of audit services on a multi-country basis.
Motivation for purchasing global audit services from a single networked provider, rather than multiple providers, arises from an efficiency perspective. It is costly to contract with multiple providers in different countries that are using different methodologies and different standards. By purchasing from one network provider, the multinational client outsources the coordination of the audit to one firm in the network that will then set deadlines and work programmes for the other audit firms. Network theory would suggest that an audit firm would utilise and coordinate with other firms in their own network to aid in the completion of the multi-country audit rather than using firms outside the network, as it is more efficient to use firms with similar quality and implementation standards (Lenz and James, 2007). However, overseas subsidiaries may appoint their own auditors who are not members of the network of the parent company auditor. Given the tight deadlines for completion of multi-country audits, the network firm is likely to be more efficient and consistent relative to an unknown firm. Multi-country audits necessitate the provision of higher quality audit expertise. These audits often are extremely complex, involving multiple sets of national accounting and taxation regulations. Barrett et al. (2005) provide a perspective on this issue using a field study of a multinational audit which provides an example of a research methodology that could be employed in examining these issues.

Currently 20 per cent of the companies listed on the New York Stock Exchange (NYSE) are foreign, as are 50 of the 100 largest companies listed on the NYSE. To date, there has been little research into the purchase of audit services by multinational clients. While the national-level and to some extent, city-level offices have been the subject of much research, there are relatively few examples of research examining the global audit market, regulation of auditing globally or the global networks themselves. This is despite concerns expressed by regulators (for example, UK House of Lords, 2011) and market participants about the market power of global firm networks, the consistency of audit quality provided by these networks and the transparency of their network structures. The current research in this area is discussed in the following section.

Research findings regarding global audit markets

Changes in the number of suppliers from Big 8 to Big 4 would have an impact on any analysis of the global audit market, however, most research examining changes in the capacity of the audit market is focused at a national level. Despite the importance of the non-Big 4 global networks there is little research investigating these smaller audit firm networks. In relation to audit fees, there have been few attempts to model these on a global basis or to compare fees across a limited range of countries (see Hay et al., 2006 for a summary of country coverage of audit fee studies). The finding of higher fees being paid to large auditors is a relatively consistent one at a national level (Hay et al., 2006 in their meta-analysis of audit fee studies find consistent evidence of a fee premium for large firms). With respect to fee premiums for specialists, Carson (2009) using large samples from 62 countries in 2000 and 2004 finds that in both periods, audit fee premiums are consistently associated with global specialist auditors, irrespective of whether those audit firms are or are not national specialists. Verleyen and De Beelde (2011) provide further evidence of network industry specialisation within a broad group of European countries.

Research examining global audit firms focuses on the structure of these organisations. Prior research associates larger audit firms with higher audit quality as they have greater investments in brand names, their reputation and their professional staff (DeAngelo, 1981). Higher quality auditors are considered more likely to detect questionable accounting practices and report material errors as they have the expertise, resources and incentives to enhance the credibility.
and informativeness of financial information. A major mechanism by which audit firms have acted to ensure competence (and accordingly, audit quality) in a globalised environment is by the formation of global firm networks, with its resultant network-level quality controls including standardisation of delivery of audit services and extensive office and engagement level quality control processes.

Few studies have been undertaken regarding the quality of global audits or comparing audit quality by audit firm networks across countries (Francis, 2011). Francis and Wang (2008) find that Big 4 audit firms are associated with higher quality audits in countries where legal systems are strong, but do not find any difference between types of audit firms in countries with less strict legal regimes. Michas (2011) compares the extent of development of the audit profession across countries and finds more conservative accounting is associated with better developed auditing professions but only when audits are conducted by Big 4 auditors. Within countries there is a large literature where most of these studies confirm the expectation that hiring a large audit firm is associated with higher audit quality. Various proxies and constructs have been used to represent this higher audit quality attributed to large audit firm networks. Examples of such proxies of higher audit quality include higher audit fees and lower discretionary accruals.

