

Baboo Kunalsing Askurn - UP947668 - Dissertation

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Submission date: 13-Oct-2020 09:43AM (UTC-0700)

Submission ID: 134143275

File name: 159501_Baboo_Kunalsing_Askurn_Baboo_Kunalsing_Askurn_-_UP947668_-_Dissertation_1330348_599156050.pdf (5.25M)

Word count: 26309

Character count: 143790

UNIVERSITY OF PORTSMOUTH

**A critical analysis of the provision of non-audit services to
audit clients in the UK: Auditors' independence and future
reforms.**

by

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Word count: 15 000

13th October

2020

AUTHOR'S DECLARATION

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Acknowledgements

This dissertation is an important milestone for both my personal and professional paths. Several people have been instrumental in the completion of this research. I firstly would like to thank the almighty God for giving me the support and strength in life.

I thank my parents and family members for their unflinching encouragement, patience, understanding and precious love. They deserve a special mention for their countless support and huge confidence in me.

My sincere appreciation and thankfulness go to my dissertation supervisor, Dr Fang Ma, for illuminating me with her expertise. The completion of this dissertation would not have been possible without her guidance. I am very grateful for her invaluable advice and support.

Special thanks also go to my academic tutors at the University of Portsmouth. I really appreciate the support and guidance since my very first day at the University.

Collective and individual acknowledgments are also owed to my friends and non-academic staffs at the University. Being the Postgraduate Ambassador of the University and the Student Guide for the faculty of business and law was a wonderful and enriching experience.

Finally, I express my recognition to all those who supported me and/or contributed in my dissertation.

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List of Abbreviations

ACCA	Association of Chartered Certified Accountants
AGM	Annual General Meeting
AICPA	American Institute of Certified Public Accountants
AIM	Alternative Investment Market
ARGA	Audit, Reporting and Governance Authority
BDO	Binder Dijker Otte
BEIS	Business, Energy and Industrial Strategy Committee
BHS	British Home Stores
CA 2006	Companies Act 2006
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMA	Competition and Markets Authority
CNCC	Compagnie Nationale des Commissaires aux Comptes
EU	European Union
EY	Ernst & Young
FRC	Financial Reporting Council
FTSE	Financial Times Stock Exchange
GAAP	Generally Accepted Accounting Principles
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	The Institute of Chartered Accountants of Scotland
ICSA	The Chartered Governance Institute
ISA	International Standard on Auditing
KPMG	Klynveld Peat Marwick and Goerdeler
LLP	Limited Liability Partnership
NAS	Non Audit Services
NED	Non Executive Director
PCBS	Parliamentary Commission on Banking Standards
PwC	PricewaterhouseCoopers
SOX 2002	Sarbanes-Oxley Act 2002
UK	United Kingdom
USA	United States of America
VAT	Value Added Tax

Abstract

Auditors have a significant contribution in verifying the genuineness of financial statements of companies. However, statutory audits are being used as a defence for selling non-audit services which are considered more profitable. Auditors are being criticised for not showing professional scepticism and judgement which have impacted their independence and the quality of audits. In addition, the Big Four firms are dominating the market and are routinely involved in the parade of financial scandals. The collapse of British Home Stores and Carillion clearly indicates that the regulatory structure for auditing in the UK is flawed. The audit sector is stumbling from one crisis to another. The silence of accountants has resulted in severe losses for the public. Directors and audit committees are also complicit in audit failures but if they could be trusted then there would be no need to appoint statutory auditors which would then be against the law. The absence of an independent audit regulator and strong audit regime in the UK have not helped in enhancing the independence of auditors and the quality of audit. This urges for reforms in the audit sector in order to identify, address and monitor the shortcomings in audits. The sale of non-audit services to audit clients must be prohibited or intensely scrutinised by an independent audit regulator. The mandatory joint audit can be introduced to provide small-medium sized accounting firms opportunities to offer their services to top FTSE companies but also prevent the Big Four firms from controlling the audit market. Parliament must consider and implement tougher rules in auditing to bring a major reform and avoid further accounting scandals. The adoption of a Sarbanes Oxley-style regime like in the USA can perhaps increase the accountability of auditors as well as that of directors and audit committees. The focus should however be on strengthening the independence of auditors and the separation of audit and non-audit services. Hence, this dissertation shall analyse and discuss the sale of non-audit services to audit clients which as a result have undermined the auditors' independence and prompted for reforms in the audit sector in the UK.

Introduction

Research focus

The collapse of Arthur Andersen and a parade of financial scandals have put into jeopardy the independence and objectivity of auditors. There are concerns that the auditors' independence can be undermined particularly with the provision of non-audit services (NAS) to audit clients. The current regulatory structure for auditing is not strong enough to address this problem which has prompted for reforms in the audit sector in the UK. Accounting firms especially the Big Four firms have often been in the limelight for audit failures and unethical behaviours. Yet, the provision of NAS to audit clients can have both positive and negative effects. Hence, this dissertation aims to analyse the impact of selling NAS to audit clients and its implications on auditors' independence. The effectiveness of audit committees will also be assessed. The research will finally discuss future reforms which can strengthen the auditors' independence and address the shortcomings in the audit sector.

The focus will be on the provisions of the Companies Act (CA) 2006, the UK Corporate Governance Code, EU Regulations and Sarbanes-Oxley Act (SOX) 2002.

Research objectives

- To examine the regulatory structure for auditing in the UK.
- To assess the impact of market concentration and remuneration of auditors on the quality of audit and auditors' independence.
- To investigate the relationship between the provision of audit and NAS on auditors' independence, with a particular attention on audit failures and financial scandals.
- To analyse the factors which can affect the effectiveness of audit committees.
- To discuss reforms in the audit sector which can improve the quality of audit and strengthen the auditors' independence.

Dissertation structure

Chapter One: The regulatory structure for auditing

This chapter explores the legal framework of audit in the UK and serves as a basis for the upcoming chapters. The appointment and responsibilities of auditors will be discussed along with the reliability of audit reports. The role of directors in audit will also be examined.

Chapter Two: The impact of NAS on auditors' independence

This chapter analyses the audit market and investigate the link between auditors' remuneration and the quality of audit. The aim is to discuss the likely effects of NAS on auditors' independence. It is an extensive chapter which will provide justification on the sale of tax avoidance schemes and causes of audit failures and financial scandals.

Chapter Three: The effectiveness of audit committees

This chapter assesses the importance and effectiveness of audit committees in strengthening auditors' independence. Particular attention will be given to the establishment of the audit committee and responsibilities of its members.

Chapter Four: Reform in the audit sector

This chapter will put forward potential recommendations based on the discussion in the previous chapters to bring reforms in the audit sector in the UK. The appointment of a new independent audit regulator will be justified, and a comparative analysis of the CA 2006 versus the SOX 2002 will be made due to its effectiveness in USA. The benefits of implementing a Sarbanes Oxley-style regime will also be evaluated.

Chapter One – The regulatory structure for auditing

1.0 Introduction

Chapter one explores the legal framework of audit in the UK and is the starting point to address the issue of auditors' independence being compromised. It provides a background on the statutory requirements of appointing auditors and further analyses their roles and responsibilities. The qualification of auditors and effectiveness of audit reports will also be discussed. Given that the outcome of an audit is dependent on the quality of information provided to auditors, this chapter will assess the roles and responsibilities of directors in auditing. The emphasis will also be on various provisions of the CA 2006, EU Regulation, Principle H and N of the UK Corporate Governance Code and the Cadbury report.

1.1 Appointment of auditors

Auditors have the duty and responsibility to issue the audit report of a company along with their opinions after obtaining reasonable certainty that the financial statements are free from material errors or fraud.¹ A survey carried out by the Institute of Certified Financial Analysts revealed that more than 70 per cent of respondents are in fact dependent on the audit report for financial analysis and recommendations.² Directors must as such appoint an external auditor to conduct the audit of the company's accounts and issue the audit report on payment of a fee. It is actually the remuneration of auditors which can potentially have a negative impact on auditors' independence and objectivity.³ The practitioner-based study suggests that expertise is a key element in the appointment of auditors while another study stipulates that audit fee, preparation and professionalism

¹ Companies Act 2006, section 495; FRC, 'Description of the auditor's responsibilities for the audit of the financial statements' (FRC, 17 June 2016) <<https://www.frc.org.uk/auditors/audit-assurance/auditor-s-responsibilities-for-the-audit-of-the-fi/description-of-the-auditor%E2%80%99s-responsibilities-for>> accessed 24 June 2020.

² Mishari Alfraih, 'Choosing an external auditor: does the composition of boards of directors matter?' (2017) 59(3) International Journal of Law and Management 394, 395.

³ This will be discussed thoroughly in chapter two.

are more important.⁴ Auditors are therefore heavily reliant on client companies for their appointment and remuneration although they have the right to resign and hence not be reappointed.⁵ In the subsequent two sections, the appointment of auditors within private and public companies will be examined.

1.1.1 Appointment of auditors in private companies

The appointment of an auditor in a private company for each financial year can be made at any time by the directors before the company's first period for appointing auditors or if there is a casual vacancy.⁶ However, members also can appoint an auditor by passing an ordinary resolution if the company has failed to appoint an auditor during the period of appointment.⁷ It must be noted that appointing an auditor is of great significance for members as the latter reports to them. Thus, the recommendation of whether to appoint or re-appoint the auditor is usually conferred to them for approval in general meetings.⁸

However, if an auditor has not been appointed before the next period for appointing auditors then any auditor in office is automatically re-appointed unless the company's articles state otherwise, members are against the re-appointment or the directors agreed that no auditor should be appointed for the financial year.⁹ Members have in fact expressed concerns that the appointment process of auditors is opaque and they are not informed about the contractual terms agreed between directors and auditors,¹⁰ yet they are empowered to prevent an auditor from being automatically re-appointed with at least 5 per cent of the voting rights.¹¹ Hence, if the relationship between directors and auditors get too friendly and can possibly lead to manipulation of accounting figures or jeopardise

⁴ Kym Butcher, 'Auditor appointment in compulsory audit tendering' (2011) 24(2) Accounting Research 104, 108.

⁵ Companies Act 2006, section 516-518.

⁶ *ibid* section 485(3).

⁷ *ibid* section 485(4).

⁸ Mike Metcalf, 'Changing auditors' (ICAEW, 2013) <<https://www.icaew.com/library/library-collection/ebooks/icsa/changing-auditors>> accessed 2 July 2020.

⁹ Companies Act 2006, section 487(2).

¹⁰ ICAEW, 'Audit quality: Shareholder involvement' (ICAEW 2005) pg 5.

¹¹ Companies Act 2006, section 488.

the auditors' independence, as was the case in Enron scandal¹² then members have the power to intervene by terminating the automatic re-appointment of the auditor.

1.1.2 Appointment of auditors in public companies

There are few differences on the appointment of auditors between private and public companies. The CA 2006 states that 'the appointment of an auditor in a public company should be done before the end of the accounts meeting of the company at which the company's annual accounts and reports for the previous financial year are laid.'¹³ The appointment is often made by members¹⁴ or by directors in specific circumstances.¹⁵ Generally, while an auditor in office can automatically be re-appointed in a private company, this may not be the same in a public company as there is no automatic procedure for re-appointment.¹⁶ In addition, the secretary of state is empowered upon receipt of a notice to appoint an auditor if the public company has failed to do so.¹⁷ However, if the company fails to give notice within one week of the end of the accounts meeting to the secretary of state then this is deemed to be an offence and the person who is guilty of the offence is subjected to a fine.¹⁸

Moreover, the audit committee¹⁹ has a vital contribution in the appointment of auditors for larger public companies. A public company which is also a public-interest entity must submit a recommendation made by the audit committee to the directors who will then scrutinise and consider an auditor for appointment.²⁰ The EU Regulation clearly mentions that the recommendation must not be influenced by a third party otherwise it will be void if it significantly affects the appointment of a specific auditor or audit firm.²¹ Thus, the onus is on members of the audit committee to act independently and use their expertise to

¹² To be discussed in chapter two.

¹³ Companies Act 2006, section 489(2).

¹⁴ *ibid* section 489(4).

¹⁵ *ibid* section 489(3).

¹⁶ Lee Roach, *Company Law* (OUP 2019) 548.

¹⁷ Companies Act 2006, section 490(1)(2).

¹⁸ *ibid* section 490(3)(4).

¹⁹ The duties and responsibilities of audit committees will be further examined in chapter three.

²⁰ EU Regulation No 537/2014, Article 16; Companies Act 2006, section 489A(3).

²¹ *ibid*.

provide constructive challenge²² when required during the appointment process. In *Industrial and Commercial Bank of China v Amban*²³, PwC had resigned as statutory auditor of the client company and accused the audit committee for failing to convene appropriate meetings.²⁴ This is a breach of the Code²⁵ and failure to act independently or hold management to account can affect the credibility of the audit committee and the company as a whole. The effectiveness of audit committees will be discussed thoroughly in chapter three. The upcoming section will examine the eligibility of a person to carry out the audit of a company.

1.2 Qualification of auditors and the independence requirement

Basically, only individuals who are suitably qualified as auditors can perform the statutory audit of a company. The CA 2006 states that 'an individual is only eligible to undertake the statutory audit of a company if he is a member of a recognised supervisory body and is fit for appointment under the rules of that body.'²⁶ It is unlawful if a person performs the audit of a company despite being ineligible.²⁷ Prior research has revealed that auditors who are not suitably qualified are more likely to falsify data and perform low quality audits compared to professionally qualified auditors.²⁸ Thus, if an individual claims to be an auditor without a professionally recognised qualification then this may compromise his position and ethical standard in the audit sector compared to a qualified and experienced auditor who can instead be entrusted with additional responsibilities as he is accountable to a professional body. A qualified auditor may in fact refrain from engaging in the

²² FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle H.

²³ [2020] EWHC 272 (Comm).

²⁴ *ibid* [80]; Nikunj Ohri, 'Audit Regulator Probing Role Of Auditors Of Reliance Capital, Reliance Home Finance' (*Bloomberg Quint*, 23 January 2020) <<https://www.bloomberquint.com/business/audit-regulator-probing-role-of-auditors-in-reliance-capital-reliance-home-finance>> accessed 8 October 2020.

²⁵ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle H and Provision 25.

²⁶ Companies Act 2006, section 1212(1); FRC, 'Professional Oversight Board' (FRC 2010) Provision 2.3 (ACCA, ICAEW, ICAI and ICAS).

²⁷ Companies Act 2006, section 1213(1).

²⁸ Stephen Sundgren, 'Auditor choices and auditor reporting practices: evidence from Finnish small firms' (1998) 7(3) *European Accounting Review* 441, 451.

provision of NAS to audit clients due to a fear that his independence or integrity can be questioned.²⁹

Nonetheless, a person 'must resign with immediate effect by giving notice to the company if he becomes ineligible at any time during his term of office to act as a statutory auditor.'³⁰ Failure to give notice or acting illegally as a statutory auditor is an offence³¹ and the person who is guilty of that offence is subjected to a fine.³²

Furthermore, an auditor must comply with the independence requirements which prohibit certain persons from undertaking an audit such as the staff of an audited entity.³³ If a statutory auditor is prohibited to undertake his duties then he must also give notice to the client for resigning due to his lack of independence.³⁴ An example is the collapse of BHS³⁵ which led to the immediate resignation of PwC's audit partner Steve Denison and payment of a fine of £325,000 after being heavily criticised by the FRC for his lack of independence and responsibility on signing off the audited company's accounts.³⁶ It must be noted that performing the statutory audit of a company while in breach of the independence requirement constitutes a criminal offence.³⁷ This clearly shows that even though an auditor can be highly qualified and experienced, there are still temptations to provide lucrative services to the client other than the statutory audit as these can possibly bring more income to the auditor but at the expense of his independence being undermined. It is this lack of independence and supervision by an independent audit regulator which urges for reform in the audit sector (to be discussed in chapter four).

The secretary of state is nevertheless empowered to command a suitable person to perform a second audit of the accounts if the first audit was performed by an ineligible

²⁹ The provision of NAS to audit clients will be discussed thoroughly in chapter two.

³⁰ Companies Act 2006, section 1213(2).

³¹ *ibid* section 1213(3).

³² *ibid* section 1213(4).

³³ *ibid* section 1214(2)(a).

³⁴ *ibid* section 1215(1).

³⁵ To be discussed in chapter two – Collapse of British Home Stores.

³⁶ Nick Hault, 'Yorkshire chairman Steve Denison resigns after fine and suspension over BHS audit' (*The Telegraph*, 10 July 2018) <<https://www.telegraph.co.uk/cricket/2018/07/10/yorkshire-chairman-steve-denison-resigns-fine-suspension-bhs/>> accessed 11 July 2020.

³⁷ Companies Act 2006, section 1215(2).

person or a person restricted to do so because of lack of independence.³⁸ Therefore, the intervention of the secretary of state may result in greater transparency and fairness in the audit process ensuring a better quality of financial reporting.³⁹ The importance of auditors' independence is further analysed in chapter two.

1.3 Role and responsibilities of auditors

Past data has found that there are considerable differences in opinions between auditors and users of audited financial statements regarding the duties and responsibilities of auditors.⁴⁰ Auditors are expected to have a higher level of responsibility and accountability than what is usually conferred on them by the board of directors.⁴¹ In *Equitable Life Assurance Society v EY*,⁴² it was held that 'auditors owe the company an implied contractual duty of care in and about the manner in which the audit is conducted.'⁴³ However, little attention has been given on the responsibilities of auditors in relation to audit failures and corporate corruption.⁴⁴ There is not a straightforward reference to the statutory auditor's responsibility despite the existence of audit standards such as the International Standard on Auditing (ISA) 200 referring to the overall objectives of the independent auditor and ISA 240 specifying the auditor's responsibility towards fraud in the audit of financial statements.⁴⁵ The lack of clarity about the roles and responsibilities of auditors could result in auditors overlooking their duty to identify fraud and money-laundering activities that could have a serious impact on the financial statements as that was not explicitly explained by the audit standards.

³⁸ *ibid* section 1248(2).

³⁹ Benjamin Fung, 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 2(2) *Journal of Management* 72, 75.

⁴⁰ Peter Schelluch, 'Assurance provided by auditors' reports on prospective financial information: implications for the expectation gap' (2006) 46(4) *Accounting and Finance* 653, 654.

⁴¹ *ibid*.

⁴² [2003] EWCA Civ 1114.

⁴³ *ibid* [107].

⁴⁴ Rasha Kassem, 'External Auditors and Corporate Corruption: Implications for External Audit Regulators' (2016) 10(1) *Current Issues in Auditing* 1, 5.

⁴⁵ *ibid*.

However, the CA 2006 enables the auditor to carry out investigations that will allow him to provide an opinion as to whether the company has kept its accounting records properly and whether the directors' remuneration report is in accordance with those records.⁴⁶ If the auditor is of the opinion that the company has not been successful in keeping its accounting records properly or there is a discrepancy between the directors' remuneration report and the accounting records then the auditor has the responsibility to document that fact in his report.⁴⁷ Failure to obtain any relevant information and explanations which are required for the audit must also be stated in the audit report.⁴⁸ Furthermore, if any designated individual who does not provide the auditor with the required information or provides an information that is misleading, false or deceptive will be treated as an offence with penalties ranging from payment of a fine to imprisonment.⁴⁹ Consequently, this can have an adverse effect on the audited entity's reputation and may require immediate investigations by regulatory bodies on the cause of this offence.

The Cadbury report states that the responsibilities of the auditors are extended to a wider audience as they have to provide shareholders with an external and independent check on the directors' financial statements.⁵⁰ Similarly, the FRC allows auditors to evaluate the suitability of accounting policies and financial disclosures made by the directors.⁵¹ Auditors are therefore empowered to draw conclusions on the directors' use of the going concern basis and whether they may have doubts on the company's suitability to continue as a going concern.⁵² If they come to a conclusion that material uncertainty prevails in the company then they should document that fact in the audit report although future events may require the company to stop operating as a going concern.⁵³

⁴⁶ Companies Act 2006, section 498(1).

⁴⁷ *ibid* section 498(2).

⁴⁸ *ibid* section 498(3).

⁴⁹ *ibid* section 501(1) – (5).

⁵⁰ Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (Gee & Co. Ltd 1992) para 2.7.

⁵¹ FRC, 'Description of the auditor's responsibilities for the audit of the financial statements' (FRC, 17 June 2016) <<https://www.frc.org.uk/auditors/audit-assurance/auditor-s-responsibilities-for-the-audit-of-the-fi/description-of-the-auditor%E2%80%99s-responsibilities-for>> accessed 4 August 2020.

⁵² *ibid*.

⁵³ *ibid*.

Nevertheless, an emerging body of literature suggests that auditors have used their skills incorrectly to conceal and contribute to anti-social practices.⁵⁴ They are often blamed for carrying out low quality audits especially if an organisation fails shortly after being audited.⁵⁵ This was among the main controversies in the collapse of Carillion⁵⁶ as the company went into liquidation shortly after its accounts were signed off as going concern by KPMG. Hence, this raises doubts on the auditors' duty of care and obligations towards various stakeholders. It can be deduced that a long-term audit engagement can possibly create a strong friendly relationship between the statutory auditor and the client company but at the same time, this can be the beginning of an audit failure if the auditor complacently signs off accounts without realising the impact this can have on stakeholders. It will further put into jeopardy the auditor's independence and integrity. The next section will assess the reliability of audit reports.

1.4 Reliability of audit reports

The main function of an auditor is to issue a report to the company's members on the annual accounts of the company as mentioned in section 1.1 although it was held in *Re Allen and Co (London) Ltd*⁵⁷, that they do not need to personally ensure it is submitted to them.⁵⁸ The importance for a company to have its accounts audited for the financial year was explained by Lord Oliver in *Caparo Industries Plc v Dickman*⁵⁹ who stated that 'the auditor must provide shareholders with reliable information so they can scrutinise the conduct of the company and use their powers to reward or eliminate those to whom that conduct is confided.'⁶⁰

⁵⁴ Julius Otusanya, 'The Role of Auditors in the Nigerian Banking Crisis' (2010) 9(1) Accountancy Business and the Public Interest 159, 162.

⁵⁵ *ibid* pg 161.

⁵⁶ To be discussed in chapter two – Collapse of Carillion.

⁵⁷ [1934] Ch. 483.

⁵⁸ *ibid*.

⁵⁹ [1990] 2 A.C. 605 (HL).

⁶⁰ *ibid* [630].

Shareholders are in fact not the only users who rely on the annual accounts being accurate but various other stakeholders such as investors rely on its accuracy.⁶¹ To this extent, directors may paint the financial figures of the company in an overly favourable light to fraudulently represent the actual financial position of the company, for example stating that the company is making profits when it is not.⁶² Similarly, they can also conceal the profits obtained from tax avoidance schemes⁶³ if auditors do not exercise independent judgment before issuing the audit report. Hence, the audit report should be the key document symbolising an independent third-party verification of the information supplied by directors⁶⁴ otherwise it can be a criminal offence if a person knowingly or recklessly attempts to mention any information which is misleading, false or deceptive in the audit report and can be subjected to a fine.⁶⁵ It is noted that the auditors documented an unfavourable opinion in the audit report of Northamptonshire County Council from 2015 to 2017 but these were continuously ignored.⁶⁶ Thus, there was not any consistency in the way audit reports were received and being addressed.⁶⁷ Consequently, this raises concerns on the responsibilities and effectiveness of regulatory bodies in monitoring these shortcomings. It prompts for a major reform in the audit sector in the UK if regulatory bodies are not fully empowered or do not have the authority to monitor and hold the organisation accountable for such deficiencies. The benefits of appointing a new independent audit regulator will be discussed in chapter four.

Moreover, the qualification of opinion in the audit report must be described in a manner which is not ambiguous and does not confuse the reader as to its meaning and implications for understanding the financial statement.⁶⁸ Sir John Kingman in his review stated that 'findings should not be presented simply as pass or fail, yes or no by the auditor but the audit report should instead provide judgemental views as graduated

⁶¹ ICAEW, 'Stakeholder expectations of audit' (ICAEW 2008) Pg 8.

⁶² Lee Roach, *Company Law* (OUP 2019) 551.

⁶³ To be discussed in chapter two – Tax avoidance schemes.

⁶⁴ Lee Roach, *Company Law* (OUP 2019) 551.

⁶⁵ Companies Act 2006, section 507(1)(4).

⁶⁶ Sir Tony Redmond, 'Effectiveness of external audit' (Independent Review 2019) Provision 5.3.5.

⁶⁷ *ibid.*

⁶⁸ Suzanie Chua, 'The auditor's liability in negligence in respect of the audit report: Part 1' (1993) 14(11) *Company Lawyer* 203, 207.

findings such as describing an estimate being cautious, balanced or optimistic.⁶⁹ It is revealed that graduated findings are well perceived by investors and can result in greater transparency as the conclusions drawn by auditors shall be more elaborated, ultimately providing further reliable data which shareholders can use to challenge management in case of any anomaly.⁷⁰ This was also supported by Sir Donald Brydon in his review who stated that 'there must be continuity between successive audit reports and disclosure of graduated findings must be made.'⁷¹

However, there is presently very little appetite for auditors to adopt this approach.⁷² A survey by the Audit Quality Forum recommends that 'the readability of audit reports can be improved by shifting the auditor's opinion to the front and moving the rest of the standardised boilerplate text to the back or into the appendix.'⁷³ Therefore, this can prove to be a sustainable initiative and corporate governance practice as shareholders and investors will have a quicker access to the information they require.

It is true that auditors have a major contribution in carrying out the audit of a company's accounts and issuing the audit report, but directors as well have a significant contribution in the audit which is discussed below.

1.5 Responsibilities of directors in auditing

A strong corporate management is usually dependent on the oversight and scrutiny of directors of a company.⁷⁴ However, if directors are not fully responsible or bear few obligations towards the company then their professionalism and ethical behaviours can be compromised.⁷⁵ It is argued that the top benefits derived by directors from board membership are high esteem, reputation, personal development and networking.⁷⁶

⁶⁹ Sir John Kingman, 'Review of the FRC' (Independent Review 2018) Provision 3.25.

⁷⁰ *ibid* Provision 3.28.

⁷¹ Sir Donald Brydon, 'The quality and effectiveness of audit' (Independent Review 2019) Provision 2.3.6.

⁷² Sir John Kingman, 'Review of the FRC' (Independent Review 2018) Provision 3.27.

⁷³ Richard Reid, 'Audit reports need to be more open and readable' (2007) 28(5) *Company Lawyer* 145, 146.

⁷⁴ Suman Banerjee, 'Directors' duties of care and the value of auditing' (2016) 19(1) *Finance Research Letters* 1.

⁷⁵ *ibid*.

⁷⁶ Suraj Srinivasan, 'Consequences of Financial Reporting Failure for Outside Directors' (2005) 43(2) *Accounting Research* 291, 292.

Directors who are in fact more proactive, competent and committed to their duties are more likely to be rewarded with additional benefits and responsibilities but those who underperform or are not ethical can be penalised by losing their benefits or position as director in extreme cases.⁷⁷ The UK Corporate Governance Code states that 'a fair, balanced and understandable review of the organisation's performance and prospects must be provided by the board.'⁷⁸ This principle⁷⁹ can be highly effective in ensuring transparency and fairness in auditing as directors will be required to disclose and provide genuine information about the company's financial situation to auditors. It further implies that if auditors have failed to provide a reliable and adequate audit report due to misleading information supplied by directors then the directors can potentially be in breach of principle N⁸⁰ which as result can jeopardise their positions in the company.

An analysis conducted by Grant Thornton found that more than 35 per cent of FTSE 350 companies totally complied to the UK Corporate Governance Code and that was strongly appreciated by shareholders.⁸¹ Nevertheless, while the Financial Reporting Council (FRC) documented a rising trend about companies complying with the Code,⁸² the actual figure is still not close to 100 per cent.⁸³

In addition, the CA 2006 states that 'directors can only approve annual accounts which provide a true and fair view of the assets, liabilities, financial position and profit or loss for both individual and group accounts.'⁸⁴ The auditor is therefore required to take into account the directors' duty and approval of the annual accounts.⁸⁵ However, Sir Donald Brydon suggested that 'the term true and fair should be replaced in UK company law to present fairly, in all material respects.'⁸⁶ Consequently, the replacement will enhance the quality and accuracy of financial reporting and auditing as the board will have the

⁷⁷ *ibid.*

⁷⁸ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle N.

⁷⁹ *ibid.*

⁸⁰ *ibid.*

⁸¹ Grant Thornton, 'Corporate Governance Review' (Grant Thornton 2018) Pg 4.

⁸² FRC, 'The UK Corporate Governance Code' (FRC 2018).

⁸³ Eddie McLaney, *Business Finance: Theory and Practice* (11st edn, Pearson 2017) 12.

⁸⁴ Companies Act 2006, section 393(1).

⁸⁵ *ibid* section 393(2).