**Regulation of globalized auditing**

In the context of increasing globalization of business in general, and the audit market in particular, the global regulators of the audit profession have become increasingly active and important. In particular, the International Federation of Accountants (IFAC) and its related board, the International Auditing and Assurance Standards Board (IAASB) have responsibility for the development of a high quality global audit profession. The role of the IAASB is to develop internationally consistent auditing standards by a board that asserts to represent the public interest. As discussed by Humphrey, Loft and Samsonova-Taddei in Chapter 13 of this volume, the role of IFAC is to provide guidance and funding to support the IAASB, including the development of a Code of Ethics for professional accountants. IFAC is overseen by a Public Interest Oversight Board, members of which include International Organization of Securities Commissions (IOSCO), the World Bank, the Financial Stability Board and representatives of international banking, financial and insurance regulators. Of particular importance to both IFAC and the IAASB are the global firm networks that hold the main responsibility for implementation of the standards developed as well as the moral guidance and leadership of the audit profession, especially in countries where the quality of audit practice has been regarded as sub-optimal.

The concern commonly expressed by regulators and users of financial statements is whether high quality auditing can be achieved at a consistent level globally. Regulators recognize that the global firm networks are of critical importance in developing confidence in the integrity of financial statements throughout the world. The global audit firm networks have organized themselves through the Forum of Firms and Transnational Auditors Committee of IFAC as well as through the Global Policy Symposium as a means of jointly influencing regulators at the international and national levels. At the same time, the membership bodies of the accounting profession have themselves become more globally focused. Greater reciprocal recognition of qualifications gained in other countries is happening between professional bodies as part of groups such as the Global Accounting Alliance (GAA) which represents 11 leading professional accounting institutes with over 785,000 members, including the American Institute of Certified Public Accountants, the Institute of Chartered Accountants in England and Wales and Canadian Institute of Chartered Accountants, as well as Japan, Hong Kong, Germany, South Africa,
Australia and New Zealand. Global accounting bodies such as Chartered Institute of Management Accountants and Association of Chartered Certified Accountants have seen increased membership numbers with qualification programmes being offered in multiple countries. Currently the Institute of Chartered Accountants in Australia is merging with the New Zealand Institute of Chartered Accountants to create a larger organisation and further mergers of professional bodies particularly at the regional level seem likely to occur.

Currently the US Securities Exchange Commission (SEC) has not endorsed International Standards on Auditing (ISAs) for use in the audit of companies listed in the United States, as standards for auditing are set by the PCAOB (which has observer status at the IAASB). The PCAOB was set up under the Sarbanes-Oxley Act, as a legislative response to concerns regarding the quality of audits as a result of the collapse of Arthur Andersen associated with Enron’s demise. In a global economy, national regulation can also have an impact on the global audit market. For example, the Sarbanes-Oxley Act has extraterritorial implications for audit firms and clients outside the United States requiring registration and inspection of audit firms located outside the United States by the PCAOB. This impact is particularly evident in relation to audit firms’ abilities to offer specific services to subsidiaries of US listed multinationals operating in other countries and for auditors of other firms with cross-listings on US stock exchanges.

While global firm networks are an important mechanism in maintaining audit quality throughout the world, they demonstrate a regulatory concern in that the structure of regulation of the audit profession is at a national level, and there is no effective regulation or enforcement at a global level. The current system of regulation and enforcement of audit firm networks, which predominately occurs at a national level, is likely to be inadequate when audit firm networks and their clients span multiple jurisdictions. Accordingly, cross-border issues may essentially be unregulated. As a result, the IAASB, as a standard setting body without enforcement powers, runs the risk of being ineffective in the current environment. While standards for auditing practice are set at the international level (by the IAASB), they are adopted at a national level and accordingly enforcement is conducted entirely at this level. It has been difficult for regulators to enforce standards in a similarly integrated fashion across countries, however the formation of the International Forum of Independent Audit Regulators (IFIAR) is one step towards exchange of information between regulators across countries. One area where national regulators are connected but yet have taken different paths is in inspections of registered public audit firms and in particular the nature of disclosure regarding the results of the inspections. The PCAOB has the ability to conduct inspections of over 900 non-US audit firms involved in the conduct of audits of firms listed on US stock exchanges in 85 countries where local regulations permit them to do so. In some cases, inspections are conducted jointly with local regulators. Chairman Doty of the PCAOB (2011a) highlighted a key difficulty that the

… PCAOB is unable to inspect audits of firms that have registered with the PCAOB in order to be able to conduct or participate in audits of U.S. public companies but that are located in certain jurisdictions that have resisted inspections. This means enormous components of the audits of multi-national companies escape review, even when the firm that signed the audit report is a large U.S. accounting firm.