⁸⁶ Sir Donald Brydon, 'The quality and effectiveness of audit' (Independent Review 2019) Provision 2.3.2.

obligation to approve annual accounts which are free from material errors and misstatement.⁸⁷ Auditors will then verify if the annual accounts fully comply to the appropriate accounting and ethical standards.⁸⁸ It must be noted that directors are often referred to as the clients of audit firms for practical purposes which may foster a good working relationship but at the same time it can give rise to corruption and money laundering activities especially through the provision of NAS and tax avoidance schemes.⁸⁹

Lord Russell stated in *Thomas v The Corporation of Devonport*,⁹⁰ that auditors are bound to be fair and reasonable while carrying out the audit of a company such that if they identify any improper or illegal payments to have been made by the directors then they must disclose that information and make it publicly available.⁹¹ This is in fact a good governance practice which can raise the standard of auditing in the audit sector and strengthen the independence of auditors.

Directors are also bound to comply with the seven duties mentioned in the CA 2006.⁹² However, the case of *Vijay v India*⁹³ is a pertinent example where the director had breached the duties of directors and was involved in money laundering activities but also the auditor for the period, PwC UK was alleged for the irregularities which occurred due to the sale of NAS and for not conducting its audit properly.⁹⁴ Directors can as such be liable for sanctions⁹⁵ for breaching their duties towards the company and stakeholders.

Prior research has also revealed that an adverse relationship prevails between non-executive directors (NEDs) and the possibilities of corruption while another study confirms

⁸⁷ *ibid*, Provision 2.3.5.

⁸⁸ Companies Act 2006, section 475(1).

⁸⁹ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 86; To be discussed further in chapter two.

⁹⁰ [1900] 1 QB 16.

⁹¹ *ibid* [21].

⁹² Companies Act 2006, section 171-177.

⁹³ [2020] EWHC 924 (Admin).

⁹⁴ *ibid*; Khushboo Narayan, 'Vijay Mallya row: Advisory firms call into question auditors' role' (*Financial Express*, 28 April 2015) <<https://www.financialexpress.com/industry/vijay-mallya-row-advisory-firms-call-into-question-auditors-role-in-united-spirits-fallout/67473/>> accessed 7 August 2020.

⁹⁵ Companies Act 2006, section 178.

that a favourable relationship exists with high quality of financial reporting.⁹⁶ The Cadbury report stated that NEDs should provide independent reasonings on 'strategy, performance, key appointments, and standards of conduct.'⁹⁷ A minimum of three NEDs present on all boards is considered satisfactory.⁹⁸ This means that NEDs must be rational, logical and challenge the board's decisions if required to ensure transparency and fairness without being involved in the company's daily operations.⁹⁹ Failure to exercise independent judgement or if NEDs are aware that statutory auditors are practicing unethical accounting practices but choose to remain silent under management power then this can constitute as a potential breach of principle H and R¹⁰⁰.

Another important factor is the remuneration of directors. It is argued that directors' remuneration as a percentage of profit and loss for unsuccessful companies are greater than that of successful companies.¹⁰¹ Nevertheless, they may act unprofessionally in both situations if the company is unable to achieve its performance and profit objectives, for example they are tempted to find alternative ways to show that the company is operating smoothly and profitably but in practice these are not in the best interest of shareholders particularly.¹⁰² Hence, the reliability of the directors towards the company and other stakeholders are impaired. The implementation of a Sarbanes Oxley-style regime¹⁰³ in the UK can possibly provide more clarity on the responsibility and accountability of directors in the audit sector. This will be discussed in chapter four.

⁹⁶ Scott Duellman, 'Accounting conservatism and board of director characteristics' (2007) 43 *Journal of Accounting and Economics* 409, 414.

⁹⁷ Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (Gee & Co. Ltd 1992) para 4.11.

⁹⁸ *ibid.*

⁹⁹ *ibid.*

¹⁰⁰ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle H and R.

¹⁰¹ AM Lakshan, 'Corporate governance and corporate failure' (2012) 2(1) *Procedia Economics and Finance* 191, 196.

¹⁰² Barry Elliott, *Financial Accounting and Reporting* (19th edn, Pearson Education 2019) 135.

¹⁰³ The Sarbanes Oxley-style regime will be examined and discussed in chapter four.

1.6 Conclusion

The audit profession is well respected and auditors have a vital contribution in providing an independent check on the company's financial statements. The regulatory framework for audit has been examined throughout this chapter which will also be the cornerstone for the upcoming chapters. The ambiguity revolving around the role and responsibilities of auditors and the quality of audit reports being challenged, have led to a rise in audit failures. Hence, the following chapter will provide an extensive analysis on the causes of audit failures and the likely effects of the provision of NAS to audit clients which can put into jeopardy the auditors' independence.

Chapter Two – The impact of NAS on auditors' independence

2.0 Introduction

The previous chapter has ascertained that the current regulatory structure in the UK seems ambiguous and has potentially contributed to the rise in audit failures. This chapter will as such provide justification on the causes of audit failures and financial scandals. It provides a background of the audit market and will analyse the link between the remuneration of auditors and quality of audit. The threats to auditors' independence will be discussed, with particular attention on the joint provision of audit services and NAS to audit clients. The effectiveness of principle M of the UK Corporate Governance Code will be examined as well as section 414 and 492 of the CA 2006.

2.1 Market concentration

The audit market was largely dominated by eight global audit firms before 1987 but following the collapse of Arthur Andersen and a chain of mergers, the audit firms have emerged as the Big Four comprising PwC, KPMG, EY and Deloitte.¹⁰⁴ The Big Four firms are leading the audit market despite repeatedly being criticised for audit failures and accounting scandals resulting in their independence and reliability being compromised.¹⁰⁵ Some of the main reasons the Big Four firms are controlling the market in spite of failures are because regulators are not effective as watchdogs and there is an absence of competition.¹⁰⁶ It is noted that Big Four firms were behind the collapse of BHS, Carillion, Co-op Bank and Quindell of which they obtained huge fees but failed to disclose pertinent information about the organisations which as a consequence impacted jobs, savings, pensions and tax revenues.¹⁰⁷ It is argued that the Competition and Markets Authority

¹⁰⁴ CMA, 'Statutory audit services market study' (CMA 2019) Provision 1.6.

¹⁰⁵ Lindsay Stringfellow, 'From four to zero? The social mechanisms of symbolic domination in the UK accounting field' (2015) 27(1) *Critical Perspectives on Accounting* 80, 86.

¹⁰⁶ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 3.

¹⁰⁷ Prem Sikka, 'The big four auditors are failing' (*The Guardian*, 18 April 2019) <<https://www.theguardian.com/commentisfree/2019/apr/18/big-four-auditors-failing-watchdog-not-fit>> accessed 10 August 2020.

(CMA) has not been successful in addressing the core issues related to competition and audit quality.¹⁰⁸

Statistics show that Big Four firms account for more than 95 per cent of audits of FTSE 350 companies while other accounting firms such as Grant Thornton, RSM, Mazars, Crowe and BDO are more likely to conduct the audits of unlisted companies.¹⁰⁹ The collective share of the Big Four firms in relation to the share of audit fees paid by FTSE 350 entities is also high as shown below:

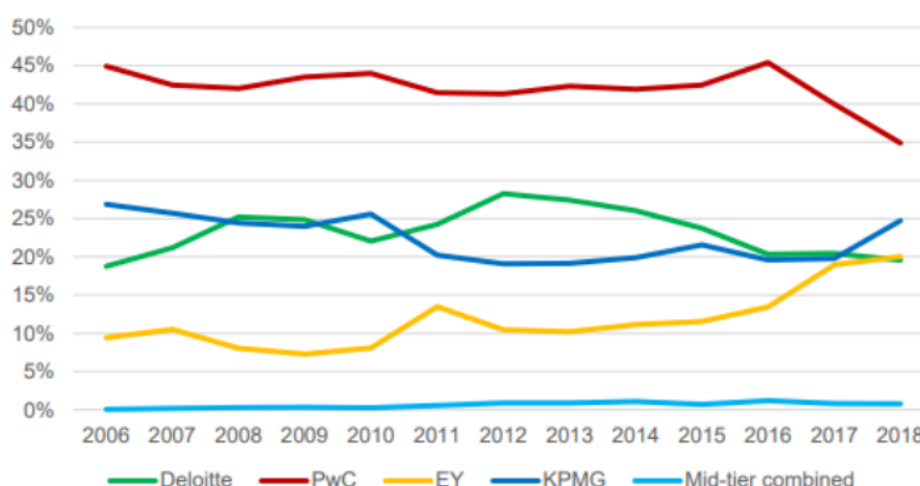


Figure I: Market share of FTSE 350 audit fees.¹¹⁰

Figure I illustrates that audit firms outside the Big Four earned less than 1 per cent of share altogether of the audit fees paid by FTSE 350 entities in 2018 compared to Big Four firms which obtained between 19 and 35 per cent each. This means that even small-medium sized businesses prefer Big Four firms to audit their annual accounts although the audit fee is higher than that charged by a firm outside the Big Four.

¹⁰⁸ *ibid.*

¹⁰⁹ CMA, 'Statutory audit services market study' (CMA 2019) Provision 1.5.

¹¹⁰ *ibid* Provision 2.20.

Various attempts have been made to separate the Big Four firms and provide equal opportunities to other accounting firms to compete in the market such as regulation to curb long audit tenure, however, there has been little success so far.¹¹¹ It is important that the work of audit committees in assessing the effectiveness of statutory audits and the measures adopted to the appointment of statutory auditors are described in the annual report.¹¹²

Nonetheless, a review by Grant Thornton suggested that some companies have not switched to another auditor since 1973 while others have not changed their auditor at all since incorporation.¹¹³ Therefore, this clearly indicates that there is a lack of enforcement of corporate governance principles to ensure adherence to the mandatory audit rotation in order to promote transparency and fairness.

The Sarbanes-Oxley Act 2002¹¹⁴ mandated a study of the audit market in the USA but has found no evidence of adverse consequences as a result of Big Four market domination.¹¹⁵ It was argued that only Big Four firms are capable of auditing large public companies.¹¹⁶ However, there is also no strong evidence on the effectiveness of audits performed by smaller audit firms.¹¹⁷ The FRC revealed that most companies are only rotating from one Big Four firm to another.¹¹⁸ Thus, competition in the market has increased mainly between Big Four firms due to their reputation and expertise whereas other accounting firms still find it challenging to compete in the market.¹¹⁹ The introduction of a mandatory joint, as a reform to break this market concentration will be discussed in chapter four.

¹¹¹ FRC, 'Developments in Audit' (FRC 2019) 34.

¹¹² FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 26; The effectiveness of audit committees will be discussed in chapter three.

¹¹³ Grant Thornton, 'Corporate Governance Review' (Grant Thornton 2019) Pg 60.

¹¹⁴ The Sarbanes-Oxley Act 2002 will be discussed further in chapter four.

¹¹⁵ Jere Francis, 'Does Audit Market Concentration Harm the Quality of Audited Earnings?' (2013) 30(1) Contemporary Accounting Research 325, 326.

¹¹⁶ *ibid.*

¹¹⁷ *ibid.*

¹¹⁸ FRC, 'Developments in Audit' (FRC 2019) 34.

¹¹⁹ Pat Sweet, 'Mandatory audit firm rotation fails to provide lower costs' (*AD*, 10 September 2018) <<https://www.accountancydaily.co/mandatory-audit-firm-rotation-fails-deliver-lower-cost>> accessed 14 August 2020.

2.2 Remuneration of auditors

Audit fee is the payment received by the auditor for the services he provides to an organisation.¹²⁰ The auditor's remuneration is usually established by the person who appointed the auditor, however, there are numerous factors which can influence the decision making process for determining the remuneration, for instance the reputation and expertise of the auditor, position and competitiveness in the market, size of the audit firm and cost for the relevant services.¹²¹

The CA 2006 specifies that 'the remuneration of an auditor appointed by the members must be determined by the members or if appointed by the directors or secretary of state then they are each empowered to fix the remuneration of the auditor.'¹²² Small-medium sized companies must in a note to the annual accounts disclose any amount paid to the auditor for carrying out the audit of the company.¹²³ Researchers have found that there is a positive relationship between auditors' remuneration and high-quality audits.¹²⁴ It is argued that large audit firms would offer higher quality audits than smaller firms, thus demanding higher payments because of their investments on the advanced training of employees and greater expertise in the field.¹²⁵ Consequently, large audit firms have a commitment and strong desire to safeguard their reputations globally by providing high quality services in order to avoid any litigation costs which may arise from audit failures.¹²⁶

Nevertheless, various issues have been linked periodically to the remuneration of auditors which can impede their independence. There are two situations where an auditor's independence can be compromised namely the fee income dependency from the client company and the provision of NAS to audit clients.¹²⁷ The fee income received by an auditor for the audit of an organisation may involve a high percentage of the auditor's total

¹²⁰ Mohammad Osman, 'Auditor characteristics and the issuance of going concern opinion' (2016) 10(17) *International Business Management* 3733, 3735.

¹²¹ Hassan Musa, 'Determinants of Audit fees' (2017) 7 *Journal of Business and Social Science* 716,718.

¹²² Companies Act 2006, section 492 (1)-(5).

¹²³ *ibid* section 494; The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, regulations 4 and 5.

¹²⁴ Charles Jordan, 'The Impact of Audit Quality on Earnings Management' (2010) 26(1) *Applied Business Research* 19, 20.

¹²⁵ *ibid*.

¹²⁶ *ibid*.

¹²⁷ Lee Roach, *Company Law* (OUP 2019) 550.

fee income resulting in a situation where the auditor is entirely reliant on that remuneration for a living.¹²⁸ Thus, excessive dependence on the fee income received from the client may lead to a self-interest threat to the auditor's independence.¹²⁹ This may restrict the auditor's willingness or limit his ability to express a qualified opinion on the annual report as there is the risk of losing the audit client and revenue.¹³⁰ Furthermore, financial reliance will lead to fear of loss of profitability for the auditor in such a way that he may abstain from performing the relevant investigations during the audit which can severely affect his moral principles and professionalism in the audit profession.¹³¹ This clearly indicates that the economic relationship between the auditor and the client can jeopardise the auditor's independence with the fee income being the negotiation product.¹³²

There has been a significant increase in the fees charged by audit firms to FTSE 350 clients as shown below:¹³³

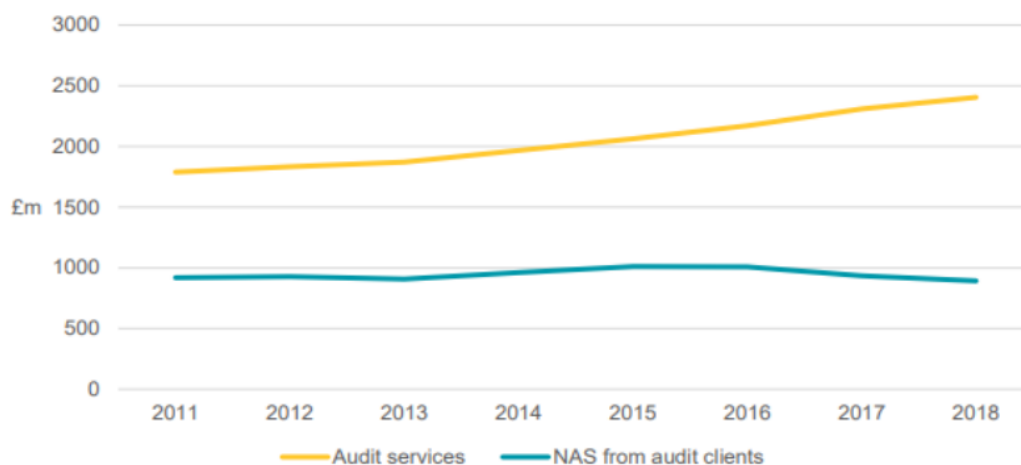


Figure II: Fees charged by Big Four and other audit firms to audit clients.¹³⁴

¹²⁸ *ibid.*

¹²⁹ International Ethics Standards Board for Accountants, 'Economic Dependence' (IESBA 2007) pg 6.