The jurisdictions referred to are China and parts of Europe. While in May 2013 a memorandum of understanding was signed with Chinese authorities, to date, the PCAOB has yet to gain access to working papers located in China to conduct audit firm inspections.

When foreign companies list in the US they earn a cross-listing premium for subjecting themselves to US institutions and US compliance activities which better protect minority
investors. Bonding to a stricter investor protection regime rewards companies located in markets with less strict investor protection regimes, including lower costs of capital (Doidge et al., 2009). Part of these heightened regulatory requirements includes the role played by the PCAOB in relation to inspections of foreign audit firms that issue audit opinions or provide substantial audit services to US listed companies. There are currently 900 non-US audit firms located in 84 countries registered with the PCAOB (as at December 2012). While there are several studies that have examined national inspection reports for audit firms in the U.S., there is now research emerging regarding PCAOB inspection reports of non-US audit firms. Bishop et al. (2012), using 175 first-time and 56 second-time inspection reports as at 4 February 2012, find that Big 4 affiliates are less likely to have deficiencies than non-Big 4 firms. They also find that the inspection deficiencies are not impacted by whether the PCAOB acts alone or cooperates with a local regulator in conducting the inspection, or whether or not these are based on the home country’s legal tradition (common law versus other). Carcello et al. (2011) highlight the importance that investors place on PCAOB inspections of international audit firms. Their finding is based on identification of negative stock price reactions to international audit firms registered with the PCAOB which were not inspected due to prohibition by their respective countries. As noted by Loft et al. (2006) and Humphrey et al. (2009), there is a need for research into the international governance structures that underpin globalised auditing, in particular IFAC and its audit standard setter the IAASB and committees such as the Forum of Firms, in light of the changes occurring in governance structures at IFAC.

Challenges in researching globalization of auditing

Until recently, high quality databases containing accounting and auditing information at a global level were not available. Accordingly, prior studies of the global audit market suffer from a lack of data, especially in relation to audit fees paid by individual clients or relatively small sample sizes, often based on surveys or voluntary disclosures. While in the late 1990s and early 2000s there was a greater availability of quality data available to researchers from global data providers, most recently researchers have noted the deficiencies in previously high quality databases which, until resolved, are likely to inhibit future large sample research using auditor identity (Francis et al., 2013). Metrics used to compare institutional factors across countries (for example, La Porta et al., 1998 and Wingate, 1997) are now outmoded and to be useful to researchers require updating. In terms of data regarding the audit firm networks themselves, the availability and content of audit firm inspection reports varies between jurisdictions. As the audit firm networks are not listed companies, publicly available information regarding the individual member firms of networks and of the network in total is still fairly limited despite the emerging availability of information presented in transparency reports as mandated in some jurisdictions. Using a range of methodological approaches there are many opportunities for research (Maijoor and Vanstraelen, 2012).

Conclusions and recommendations

Globalization is a significant factor in any understanding of audit firms, markets and clients shaping regulation and enforcement of regulation. Future research could address the internal operations of these global firm networks, including transfer pricing, to better understand the differences between networks. Like their global clients, there is little global regulatory oversight of the activities of global firm networks despite the existence of the IAASB. These issues are of greatest concern in countries where legal enforcement of quality financial reporting practices is
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weak (Choi and Wong, 2007). A key way in which to improve regulation of audit firms is to increase the transparency of disclosure of membership of global firm networks. In many cases, it is difficult to assess dates and the extent to which national firms are members of a particular global firm network and the nature of the relationship (e.g. full membership, an affiliate or correspondent relationship) from firms’ websites. Clearly defining the boundaries of the network and providing information on the quality control practices maintained across the network are important for both network members and users of financial statements audited by global firm networks.

Regulatory intervention by the EC (a regional regulator) is likely to be more successful than the currently unenforceable global regulatory requirements and could represent a ready-made de facto standard for national standard setters. In addition, IOSCO and individual national security regulators coordinated through organizations such as IFIAR could play a greater role in improving transparency by requiring additional disclosures by audit firm networks under stock exchange listing rules. The current PCAOB proposals regarding transparency around who is conducting the audit, the partner responsible and other firms involved in conducting parts of the audit, as well as extending audit firm inspections into jurisdictions such as China and parts of Europe, are also positive steps towards providing investors with information which will assist in assessing the quality of the audit and will also aid researchers investigating these issues.

References