¹³⁰ *ibid* pg 9.

¹³¹ Rani Tash, 'Auditor Remuneration and quality of audit' (2007) 22 *Managerial Auditing Journal* 761, 802.

¹³² Hassan Musa, 'Determinants of Audit fees' (2017) 7 *Journal of Business and Social Science* 716,719; The increase in audit failures and financial scandals will be discussed in the upcoming sections to support this reasoning.

¹³³ CMA, 'Statutory audit services market study' (CMA 2019) Provision 2.31.

¹³⁴ *ibid.*

Figure II shows that there is an upward trend for audit services indicating a rise in audit fees from 2012 to 2018 while there is a downward trend for NAS implying a decrease in non-audit fees paid by audit clients from 2016 onwards. This decrease means that 'the ratio of non-audit to audit fees obtained from FTSE 350 clients was 16 percent in 2017 compared to 61 percent from FTSE AIM 100 in the same year.'¹³⁵ Appendix one shows the average audit fees for top companies in the UK.

Nonetheless, there is evidence that Big Four firms have failed to charge some companies the total cost for audits, creating concerns that they are not performing their work correctly.¹³⁶ The BEIS committee argued that auditors are using the statutory audit requirement as a loss leader to obtain further lucrative work from audit clients.¹³⁷ This also signifies that a company's manager may try to manipulate the content of the audit report by accepting the NAS from the current auditor but then negotiate for a favourable audit report in return.¹³⁸ Hence, this seems to be the beginning of an unfair and wrongful statutory audit of the company.

However, there are regulations which necessitate disclosure of payments made to accounting firms for both audit and NAS because those fees can undermine their actual or perceived independence.¹³⁹ Principle M of the UK Corporate Governance Code states that 'formal and transparent policies and procedures must be set up by the board to protect the independence and effectiveness of audit functions.'¹⁴⁰ This will promote the usefulness of auditing and integrity of financial statements. Nonetheless, the effectiveness of this principle is questionable as the corporate governance code is not law, so compliance is not mandatory.¹⁴¹

¹³⁵ *ibid* provision 2.32.

¹³⁶ Simon Goodley, 'Top auditors loss-leading on fees and undercutting rivals' (*The Guardian*, 1 April 2019) <<https://www.theguardian.com/business/2019/apr/01/big-four-accountancy-firms-cost-overruns-audits>> accessed 18 August 2020.

¹³⁷ *ibid*.

¹³⁸ Sylwia Morawska, 'Inherent Agency Conflict Built Into The Auditor Remuneration Mode' (2016) 19(4) *Comparative Economic Research* 141, 143.

¹³⁹ Kev Nolland, 'Expected auditor independence and remuneration' (2012) 42 *Accounting and Business Journal* 114, 142.

¹⁴⁰ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle M.

¹⁴¹ Euan Holmes, 'UK Corporate Governance Code (July 2018)' (*Institute of Directors*, 12 September 2019) <<https://www.iod.com/news/news/articles/UK-Corporate-Governance-Code-July->

EU Regulation states that where the total fees the auditor receives from a public-interest entity exceed 15 per cent of his total fee income then the audit committee should be made aware of it and should determine whether that represents a threat to the auditor's independence.¹⁴² Researchers suggest that audit committees¹⁴³ are in a better position to fix the auditors' remuneration and handle situations where their independence can be compromised.¹⁴⁴ This was also agreed by Sir Donald Brydon who recommended that 'the negotiation of fees should be delegated to the audit committee chair.'¹⁴⁵ It was ascertained that the finance budget of some organisations incorporated the audit fees but that would result in conflict of interests as the CFO could attempt to minimise the total fees for use in other projects.¹⁴⁶ Yet, the effectiveness of the EU regulation¹⁴⁷ is doubtful as it is not clear how audit committees can genuinely assess the auditor's independence.¹⁴⁸

Given that NAS generate greater revenues to auditors, the upcoming section will discuss the implications of NAS on auditors' independence.

2.3 Relationship between NAS and auditors' independence

The fees obtained by accounting firms for NAS have long been perceived as a potential threat to auditors' independence.¹⁴⁹ NAS, for instance tax advisory, financial information technology, valuation, legal and recruitment services which are offered especially by the Big Four firms are often linked to audit failures and accounting scandals.¹⁵⁰ These

2018#:~:text=The%20UK%20Corporate%20Governance%20Code%20is%20not%20law%2C%20therefore%20compliance,a%20company%20should%20be%20directed.> accessed 11 October 2020.

¹⁴² EU Audit Regulation 2014, Article 4(3).

¹⁴³ Audit committees will be discussed in more detail in chapter three.

¹⁴⁴ JK Olowookere, 'Influence of Remuneration and Tenure on Auditors' Independence ' (2014) 16(5) Journal of Business and Management 6, 11.

¹⁴⁵ Sir Donald Brydon, 'The quality and effectiveness of audit' (Independent Review 2019) Provision 9.4.9.

¹⁴⁶ *ibid* Provision 9.4.2.

¹⁴⁷ EU Audit Regulation 2014, Article 4(3).

¹⁴⁸ Zulkarnain Muhamad, 'Audit Committee and Auditor Independence: The Bankers' Perception' (2009) 3(2) International Journal of Economics and Management 317, 321.

¹⁴⁹ Domenico Campa, 'Non-audit services provided to audit clients, independence of mind and independence in appearance' (2016) 46(4) Accounting and Business Research 422, 423.

¹⁵⁰ Jonas Tritschler, *Audit Quality* (Springer Science & Business Media 2013) 36.

consultancy services are usually more remunerative than the provision of audit services.¹⁵¹ The major concern is that these services being more profitable will have a greater impact on the auditor's desire to retain the non-audit work which as a consequence will affect the quality and rigour of its audit work, thus undermining his independence.¹⁵² Arthur Andersen is a key example of this malpractice as it had received \$25 million in audit fees from Enron but earned more than \$27 million for NAS.¹⁵³ Three viewpoints have been identified with the sale of NAS namely, 'the quality of audit is affected negatively, positively or not related.'¹⁵⁴ This means that the auditor's independence is impaired due to 'knowledge spillover (positive), economic relationship (negative) or damaged reputation (not related).'¹⁵⁵ These viewpoints will be discussed in detail below.

2.3.1 Positive or no effect of NAS

Previous studies claim that the provision of NAS to audit clients are not detrimental as it does not affect the auditor's ability to qualify his audit opinion.¹⁵⁶ It is in fact argued that the supply of NAS can lead to cost advantages and an improvement in technical competency.¹⁵⁷ There are cost advantages through knowledge spillovers as the accountants from both audit and non-audit departments can collaborate together by exchanging relevant information about the client and thus achieving economies of scope.¹⁵⁸ Consequently, it counters the probability of switching auditor as the dependency of the client on the existing auditor or accounting firm shall rise.¹⁵⁹

¹⁵¹ Yu Zhang, 'Non-audit services and auditor independence' (2016) 3(1) *Cogent Business & Management* 1, 2.

¹⁵² Lee Roach, *Company Law* (OUP 2019) 550.

¹⁵³ Ismail Adelopo, *Auditor Independence: Auditing, Corporate Governance and Market Confidence* (Routledge 2016) 98; The Enron Scandal will later be discussed in more detail in this chapter.

¹⁵⁴ Hong-Jo Park Daegu, 'Does Non-Audit Service Compromise Audit Quality?' (2017) 33(2) *The Journal of Applied Business Research* 309, 310.

¹⁵⁵ *ibid.*

¹⁵⁶ Rong Duh, 'Non-audit service and auditor independence' (2007) 10(5) *Springer Science + Business Media* 32, 36.

¹⁵⁷ Khaled Hamuda, 'Does Selling non-Audit Services Impair Auditor Independence?' (2018) 1 *Human and Community Studies Journal* 1, 6.

¹⁵⁸ *ibid.*

¹⁵⁹ *ibid.*

Moreover, a high-quality audit shall strengthen the value of the non-audit work supplied to the same company which also implies that the connection between non-audit work and the auditor's independence may not be impaired.¹⁶⁰ Similarly, a company buying NAS from its auditors usually pays a higher audit fee as compared to a company which does not but the quality is different with the high audit fee inducing the auditors to provide a clean audit report.¹⁶¹ Nevertheless, additional insights may be obtained by distinguishing particular set of NAS such as tax services which can potentially impact on the reliability and objectivity of the accountants.¹⁶² It is therefore important to differentiate the particular type of NAS which can put at risk the auditor's independence.¹⁶³

Accounting firms have long contemplated that if they did not have the authority to provide NAS to audit clients then they would not be in a position to employ highly skilled and competent accountants to manage complex business issues.¹⁶⁴ Hence, that would probably lead to low quality audits and significantly impact on the client's financial statements where investors would lose confidence and trust on auditors. It is also argued that the exposure and experience which trainees and junior auditors obtain from the provision of NAS vastly improve their auditing skills.¹⁶⁵ Therefore, this exposure prepares a junior accountant to work effectively in challenging situations.

2.3.2 Negative effect of NAS

It has periodically been argued that supplying NAS to audit clients can undermine the independence and objectivity of auditors as they are more likely to provide a favourable report based on business deals created by themselves or their colleagues from another department but within the same accounting firm.¹⁶⁶ It appears that the auditor will be either

¹⁶⁰ *ibid.*

¹⁶¹ Mark Defond, 'A review of archival auditing research' (2014) 58(1) *Journal of Accounting and Economics* 275, 279.

¹⁶² Jeffrey Patterson, 'The Effects of Recurring and Non-recurring Tax, Audit-Related, and Other Non-audit Services on Auditor Independence' (2011) 28(5) *Contemporary Accounting Research* 1510, 1511.

¹⁶³ *ibid.*

¹⁶⁴ ICAEW, 'How does joint provision of audit and non-audit services affect audit quality and independence?' (ICAEW 2014) Pg 20.

¹⁶⁵ *ibid.*

¹⁶⁶ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 36.

reluctant to interfere with the undertakings of his colleague delivering the advisory service or reluctant to report any malfunctioning of the non-audit work which will tarnish the reputation of the accounting firm.¹⁶⁷

There are concerns that accounting firms are using the statutory audit requirement as a loss leader strategy to obtain a foot in the door of the client company and eventually sell their NAS which are more profitable.¹⁶⁸ This means that a lower audit fee is charged by the accounting firm who will then negotiate for higher rates by offering advisory services in order to compensate for any probable loss encountered from the audit work.¹⁶⁹ However, this may result in conflict of interests whereby directors¹⁷⁰ may have the ultimate power over the auditors. Consequently, due to fear of losing the income from the non-audit work, auditors may be hesitant to raise a red flag or confront directors over a particular audit matter as this may ruin the auditor-client relationship.

The FRC in its 2018 reviews mentioned that the quality of audits has deteriorated in the UK economy with more than 20 per cent of FTSE 350 audits demanding further ameliorations.¹⁷¹ Accounting scandals, for instance, Enron, café-chain Patisserie Valerie, retailer BHS, Carillion and travel company Thomas Cook are cases where auditors were thoroughly investigated for their lack of independence particularly because of their extensive involvement in non-audit work rather the audit of the clients' accounts.¹⁷² Therefore, this had a damaging effect on the quality of audit and led to severe sanctions for misconduct where applicable.¹⁷³

In addition, significant shortcomings were discovered in the audit system during the 2008 financial crisis, for example the audits of large financial institutions resulted in clean audit reports although serious concerns and fraudulent dealings were discovered in their

¹⁶⁷ ICAEW, 'How does joint provision of audit and non-audit services affect audit quality and independence?' (ICAEW 2014) Pg 15.

¹⁶⁸ Mary Canning, 'Non-audit services and auditor independence' (2010) 8(3) European Accounting Review 401, 403.

¹⁶⁹ *ibid.*

¹⁷⁰ Refer to chapter one for the roles and responsibilities of directors in auditing.

¹⁷¹ CMA, 'Final summary report on statutory audit services market study' (CMA 2019) pg 3.

¹⁷² Neil Hodge, 'Will UK mandate that Big Four separate audit units make a difference?' (*Compliance Week*, 7 July 2020) <<https://www.complianceweek.com/accounting-and-auditing/will-uk-mandate-that-big-four-separate-audit-units-make-a-difference/29159.article>> accessed 28 August 2020.

¹⁷³ *ibid.*

accounts.¹⁷⁴ It must be noted that a high percentage of the fees that are paid to accounting firms in the banking industry are accountable from the non-audit work.¹⁷⁵ The aggregate revenues obtained from audit and NAS by the Big Four and challenger audit firms are illustrated below:

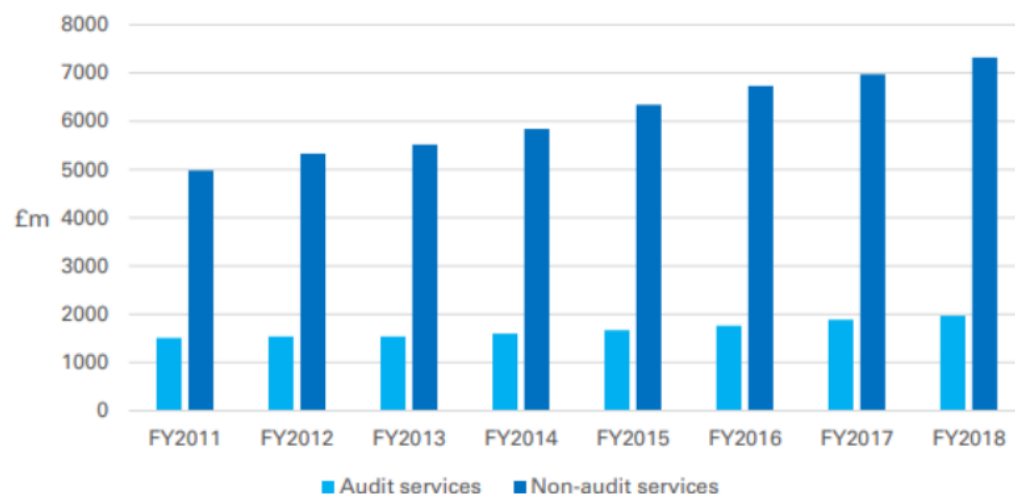


Figure III: Aggregate revenue obtained by Big Four firms.¹⁷⁶

¹⁷⁴ Sweet & Maxwell, 'Higher quality audit market proposed' (2012) 291(1) EU Focus 3, 4.

¹⁷⁵ *ibid.*

¹⁷⁶ CMA, 'Statutory audit services market study' (CMA 2019) Provision 2.33.

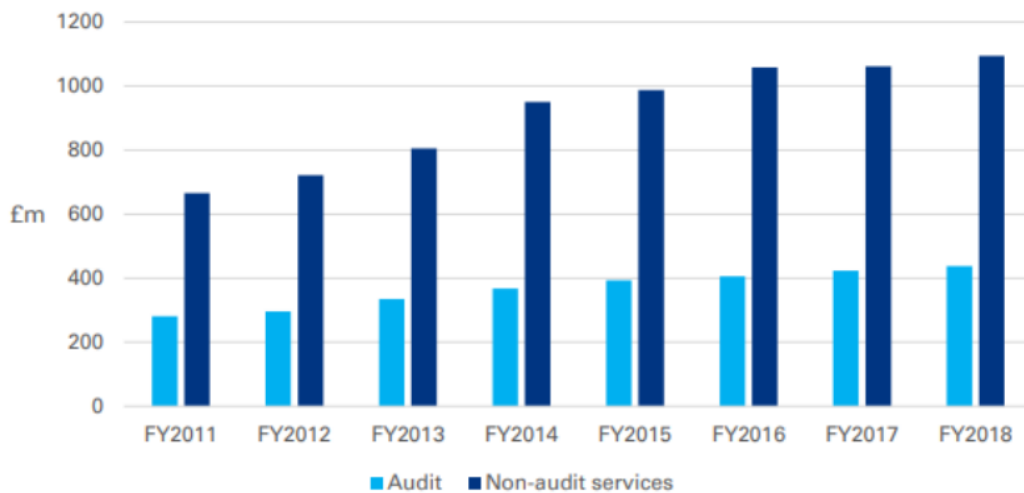


Figure IV: Aggregate revenue obtained by challenger audit firms.¹⁷⁷

Figure III shows that the Big Four firms generated additional revenues from NAS compared to audit services with a slight rise from 77 per cent in 2011 to 79 per cent in 2018.¹⁷⁸ On the other hand, figure IV shows that even challenger firms obtained most of their revenues from NAS. However, their revenues from audit services (29 per cent) take up a greater proportion of the total revenue in comparison with the Big Four firms (21 per cent).¹⁷⁹ This means that small-medium sized audit firms are experiencing a rise in their audit revenues when compared to Big Four firms.

Additionally, it was held in *Wardside House Limited v HMRC*¹⁸⁰ that ‘a self-interest threat to the auditor’s independence is created if fees due from an audited entity for both audit and NAS remain unpaid for a long time.’¹⁸¹ Similarly, professional attitudes and values are fading in accounting firms, giving rise to a culture solely focused on constant

¹⁷⁷ *ibid* Provision 2.36.

¹⁷⁸ *ibid* Provision 2.34; The aggregate revenue of each big four firm is available in appendix two.

¹⁷⁹ *ibid* Provision 2.36 and 2.37.

¹⁸⁰ [2012] UKFTT 445 (TC).

¹⁸¹ *ibid* [12].

earnings.¹⁸² This can have an adverse effect on trainee accountants as they are more likely to grow in a work environment where their ethical behaviours will be highly influenced by the existing culture.

2.4 Tax avoidance schemes

Moreover, the auditors' independence can be jeopardised because they sell tax avoidance schemes to audit clients with the aim to make higher profits and develop commercial relationships compared to being solely independent auditors. Big Four firms are under the spotlight for unethical business conduct and accounting malpractices.¹⁸³ In 2013, confidential information was disclosed by a PwC worker to the House of Commons stating that 'PwC would offer a tax avoidance scheme which had only 25 per cent probability of being upheld in court as per its regulations.'¹⁸⁴ Nevertheless, this was put differently by the committee chairperson who stated that 'the audit firm is knowingly marketing the tax scheme where it has concluded there is a 75 per cent risk of it being unlawful.'¹⁸⁵ Other accounting firms confirmed selling such schemes with only 50 per cent probability of withstanding a legal challenge.¹⁸⁶

In *Iliffe News & Media Ltd v HMRC*¹⁸⁷, a complaint was lodged to the FRC and ICAEW as EY created a tax avoidance scheme for its audit client who had the intention to conceal its revenues and dismiss the claims of workers who were demanding a rise in their salaries.¹⁸⁸ It follows that tax relief was claimed on several sums payable and lower profits were published.¹⁸⁹ A similar situation was observed in *GDF Suez Teesside Ltd v HMRC*¹⁹⁰ where the appellant company sought to escape potential liabilities through a tax avoidance scheme devised by EY and the statutory auditors had a significant contribution

¹⁸² ICAEW, 'How does joint provision of audit and non-audit services affect audit quality and independence?' (ICAEW 2014) Pg 19-20.

¹⁸³ Jim Haslam, *Pioneers of Critical Accounting* (Palgrave Macmillan 2016) 261.

¹⁸⁴ *ibid.*

¹⁸⁵ *ibid.*

¹⁸⁶ *ibid.*

¹⁸⁷ [2012] UKFTT 696 (TC).

¹⁸⁸ *ibid* [80].

¹⁸⁹ *ibid* [304].

¹⁹⁰ [2018] EWCA Civ 2075.

in it.¹⁹¹ Furthermore, in *Greene King Plc v HMRC*¹⁹², the project Sussex by EY was declared unlawful because the scheme included loans between subsidiary companies with the final aim being to avoid tax.¹⁹³ It is argued that EY would derive more profits from the Sussex scheme compared to the auditing of the company.¹⁹⁴

The Luxembourg Leaks also exposed a huge marketing of tax avoidance schemes by PwC with giant corporations including Amazon, Deutsche Bank, FedEx, JP Morgan and Ikea.¹⁹⁵ However, no information was retrieved on the code of ethics and morality between the auditors who will audit the company and tax professionals who will devise the tax avoidance schemes.¹⁹⁶ A scheme devised by PwC was in fact declared as illegal and fiction by Lord Gross in *Vocalspruce Limited v HMRC*¹⁹⁷. Moreover, in *Travel Document Service v HMRC*¹⁹⁸, a scheme devised by Deloitte was sold to Ladbroke Group with the objective to make two subsidiary companies to voluntarily transact with each other in order to obtain a tax loss in only one subsidiary company whereas the group as a whole would incur no real losses.¹⁹⁹ Nonetheless, the transactions went outside the scope of anti-avoidance rules and the first-tier tribunal rejected the scheme.²⁰⁰ Likewise, in *Pendragon Plc v HMRC*²⁰¹, Lord Lloyd went to a greater extent to state that a VAT avoidance scheme designed by KPMG was an abuse of right and law.²⁰² Therefore, this may raise concerns on the independence of auditors as they will report on the financial statements based upon those schemes but can manipulate figures to promote a clean and healthy audit report.

The collaboration of auditors in the tax avoidance scheme clearly shows a breach of their code of ethics and integrity as confidential information pertaining to the client company

¹⁹¹ *ibid* [2].

¹⁹² [2016] EWCA Civ 782.

¹⁹³ *ibid* [51].

¹⁹⁴ *ibid*.

¹⁹⁵ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 46.

¹⁹⁶ *ibid*.

¹⁹⁷ [2014] EWCA Civ 1302 [44].

¹⁹⁸ [2017] UKUT 45 (TCC).

¹⁹⁹ *ibid* [3].

²⁰⁰ *ibid* [4].

²⁰¹ [2013] EWCA Civ 868.

²⁰² *ibid* [1].

may be leaked to their colleagues on the tax advisory department. Auditors from an economic perspective will provide tax suggestions in order to develop or enhance their auditor-client relationship but also need to carry out a risk assessment in the company's tax management activities.²⁰³ This means that in order to avoid an audit failure or tarnish their own reputations, they are more likely going to assist or supervise the tax team as they have a better understanding of the industry characteristics of the client, giving them a dominant position in the success rate of the tax avoidance scheme.²⁰⁴ Thus, this jeopardises the independence of auditors and although a revised code of ethics²⁰⁵ may now prevent audit firms in engaging in such practices, little has been done to explain why such practices were even allowed in the first instance. The lack of monitoring and supervision by an effective regulator is probably the reason behind this loss of transparency.

2.5 Financial scandals and audit failures

The demise of Arthur Andersen and several other financial scandals have raised concerns on the independence and the responsibilities of auditors in alerting investors and the general public of the realities behind closed doors of auditing and corporate malpractices.²⁰⁶ In the 1960's, the UK economy lost confidence in the accountancy profession as major UK-based companies were involved in money laundering activities and audited financial statements were materially incorrect.²⁰⁷ Members of companies are usually ignorant of this occurrence unless the information becomes public, for example if the organisation goes into administration or falls into the hands of a liquidator who has the duty to investigate and report on any issues in the governance of the company.²⁰⁸ Thus, some of the biggest audit failures and scandals shall be examined below.

²⁰³ Ru Lee, 'The Impacts of IFRSs and Auditor on Tax Avoidance' (2018) 8(6) *Advances in Management & Applied Economics* 17, 20.

²⁰⁴ *ibid.*

²⁰⁵ ICAEW, 'Code of Ethics' (ICAEW 2018).

²⁰⁶ David Cooper, 'Auditor and audit independence in an age of financial scandals' (2007) 12(1) *Advances in Public Interest Accounting* 1, 15.

²⁰⁷ Jamie Elliott, *Financial Accounting and Reporting* (19th edn, Pearson Education 2019) 135.

²⁰⁸ *ibid.*

2.5.1 The Enron scandal

The Enron corporation fell into bankruptcy in 2001 as it concealed the fact that it had off-balance sheet debts and overstated its earnings by more than \$500 million.²⁰⁹ This means that the organisation was not in a healthy financial situation since incorporation and manipulated its accounting figures to hide any shortcomings.²¹⁰ However, this scandal raises questions over the independence of auditors who as a watchdog did not report the irregularities as a matter of concern but were in fact collaborating with the organisation to conceal those debts. The accounting firm, Arthur Andersen, was eventually blamed for not showing professional scepticism.²¹¹

A series of circumstances led to the conclusion that Arthur Andersen did not carry out its duties and responsibilities in an objective manner. Firstly, the firm was obtaining more revenues from NAS compared to audit services and the NAS involved the development of accounting schemes which would allow the company to keep its liabilities off records.²¹² Secondly, Enron was the audit partner's sole and principal client for several years implying that the audit partner was economically dependent on keeping a good relationship with the organisation for his remuneration.²¹³ Thirdly, a number of employees left their jobs at Arthur Andersen to work for Enron and the existing relationship was perceived to be too friendly.²¹⁴ These facts clearly validate the reasonings and analysis discussed throughout this chapter to conclude that the independence of auditors have been compromised for private and mutual gains.

²⁰⁹ Peter Behr, 'Enron Says Profit Was Overstated' (*The Washington Post*, 9 November 2001) <<https://www.washingtonpost.com/archive/business/2001/11/09/enron-says-profit-was-overstated/01411023-b659-45ac-b72c-d9c37b22749e/>> accessed 7 September 2020.

²¹⁰ *ibid.*

²¹¹ Lucy Skoulding, 'Audit scandals of the past and now' (*Accountancy Age*, 12 April 2019) <<https://www.accountancyage.com/2019/04/12/life-after-bhs-carillion-patisserie-valerie-is-there-light-at-the-end-of-the-tunnel-for-audit/>> accessed 7 September 2020.

²¹² Stella Fearnley, 'The Reform of the UK's Auditor Independence Framework after the Enron Collapse' (2004) 8(1) *International Journal of Auditing* 117, 138.

²¹³ *ibid.*

²¹⁴ *ibid.*

2.5.2 Collapse of British Home Stores (BHS)

The fall of BHS led to various questions about the role and independence of PwC. It is argued that the fees charged by PwC for NAS were much higher than the normal audit fees and the same person at PwC was responsible for the audit and non-audit work.²¹⁵ The FRC further documented that 'PwC's audit partner, Steve Denison recorded 31 hours on NAS from 1 January 2015 to 9 March 2015 but just 2 hours on the audit.'²¹⁶ This implies that the audit partner and his team spent only two hours to conclude that BHS was a going concern although enough evidence had not been provided to support that statement and directors were appeased by backdated audit report.²¹⁷ This is undoubtedly the core of an audit failure and the independence of auditors have been impaired due to spending more time on lucrative NAS for higher remuneration than the actual audit of the company. They have failed to draw attention on money laundering activities and raise red flags where necessary.²¹⁸

Directors are also complicit in this matter²¹⁹ but if they could be relied upon then there would be no need to invest massively on statutory audits which would be against the objectives of S 475 of the Companies Act 2006 and Principle M of the UK Corporate Governance Code. Hence, auditors often put forward that they have various measures in place to safeguard their independence and integrity²²⁰, yet the collapse of BHS is an obvious example which proves that PwC adopted a profit making approach through its provision of NAS to BHS even though that has jeopardised its independence, reputation and conformity to ethical standards.

²¹⁵ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 37.

²¹⁶ FRC, 'BHS The Settlement Agreement' (FRC 2018) Pg 5.

²¹⁷ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 14.

²¹⁸ *ibid*.

²¹⁹ *Ibid*; Refer to discussion in chapter one for the role and responsibilities of directors in audit.

²²⁰ Khaled Hamuda, 'Does Selling non-Audit Services Impair Auditor Independence?' (2018) 1 Human and Community Studies Journal 1, 6.

2.5.3 Collapse of Carillion

The audit failure of Carillion prompts for a radical change in financial reporting and the role of watchdogs. The company entered into liquidation in 2018 resulting in massive job losses, huge pension deficits, outstanding debts and heavy costs to UK taxpayers.²²¹ This raises concerns as how the accounts of the company were signed off by KPMG as a going concern in 2017 but then went into liquidation only few months later with billions of debts.²²² S 414 of the CA 2006 empowers the directors to approve and sign off financial accounts of the company²²³ but it is the responsibility of the auditors to provide reasonable assurance that the accounts are free from material misstatement.²²⁴ If the auditors could not obtain sufficient evidence to provide that assurance then they could have issued a modified opinion on the accounts.²²⁵

However, KPMG did not fulfil its statutory duties correctly and was heavily criticised for giving the company a clean report when that was not the case.²²⁶ It is noted that KPMG audited the organisation for 19 years and pocketed more than £25 million in audit fees alongside the extra fees for taxation and assurance services.²²⁷ Nevertheless, KPMG did not challenge Carillion's management or even identify any shortcomings which affected its independence. If KPMG had performed its auditing correctly then warning signs could have been issued at an early stage to inform the stakeholders about the actual financial situation of the company and reduce any losses. Thus, failure to provide professional scepticism means that KPMG was complicit in Carillion's accounting practices and its independence was compromised.²²⁸ The role of the FRC should also be reviewed as it should have monitored and investigated such a case in an effective and efficient way right from the start.

²²¹ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 11.

²²² *ibid.*

²²³ Companies Act 2006, section 414.

²²⁴ FRC, 'International Standard on Auditing 200' (FRC 2016) Pg 4.

²²⁵ FRC, 'International Standard on Auditing 705' (FRC 2016) Pg 3.

²²⁶ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 11.

²²⁷ UK Government, 'Carillion' (*Parliament UK*, 16 May 2018) <<https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76902.htm>> accessed 8 September 2020.

²²⁸ Rod Sweet, 'Carillion's accounting tricks: MPs' damning verdict' (2018) 9(2) *Construction Research and Innovation* 48, 50.

2.6 Conclusion

The importance of auditors' independence and objectivity have been evaluated in this chapter. It is acknowledged that auditors must not only be independent in their minds when auditing a company, but efforts must also be made to appear independent in the minds of stakeholders. This chapter recognises that the audit profession has some intrinsic attributes that may make auditors appear not independent through the joint supply of audit services and NAS, but it still remains a widely known profession. The effectiveness of regulators and corporate governance standards should also be reassessed because the audit sector is stumbling from one crisis to another. Hence, the upcoming chapter three will analyse the effectiveness of audit committees and chapter four will discuss the potential recommendations which can bring reforms in the audit sector in the UK with the aim to enhance the auditors' independence.

Chapter Three – The effectiveness of audit committees

3.0 Introduction

Chapter two has discussed the main causes of audit failures and the impact of NAS to the same audit client which can affect the auditor's independence. Chapter three will serve as a supplement of chapter two to discuss the effectiveness of audit committees in enhancing corporate governance practices and strengthening the independence of auditors. It will examine the importance of establishing an audit committee and will provide an analysis of its responsibilities. There will be further discussion on its oversight duties and relationship with stakeholders. A particular attention will also be given to the usefulness of provisions 24 and 25 of the UK Corporate Governance Code.

3.1 Establishment of the audit committee

There is a growing research literature on the composition and usefulness of audit committees in enhancing the statutory auditor's independence. This is partly caused by the rise in audit failures and accounting scandals.²²⁹ It is the publication of the Cadbury report in 1992 which originally required listed companies in the UK to establish audit committees.²³⁰ The report stated that 'the audit committee should consist of a minimum of three NEDs with written terms of reference which deal distinctly with their membership, authority and duties.'²³¹ This recommendation was perceived to be successful as the audit committee would review and monitor the external auditor's independence.²³² The UK Corporate Governance Code also 'allows membership of two NEDs in the audit committees of smaller companies but at least one member must possess recent and

²²⁹ Zulkarnain Muhamad, 'Audit Committee and Auditor Independence: The Bankers' Perception' (2009) 3(2) International Journal of Economics and Management 317, 331; Refer to Chapter two.

²³⁰ Andrew Goddard, 'Audit committees, Cadbury Code and audit fees: an empirical analysis of UK companies' (2000) 15(7) Managerial Auditing Journal 358, 371.

²³¹ Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (Gee & Co. Ltd 1992) para 4.35(a)(b).

²³² Paul Collier, 'Audit Committees in Major UK companies' (1993) 8(3) Managerial Auditing Journal 25, 28.

relevant financial experience.²³³ The EU Directive 2006/43/EC clearly mentions that 'a member must have competence in accounting and/or auditing.'²³⁴ The importance of having the relevant skills and experience implies that the audit committee will be able to identify shortcomings on financial statements and raise a red flag if applicable. In contrast, if an audit committee has not been established then the external auditor can be influenced by the board's standpoints and may probably overlook any accounting wrongdoings or money laundering offences on the company's accounts for commercial purposes. Thus, the auditor's independence can be compromised, and it will be a failure of corporate governance. It is recommended that no NED should be involved on all three board committees (audit, nomination and remuneration) concurrently in order to enhance transparency and fairness.²³⁵

Prior research has revealed that although many companies establish audit committees, they do not rely on them indicating that these committees have been set up solely for regulatory purpose.²³⁶ A survey by BDO found that more than 75 per cent of executive directors of FTSE 100 companies were not satisfied with the quality of work of audit committees.²³⁷ Additionally, when Barclays Bank changed its auditor in 2015 from PwC to KPMG, there were concerns due to the fact that the chair and deputy chair of the audit committee of Barclays, Mike Ashley and Michael Rake, were both ex-employees of KPMG.²³⁸ Consequently, if the audit committee and external auditors become too friendly then the organisational relationship between both parties can be interrogated as the external auditors may show less or no scepticism when auditing the company. The Enron scandal is a classic example of this issue.²³⁹ It is worth noting that more than 60 per cent of FTSE100 finance directors are associated with the Big Four firms.²⁴⁰ It is also argued that during audit conflicts, members of the audit committee would support the external

²³³ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 24.

²³⁴ EU Directive 2006/43/EC, Article 41(1).

²³⁵ Sir Derek Higgs, 'The role and effectiveness of non-executive directors' (Independent Review 2003) provision 13.7.

²³⁶ Andrew Goddard, 'Audit committees, Cadbury Code and audit fees: an empirical analysis of UK companies' (2000) 15(7) *Managerial Auditing Journal* 358, 371.

²³⁷ *ibid.*

²³⁸ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 98.

²³⁹ Refer to detailed discussion in chapter two.

²⁴⁰ Prem Sikka, 'Reform in Auditing' (Independent Review 2018) pg 98.

auditors compared to the company's management.²⁴¹ Hence, this reasoning can be interpreted as both positive and negative. It is positive if the audit committee is supporting the external auditors by challenging management for instance over a money laundering issue found on the company's accounting records but on the other hand, it can be negative if because of the closeness of their relationship with the audit partner or accounting firm, they are not being independent in their duties. This will be discussed further in the upcoming sections.

3.2 Responsibilities of the audit committee

Audit committees have a significant contribution in ensuring transparency and fairness in many organisations.²⁴² Some key roles and responsibilities of the audit committees as specified in the UK Corporate Governance Code are:

- 'Monitoring the integrity of the financial statements of the company and reviewing the financial reporting judgements;
- Providing advice on whether the annual report and accounts, as a whole is fair, balanced and understandable, and provides pertinent information to shareholders;
- Making recommendations to the board, about the appointment, removal and remuneration of the external auditor;
- Reviewing and monitoring the auditor's independence and objectivity;
- Developing and implementing policy on the engagement of the external auditor to supply NAS.'²⁴³

The EU regulation also requires 'external auditors carrying out the audits of public-interest entities to submit a report detailing the results of the statutory audit to the audit committee and providing a declaration of their independence.'²⁴⁴ Thus, audit committees are

²⁴¹ Andrew Goddard, 'Audit committees, Cadbury Code and audit fees: an empirical analysis of UK companies' (2000) 15(7) *Managerial Auditing Journal* 358, 371.

²⁴² Zulkarnain Muhamad, 'Audit Committee and Auditor Independence: The Bankers' Perception' (2009) 3(2) *International Journal of Economics and Management* 317, 331.

²⁴³ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 25.

²⁴⁴ Regulation No 537/2014, Article 11.

perceived as an effective check and balance in corporate governance in order to support management in its oversight functions.²⁴⁵

Nevertheless, audit committees have been heavily criticised for not being independent and objective in their duties.²⁴⁶ They operate as a rubber stamp and there is no guarantee that they are fully responsive to their responsibilities.²⁴⁷ There is anecdotal evidence stating that 'audit committees are falling short of doing what they are expected to do.'²⁴⁸ It must be noted that auditors were referred as cheerleaders for failing to expose money laundering activities on the balance sheets of their audit clients.²⁴⁹ However, if the statutory auditor's independence has been compromised for failing to expose any risks then it also means that the audit committee has failed in its duties because the committee is responsible to monitor, review and approve financial statements at first instance. In *SL Claimants v Tesco Plc*²⁵⁰, Tesco's audit committee was aware that the company's fixed asset impairment was calculated using rates 'which were beyond PwC's acceptable range, but it instead adopted the aggressive accounting practices in order to enhance Tesco's financial reporting.'²⁵¹ Failure to perform its duties effectively constitute a breach of provision 25 of the UK Corporate Governance Code implying that audit committees should be primarily interrogated especially over the string of accounting scandals discussed in chapter two.

Previous research has also found that many companies do not consider their audit committees to possess recent and sufficient accounting knowledge to review financial statements as a whole.²⁵² This is a breach of article 41(1) of the EU Directive 2006/43/EC, as mentioned in the first section of this chapter. Therefore, this lack of accounting

²⁴⁵ Paul Collier, 'Audit Committees in Major UK companies' (1993) 8(3) *Managerial Auditing Journal* 25, 29.

²⁴⁶ Zulkarnain Muhamad, 'Audit Committee and Auditor Independence: The Bankers' Perception' (2009) 3(2) *International Journal of Economics and Management* 317, 321.

²⁴⁷ *ibid.*

²⁴⁸ *ibid.*

²⁴⁹ Richard Crump, 'Auditors' (*Accountancy Age*, 19 June 2013) <<https://www.accountancyage.com/2013/06/19/auditors-acted-as-cheerleaders-for-questionable-bank-reporting/>> accessed 16 September 2020.

²⁵⁰ [2019] EWHC 3315 (Ch).

²⁵¹ *ibid* [72].

²⁵² Dan Dhaliwal, 'The Association Between Accruals Quality and the Characteristics of Accounting Experts and Mix of Expertise on Audit Committees' (2010) 27(3) *Contemporary Accounting Research* 787, 792.

expertise can be looked upon as a barrier which will prevent members of the audit committee to identify shortcomings and ask probing questions to management and external auditors. It further raises concerns on how they were even selected if they do not possess the relevant skills and experience. If at least one member does not have recent and sufficient financial experience, then this is against provision 24 of the UK Corporate Governance Code. Members of the audit committee may not be able to strengthen the external auditor's independence as a measure of corporate governance if they are themselves not independent and competent in their field. The effectiveness of audit committees, as part of their responsibilities to act as watchdog in strengthening the independence of external auditors will be thoroughly analysed in section 3.4.

3.3 Relationship with stakeholders

There are contrasting views on the perceived relationship of audit committees with stakeholders and whether they are truly independent. Article 39(1) of the Audit Directive requires 'a majority of the members of the audit committee to be independent.'²⁵³ A research has even reckoned that members of the audit committee were independent, objective and collaborative in helping executive directors and management to reinforce the regulatory framework of the company.²⁵⁴

The FRC in its guidance has stated that 'the audit committee should report to the board on issues regarding the financial statements of the company and how they were handled.'²⁵⁵ Therefore, if audit committees fulfil their responsibilities as expected then it will provide a reliable communication network between external auditors and the board.²⁵⁶ It was found that companies which have a good corporate governance system tend to have an independent audit committee as NEDs do not have any personal or economic

²⁵³ Audit Directive 2014/56/EU, Article 39(1).

²⁵⁴ UK Government, 'Are audit committees independent and do they represent shareholders?' (*UK Government's website*, 2 April 2019) <<https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171809.ht>> accessed 17 September 2020.

²⁵⁵ FRC, 'Guidance on Audit Committees' (FRC 2016) Provision 29.

²⁵⁶ Zulkarnain Muhamad, 'Audit Committee and Auditor Independence: The Bankers' Perception' (2009) 3(2) *International Journal of Economics and Management* 317, 319.

interest in the business.²⁵⁷ This means that they are not hesitant to challenge management or auditors over regulatory issues. Moreover, the submission of audit committee reports with financial statements, providing information such as discussions with the board and external auditors will provide investors and shareholders a piece of mind that the audit committee is independent in the financial reporting process.²⁵⁸ This may enhance the confidence of investors in the quality of financial reporting and audit.

However, it is argued that although the guidelines imposed by the FRC²⁵⁹ to safeguard the independence and reliability of audit committees, they still remain confined under management power.²⁶⁰ The relationship and engagement between shareholders and the audit committee is also not clear on the appointment of statutory auditors.²⁶¹ Furthermore, there are various NEDs who often have been recommended by management to sit on the audit committee instead of going through the standard recruitment and selection process.²⁶² It must be noted that the Bank of Credit and Commerce International had a weak audit committee because it was controlled mainly by executive directors and management rather than being independent and impartial.²⁶³ Thus, the existence of social affiliation between members of the audit committee, executive directors and management of the company creates doubts on whether they are independent and diligent in their oversight responsibilities towards statutory auditors. In *Re City Equitable Fire Insurance Company*²⁶⁴, it was held that highly important decisions should be taken by the executive directors and management of the company only²⁶⁵ but in *Oliver & Son Ltd. v Douglas*²⁶⁶, it was held that executive directors should nevertheless exercise a higher standard of

²⁵⁷ *ibid.*

²⁵⁸ *ibid.*

²⁵⁹ FRC, 'Guidance on Audit Committees' (FRC 2016).

²⁶⁰ UK Government, 'Are audit committees independent and do they represent shareholders?' (*UK Government's website*, 2 April 2019) <<https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171809.ht>> accessed 17 September 2020.

²⁶¹ *ibid.*

²⁶² *ibid.*

²⁶³ B Mohammed, 'Corporate Governance: Directors, Shareholders and the Audit Committee' (2003) 11(2) *Journal of Financial Crime* 150, 153.

²⁶⁴ [1925] Ch. 407.

²⁶⁵ *ibid* [408].

²⁶⁶ 1982 S.L.T. 222.

care²⁶⁷. Therefore, this legal reasoning stipulates that executive directors and management should assist but not fully dictate the audit committee about its oversight responsibilities such that the purpose of establishing the committee becomes pointless with no real value.

3.4 Monitoring the independence of external auditors

The audit committee has a huge contribution in the appointment of external auditors and monitoring their independence.²⁶⁸ It is responsible for the selection procedure of the external auditor, approving the terms of engagement and assessing the effectiveness of the audit process along with providing a recommendation to shareholders on whether to have the same external auditor for the next financial year.²⁶⁹ Another important function is to agree on the remuneration to be paid to the external auditor and satisfy itself that the fee payable for audit services is correct and relevant for a high quality audit.²⁷⁰ Thus, for independence purposes, the audit committee has to ensure that the appropriate fee is being paid to the external auditor for the services rendered.

However, there are concerns on the effectiveness of audit committees in appointing external auditors and reviewing their remuneration.²⁷¹ The CMA, despite its effort to enhance the independence of auditors, found that audit committees did not monitor the work of external auditors constructively which led to a fragile audit system and poor quality audits.²⁷² This obviously raises doubts on the reliability of audit committees in acting as watchdog to enhance the external auditors' independence either because they do not have the required expertise in accounting and auditing or they do not have the skills to ensure whether the auditors are objective in their duties. It must be noted that directors

²⁶⁷ *ibid* [228].

²⁶⁸ Companies Act 2006, sections 485A and 489A (Refer to chapter one); FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 25; Refer to discussion in chapter one.

²⁶⁹ FRC, 'Guidance on Audit Committees' (FRC 2016) Provisions 57-65.

²⁷⁰ *ibid*.

²⁷¹ UK Government, 'Are audit committees independent and do they represent shareholders?' (*UK Government's website*, 2 April 2019) <<https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171809.ht>> accessed 17 September 2020.

²⁷² *ibid*.

have a duty to promote the success of the company²⁷³ and ensure that its audit committee has the appropriate skills and experience²⁷⁴ whereas the audit committee is required to act independently of the executive in order to protect the interests of shareholders in financial reporting and auditing.²⁷⁵ If the audit committee is unable to monitor the work of external auditors effectively then it has certainly failed in its duties²⁷⁶ but it further implies that directors are complicit in it as they have not established a proper audit committee with appropriate skills and experience which can be a breach of s 172 of the CA 2006 and principle K of the UK Corporate Governance Code. It further challenges the integrity of the company and its adherence to corporate governance measures in promoting a culture of fairness and equity.

A survey conducted by KPMG further concluded that more than 50 per cent of CEOs attend audit committee meetings.²⁷⁷ This implies that the effectiveness of audit committees in strengthening the independence of statutory auditors may highly be influenced by CEOs, executive directors and management. It must be noted that if the chair is also the CEO of the same company then it is a breach of provision 9 of the UK Corporate Governance Code. The presence of a CEO in an audit committee meeting probably indicates that the audit committee may only fulfil part of its responsibilities but not fully as it may not be effective in overseeing the company's relations with the external auditor or support them in challenging management due to fear of damaging existing social ties with the company.

Furthermore, the recruitment process of external auditors by audit committees has also been under intense scrutiny. The CMA has revealed that the selection of auditors is not done in accordance with the interests of shareholders but mainly with that of the company and its management.²⁷⁸ It is argued that the only genuine requirement to select an auditor

²⁷³ Companies Act 2006, section 172.

²⁷⁴ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principle K.

²⁷⁵ FRC, 'Guidance on Audit Committees' (FRC 2016) Provision 3.

²⁷⁶ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 25.

²⁷⁷ Arnie Wright, 'Audit committee effectiveness and auditor independence' (2002) 12(3) Accounting Review 1, 5.

²⁷⁸ CMA, 'Statutory audit services market study' (CMA 2018) Provision 3.13.

is that the company gets on well with the audit partner.²⁷⁹ The selection criteria used by some FTSE 350 companies is shown below:



Figure V: Criteria adopted by FTSE 350 companies for selecting auditors.²⁸⁰

Figure V shows that only 9 out of 24 companies incorporated scepticism and challenging management as part of their criteria to select an external auditor whereas 23 companies would also include cultural fit and personal chemistry in their lists. This clearly means that the requirement to exercise independent judgement is being overtaken by cultural fit which appears to favour social ties between the audit partner and the audit committees. Thus, this lack of transparency is likely to impair the external auditor's independence due to inability to exercise professional scepticism where required and being complicit with the audit client.

²⁷⁹ ibid provision 3.22.

²⁸⁰ ibid provision 3.23.

In addition, big gaps were found on the amount of time audit committees would devote to their duties relating to statutory audit.²⁸¹ A survey conducted on 18 companies of the FTSE 350 index has revealed that members of the audit committee would spend only 23 hours in overseeing and monitoring the statutory auditor's duties whereas they would spend 55 hours on all other duties for the financial year.²⁸² Some FTSE 100 companies even spent no more than 40 hours annually on statutory audit duties.²⁸³ This particularly raises doubts on the effectiveness of smaller audit committees in monitoring the independence and objectivity of the statutory auditor.

Moreover, the audit committee should oversee the statutory auditor's compliance with the FRC ethical standards²⁸⁴ and the amount of money the company pays to the auditor as part of its total fee income for both audit and NAS.²⁸⁵ A study by the CMA has found that the remuneration of newly appointed auditors was 44 per cent lower in the first financial year but then the fees payable were increased as the auditors obtained a foothold in the company.²⁸⁶ This obviously confirms the reasoning discussed in chapter two whereby auditors use the statutory audit requirement as a loss leader strategy to secure additional lucrative work, which explains the rise in their remuneration. It must be noted that the audit committee is empowered to approve the provision NAS such that it does not undermine the independence of the statutory auditors.²⁸⁷ Nevertheless, if the external auditor is paid more for a low-quality audit or he spends more time on NAS than audit services, then this means that the audit committee has not fulfilled its responsibilities as expected. It is a breach of provision 25 of the UK Corporate Governance Code as the audit committee has failed to implement an appropriate policy on the supply of NAS taking

²⁸¹ UK Government, 'Are audit committees independent and do they represent shareholders?' (*UK Government's website*, 2 April 2019) <<https://publications.parliament.uk/pa/cm201719/cmselect/cmbais/1718/171809.htm>> accessed 17 September 2020.

²⁸² CMA, 'Statutory audit services market study' (CMA 2018) Provision 3.38.

²⁸³ *ibid* provision 3.40.

²⁸⁴ FRC, 'Revised Ethical Standard' (FRC 2019).

²⁸⁵ FRC, 'Guidance on Audit Committees' (FRC 2016) Provision 67.

²⁸⁶ CMA, 'Statutory audit services market study' (CMA 2018) Provision 3.21.

²⁸⁷ FRC, 'Guidance on Audit Committees' (FRC 2016) Provisions 72-74.

into account the risks this may pose on the independence of the statutory auditor. It can further affect the confidence of investors and shareholders.

3.5 Conclusion

This chapter has acknowledged that audit committees in the UK are well established. It is ascertained that an effective audit committee will adhere to provisions 24 and 25 of the UK Corporate Governance Code which will ultimately strengthen the statutory auditors' independence and protect the interests of shareholders in financial reporting. However, audit committees are not acting independently of executive directors and management which has led to an increase in audit failures. The creation of an audit committee appears to be more of a regulatory requirement which necessitates mere fulfilment rather than a contribution to address deficiencies in corporate governance. Hence, as a potential remedy, a new independent audit regulator must be appointed which can hold audit committees accountable in their oversight responsibilities.²⁸⁸ This remedy along with other regulatory measures to enhance auditors' independence and promoting a culture of transparency will be discussed in the upcoming chapter four, reform in auditing.

²⁸⁸ To be examined in chapter four.

Chapter Four – Reform in the audit sector

4.0 Introduction

Chapter one has examined the current regulatory structure for auditing whereas chapter two has discussed the impact of NAS on auditors' independence and chapter three has analysed the factors affecting the effectiveness of audit committees. This final chapter shall take into account the discussion made throughout the previous chapters to recommend potential reforms in the audit sector in the UK. It will start by explaining the importance of appointing a new audit regulator and will further discuss the separation of audit and NAS to strengthen the auditors' independence. The USA has been chosen for a comparative analysis of its Sarbanes–Oxley Act (SOX) 2002 versus the CA 2006 due to its effectiveness in enhancing the auditors' independence and improvement in the quality of audit. The significance and advantages of adopting this legislation in the UK will be discussed in this chapter.

4.1 Appointment of a new audit regulator

The rise in audit failures and series of financial scandals²⁸⁹ have led to concerns not only over the roles and responsibilities of auditors and audit committees but also on the effectiveness of the FRC in its oversight duties. Sir John Kingman has acknowledged in his report that the FRC is ready to act above its basic statutory powers and is an effective custodian of the UK Corporate Governance Code which is highly recognised over the world.²⁹⁰ Principles K and M of the UK Corporate Governance Code²⁹¹, for instance are instrumental in promoting transparency and fairness in the audit sector.

However, it is argued that the FRC's powers are restricted in certain areas of auditing or even non-existent such that it has additional responsibilities without further authorities.²⁹²

²⁸⁹ Refer to discussion in chapter two.

²⁹⁰ Sir John Kingman, 'Review of the FRC' (Independent Review 2018) Provision 9.

²⁹¹ FRC, 'The UK Corporate Governance Code' (FRC 2018) Principles K and M (Discussed in chapters two and three).

²⁹² Sir John Kingman, 'Review of the FRC' (Independent Review 2018) Provision 11.

Members of parliament in the UK 'even described the FRC as chronically passive.'²⁹³ Following the collapse of Carillion and BHS²⁹⁴, it can be deduced that the FRC has not been competent in monitoring the independence of auditors and managing conflict of interests which impacted the audit sector. Therefore, the appointment of a new independent audit regulator with well-defined authorities and objectives can be a major reform in the audit sector²⁹⁵ as explained below.

The Kingman report recommends that the new regulator should be titled 'the Audit, Reporting and Governance Authority which must have the strategic objective to safeguard public interest by ensuring high standards of statutory audit and corporate governance.'²⁹⁶ The new regulator can be more effective than the FRC as it will have the responsibilities and powers such as:

'To regulate the audit profession; Maintain and promote the UK Corporate Governance Code, reporting annually on its compliance; Monitor and report on developments in the audit market, including the extent of any cross-subsidy from NAS; Appointment of inspectors to investigate a company's affairs where there are public interest concerns...'²⁹⁷

Consequently, the audit regulator can be a step ahead in anticipating and addressing emerging issues in the audit sector particularly in monitoring the independence of statutory auditors. If this corporate measure (appointment of an independent audit regulator) was adopted years ago then it could have prevented major audit failures. The collapse of BHS for example, discussed in section 2.4.2²⁹⁸ could have been prevented if an independent regulator would monitor the time spent on the provision of audit services and NAS right from the beginning.

²⁹³ Julia Kollewe, 'FRC tightens accounting standards after corporate failures' (*The Guardian*, 30 September 2019) <<https://www.theguardian.com/business/2019/sep/30/frc-accounting-carillion-patisserie-valerie>> accessed 27 September 2020.

²⁹⁴ Refer to discussion in chapter two for more details.

²⁹⁵ Sir John Kingman, 'Review of the FRC' (Independent Review 2018) Recommendation 1, pg 19.

²⁹⁶ *ibid* Recommendations 3 and 4.

²⁹⁷ *ibid* Recommendation 8.

²⁹⁸ Refer to chapter two.

Sir Donald Brydon has also supported the proposal to appoint a new audit regulator as it will provide greater transparency and encourage good audit practices.²⁹⁹ It must be noted that France has implemented this corporate measure by establishing an independent audit body named as *Compagnie Nationale des Commissaires aux Comptes* which ensures high quality audits and promotes professional auditing standards.³⁰⁰ Therefore, if this initiative has proved to be effective in France then with clear objectives and responsibilities, the establishment of a new independent audit regulator can be as productive in the UK.

4.2 Mandatory joint audit

Chapter two³⁰¹ has argued that there is a high market concentration in the audit sector with the Big Four firms dominating the market and other audit firms struggling to compete with them due to their well-established reputation. To enhance the resilience in the audit sector and increase the credibility of challenger audit firms (outside the Big Four), the CMA has recommended that 'FTSE 350 entities in the UK to be jointly audited by two audit firms, with one being a non-Big Four firm.'³⁰² This recommendation can be highly effective in ensuring the independence of auditors if it is implemented correctly as examined below.

The main objective of this remedy is to break the market concentration in the audit sector such that two independent audit firms will perform the auditing of the company by thoroughly organising and splitting the fieldwork between them but concluding with a single audit report duly signed by both audit firms.³⁰³ Thus, there will be greater knowledge transfer which will not only increase the expertise of the auditors but also have a positive impact on the quality of audit.³⁰⁴ It can further improve the effectiveness of audit

²⁹⁹ Sir Donald Brydon, 'The quality and effectiveness of audit' (Independent Review 2019) Provision 26.1.2.

³⁰⁰ Yves Nicolas, 'The French statutory audit' (French Government, CNCC 2014) pg 1-10.

³⁰¹ Refer to section 2.1 in chapter two for more details.

³⁰² CMA, 'Statutory audit services market study' (CMA 2019) Recommendation 2a, pg 144.

³⁰³ *ibid* pg 145; Han Donker, 'Joint audits and mutual ties of audit firm networks' (2020) 63(1) Business Horizons 435, 449.

³⁰⁴ Florian Hoos, 'Who's Watching? Accountability in Different Audit Regimes and the Effects on Auditors' Professional Skepticism' (2019) 156(1) Journal of Business Ethics 563, 575.

committees as they will have to verify that the work of each of the joint auditors is equal, coherent and well structured.³⁰⁵ Nevertheless, the two audit firms may have to share the costs of any potential liabilities.³⁰⁶

Several audit firms, for instance RSM and Mazars have widely supported this corporate remedy but there are also disagreements from other firms.³⁰⁷ PwC has expressed concerns that the 'joint audit may involve material risks to audit quality while BDO stipulated that joint audit can confine challenger audit firms to be the minority parties as Big Four firms will have greater control in the market.'³⁰⁸ Joint audits may constrain the remuneration of auditors from both audit firms, yet there is little evidence to show that the overall quality of audit can be negatively affected.³⁰⁹

The mandatory joint could have probably averted the collapse of Carillion³¹⁰ as two auditors from two separate audit firms would be performing the audit of the company and each audit partner would have to review the company's accounts closely before signing off the audit report. It reduces the likelihood for accounting figures to be manipulated. The remedy has in fact already been implemented in France as joint audits are compulsory for large organisations preparing consolidated financial statements.³¹¹ A survey in France has even found that the collaboration of one Big Four audit firm and one non Big Four audit firm can lead to high quality audits.³¹² On the other hand, in the UK, section 485 and 489 of the CA 2006 (discussed in chapter one) do not specifically mention about the mandatory joint audit or the appointment of auditors from two different audit firms but the Act does make reference to the appointment of 'an auditor or auditors for a single company...'³¹³ This possibly means that the mandatory joint audit can be carefully

³⁰⁵ Sara White, 'CMA wants Big Four operational split and mandatory joint audits' (*Accountancy Daily*, 18 April 2019) <<https://www.accountancydaily.co/cma-wants-big-four-operational-split-and-mandatory-joint-audits>> accessed 29 September 2020.

³⁰⁶ *ibid.*

³⁰⁷ CMA, 'Statutory audit services market study' (CMA 2019) pg 148.

³⁰⁸ *ibid.*

³⁰⁹ Han Donker, 'Joint audits and mutual ties of audit firm networks' (2020) 63(1) *Business Horizons* 435, 449.

³¹⁰ Refer to discussion in chapter two for more details.

³¹¹ Han Donker, 'Joint audits and mutual ties of audit firm networks' (2020) 63(1) *Business Horizons* 435, 449.

³¹² *ibid.*

³¹³ Companies Act 2006, section 485 and 489.

implemented in the UK, like in France which as a result can reduce audit failures, prevent corporate collapses and enhance the objective approach of auditors.

4.3 Separation of audit services and NAS

This section asserts that statutory auditors should concentrate solely in the audits of their client companies by showing professional scepticism rather than focusing on NAS which can have a negative impact in their objective approach as discussed in chapter two³¹⁴. To better achieve this outcome, an operational split between audit and NAS is required which involves different remuneration policies, management, governance practices and profit-sharing schemes.³¹⁵ This is further analysed below.

The principal purpose of this remedy is to ensure that the auditor's attention is fully vested in providing high quality audits to the client without being influenced by the lucrative non-audit work.³¹⁶ It will require a restructure in the audit firm's management such that there will be a separate CEO and board for audit services who will be monitored by the new audit regulator³¹⁷ mentioned in section 4.1. PwC has in fact already started adopting the proposed remedy which is designed to enhance its audit quality and governance.³¹⁸ The proposed remedy is also in accordance with EU Regulation³¹⁹ which forbids the statutory auditor to provide any prohibited NAS such as payroll tax and custom duties to the audited entity.³²⁰ Hence, this may create a healthy audit environment and improve transparency in the audit sector. The split between audit and NAS can further protect the independence of auditors, raise the standards of auditing and lessen the likelihood of conflict of interests.

In addition to the EU regulation mentioned above, the FRC's ethical standard stipulates that the audit partner must be informed about the probability of selling a NAS to an audit

³¹⁴ Refer to section 2.3 in chapter two for more details.

³¹⁵ CMA, 'Statutory audit services market study' (CMA 2019) Recommendation 3, pg 187.

³¹⁶ *ibid.*

³¹⁷ *ibid.*

³¹⁸ Tom Lemmon, 'PwC audit changes are unacceptable' (*Accountancy Age*, 7 June 2019) <<https://www.accountancyage.com/2019/06/07/pwc-audit-changes-are-unacceptable/>> accessed 1 October 2020.

³¹⁹ Regulation No 537/2014, Article 5.

³²⁰ *ibid.*

client as he will evaluate the consequences and threats this may have on the independence of statutory auditors.³²¹ If the proposed NAS is a high risk and will affect the independence of auditors then the audit firm can refuse to provide the additional service to the client or even terminate the audit engagement.³²² This was highlighted in the case of *Industrial and Commercial Bank of China v Ambani*³²³ as PwC had refused to audit the company.³²⁴

Historically, the separation of audit and offshore services has been adopted and proved to be effective in Mauritius after the Enron scandal.³²⁵ Thus, this can also have a positive effect in the quality of audit and reputation of audit firms if adopted fully in the UK as it shows that the audit firm is not influenced by the non-audit work which can be more profitable.

However, to achieve the best of this remedy, there must be a complete separation of both services internationally as audit firms often have a global presence. It is argued that although Big Four firms have supported this operational split, for instance not providing tax avoidance services to audit clients, there are several court cases which have demonstrated the contrary as there is always temptation to offer NAS to audit clients.³²⁶ The CA 2006³²⁷ does require disclosure of auditors' remuneration for the services rendered, yet this is not enough as it does not address the problem of auditors' independence being undermined or the negative effects of NAS to audit clients. Hence, to curb that temptation, there must be stricter and binding legal provisions enforced by parliament to separate both audit and NAS. Binding legal provisions will ensure that audit

³²¹ FRC, 'Ethical standard' (FRC 2019) pg 67.

³²² *ibid* pg 69.

³²³ [2020] EWHC 272 (Comm).

³²⁴ *ibid* [80]; Nikunj Ohri, 'Audit Regulator Probing Role Of Auditors Of Reliance Capital, Reliance Home Finance' (*Bloomberg Quint*, 23 January 2020) <<https://www.bloombergquint.com/business/audit-regulator-probing-role-of-auditors-in-reliance-capital-reliance-home-finance>> accessed 8 October 2020.

³²⁵ PwC, 'History' (*PwC Mauritius*, 1 January 2018) <<https://www.pwc.com/mu/en/about-us/our-history.html>> accessed 1 October 2020; Enron scandal has been discussed in more details in chapter two.

³²⁶ Tom Lemmon, 'PwC audit changes are unacceptable' (*Accountancy Age*, 7 June 2019) <<https://www.accountancyage.com/2019/06/07/pwc-audit-changes-are-unacceptable/>> accessed 1 October 2020; Refer to section 2.4 in chapter two for discussion about the court cases on tax avoidance schemes.

³²⁷ Companies Act 2006, section 494 (Refer to discussion in section 2.2 in chapter two).

firms are under the obligation to separate the provision of audit and NAS to audit clients which as a result will enhance the auditors' independence.

The upcoming section will aim to bring an improvement in the effectiveness of audit committees.

4.4 Increase the accountability of audit committees

Audit committees have an important role in ensuring that statutory auditors are independent, objective and able to perform high quality audits.³²⁸ However, as discussed in chapter three, there is a strong variation in the accountability and responsibilities of audit committees which have affected their oversight duties. Therefore, as a remedy, audit committees should be placed under intense scrutiny by the new audit regulator³²⁹ who can hold them accountable for their duties and improve their effectiveness.³³⁰

The proposed remedy will ensure that audit committees are fully empowered to challenge management and external auditors when required. Audit committees are already required 'to report to the board on how they have discharged their responsibilities.'³³¹ Therefore, the obligation to report to the board can be further extended to the new audit regulator who must have the authorities to supervise audit committees, for example monitoring their compliance with provision 25 of the UK Corporate Governance Code. To create or maintain a culture of transparency and fairness, the new regulator must be able to obtain any important information from audit committees when requested but also be able to assign an observer to the committee.³³² Chapter three has discussed the fact that some audit committees have been established mainly to fulfil a regulatory requirement without having the appropriate skills while others are confined under management power. If the new regulator scrutinises the work of audit committees then they are more likely to remain unconstrained from the company's management as they will be accountable to an

³²⁸ Refer to discussion in chapter three for more details.

³²⁹ Refer to section 4.1 in this chapter.

³³⁰ CMA, 'Statutory audit services market study' (CMA 2019) Recommendation 1, pg 132.

³³¹ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 25.

³³² CMA, 'Statutory audit services market study' (CMA 2019) pg 132.

independent audit body other than the FRC. The appointment and selection of members of audit committees will also be carried out in a transparent manner and in accordance with the code³³³. Hence, if members of the audit committees have the appropriate skills and experience then they will be in a better position to ensure that the independence of external auditors are not hindered. The development of a policy on the provision of audit and NAS (required by the code³³⁴) can also have a strong and positive effect in addressing the issue of audit failures if it is devised by a highly skilled and tough-minded audit committee rather than a committee which does not have sufficient competence in the domain.

Moreover, audit committees can be entrusted with the full responsibility to appoint external auditors. In the USA, the SOX 2002³³⁵ requires 'the audit committee to take full responsibility of the appointment, compensation and oversight of external auditors.'³³⁶ It has been effective in the USA as investors are reassured that the audit process is not impaired by conflict of interests between the board and the external auditor.³³⁷ Nonetheless, this is different in the UK as the CA 2006³³⁸ and UK Corporate Governance Code³³⁹ only allow audit committees to make recommendations to the board (discussed in chapter one³⁴⁰) rather being fully engaged in the external audit process. Hence, this legislation³⁴¹ can be implemented in the UK as the power to appoint external auditors will not be solely vested to the board which as a result can protect the independence of auditors and restore the confidence of investors. However, because independence is unobservable, this remedy can only be effective if members of the audit committee are themselves not influenced by the board. The new audit regulator can as such be empowered to monitor this external audit process closely with the audit committee.

³³³ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 24.

³³⁴ *ibid* provision 25.

³³⁵ The Sarbanes-Oxley Act (SOX) 2002 will be examined further in the next section of this chapter.

³³⁶ Sarbanes-Oxley Act 2002, section 301.

³³⁷ Jane Jollineau, 'Can Audit Committee Expertise Increase External Auditors' Litigation Risk?' (2020) 37(2) *Contemporary Accounting Research* 717, 740.

³³⁸ Companies Act 2006, sections 485 and 489.

³³⁹ FRC, 'The UK Corporate Governance Code' (FRC 2018) Provision 25.

³⁴⁰ Refer to section 1.1.2 in chapter one for more details.

³⁴¹ Sarbanes-Oxley Act 2002, section 301.

4.5 Sarbanes Oxley-style regime in the UK

The previous section has assessed the importance of s 301 of the SOX 2002 in empowering audit committees in the USA. The SOX 2002 which was passed in the aftermath of Enron scandal³⁴² aims to safeguard the interests of stakeholders from fraudulent financial reporting and audit failures.³⁴³ It has in fact been effective in the USA as auditors' independence have increased and there is a significant amelioration in the quality of audit.³⁴⁴ The UK can as such explore and adopt the benefits of this legislation which will be further examined below.

The SOX 2002 'prohibits auditors from providing certain services to public companies, for instance bookkeeping, actuarial, legal, broker-dealer and valuation services.'³⁴⁵ It is unlawful if accounting firms provide any of these NAS to their audit clients simultaneously.³⁴⁶ The prohibition of selling these NAS to audit clients can also be implemented in the CA 2006 as it will prevent statutory auditors from acting illegally which as a result can strengthen their independence and reduce the likelihood of audit failures.

Nevertheless, this may require strong supervision by the new audit regulator³⁴⁷ or currently the FRC to ensure its effectiveness. It must be noted that the FRC argued that it is in favour of a Sarbanes Oxley-style regime in the UK because it will bring a reform in the audit sector and enhance accountability within companies³⁴⁸, yet no progress appears to have been made for its implementation.

Moreover, the SOX 2002 requires 'statutory auditors to report in a timely manner to the audit committee about critical accounting practices to be used and alternative treatments

³⁴² Refer to discussion in chapter two for more details.

³⁴³ Jane Jollineau, 'Can Audit Committee Expertise Increase External Auditors' Litigation Risk?' (2020) 37(2) Contemporary Accounting Research 717, 740.

³⁴⁴ Shauna Steele, 'The Sarbanes-Oxley Act at 15: what has changed?' (*EY USA*, 21 June 2017.) <https://www.ey.com/en_us/public-policy/the-sarbanes-oxley-act-at-15-what-has-changed> accessed 6 October 2020.

³⁴⁵ Sarbanes-Oxley Act 2002, section 201.

³⁴⁶ Christiane Strohm, *United States and European Union Auditor Independence Regulation* (Springer Science & Business Media 2007) 54.

³⁴⁷ Mentioned in section 4.1 of this chapter.

³⁴⁸ Gavin Hinks, 'FRC chief indicates support for a UK version of Sarbanes-Oxley' (*Board Agenda*, 10 March 2020) <<https://boardagenda.com/2020/03/10/frc-chief-indicates-support-for-uk-version-sarbanes-oxley/>> accessed 6 October 2020.

of financial information which differ from generally accepted accounting principles.³⁴⁹ The accountant can also 'face up to 10 years in prison if found guilty of knowingly destroying or falsifying financial statements.'³⁵⁰ In contrast, in the UK, auditors are liable to a fine if they are found guilty of falsifying or manipulating the audit report.³⁵¹ The FRC, however, has stipulated that although it is in favour of a Sarbanes Oxley-style regime in the UK, it has no intention to replicate the same level of radical sanctions as in the USA.³⁵² Countries such as Canada, Japan, India and Germany have already adopted their own versions of SOX 2002.³⁵³ Thus, the UK can develop its own Sarbanes Oxley-style regime or perhaps incorporate the prohibition of certain NAS in the CA 2006 to safeguard the independence of auditors and upgrade the standard of financial reporting.

4.6 Conclusion

This chapter has discussed the remedies which can bring potential reforms in the audit sector in the UK. The establishment of a new audit regulator can be highly effective to address the issue of audit failures and the auditors' independence being compromised. The new regulator can as such be empowered to monitor the mandatory joint audit and the effectiveness of audit committees. However, there must be some amendments in the CA 2006 and UK Corporate Governance Code to prohibit the provision of certain NAS as discussed above. The UK can implement its own Sarbanes Oxley-style regime before another corporate collapse which can impair the future of the audit profession.

This dissertation will now proceed by providing a thorough conclusion about the outcome of its research focus and objectives.

³⁴⁹ Sarbanes-Oxley Act 2002, section 204.

³⁵⁰ *ibid* section 802.

³⁵¹ Companies Act 2006, section 507.

³⁵² Huw Jones, 'UK watchdog backs tougher Sarbanes Oxley-style rules for top companies' (*Thomson Reuters*, 9 March 2020) <<https://www.reuters.com/article/britain-accounts/uk-watchdog-backs-tougher-sarbanes-oxley-style-rules-for-top-companies-idUSL8N2B25QJ>> accessed 6 October 2020.

³⁵³ Michael Izza, 'The consequences surrounding internal control' (*ICAEW*, 4 October 2019) <<https://www.icaew.com/technical/audit-and-assurance/inquiry-into-audit/commentary-on-audit-reviews/the-consequences-surrounding-internal-control>> accessed 7 October 2020.

Conclusion

This dissertation has discussed the implications of selling NAS on the auditors' independence. Auditors are strongly recognised for their input in the audits of financial statements. However, there are shortcomings in the regulatory structure for auditing which have jeopardised their independence and urged for radical reforms. The audit market is being dominated by the Big Four firms due to lack of competition. The effectiveness of regulatory bodies has also been in the limelight following the rise in audit failures and financial scandals.

Chapter two has ascertained that auditors are using the statutory audit requirement as a loss-leader strategy to obtain a foothold in the client's company and sell lucrative NAS to boost their remuneration. The sale of NAS can have positive or even no effect on the auditors' independence and quality of audit. Nevertheless, the negative effects usually outweigh the positive ones. The collapse of BHS shows that auditors are financially dependent on their clients and are engaging in anti-social practices which can compromise their independence and integrity. Moreover, the provision of tax avoidance schemes to audit clients can generate additional income to accounting firms, but it can also lead to leakage of confidential information from the audit department to the non-audit department. Yet, the movement of such information or files in accounting firms remain unknown. There is no transparency and fairness.

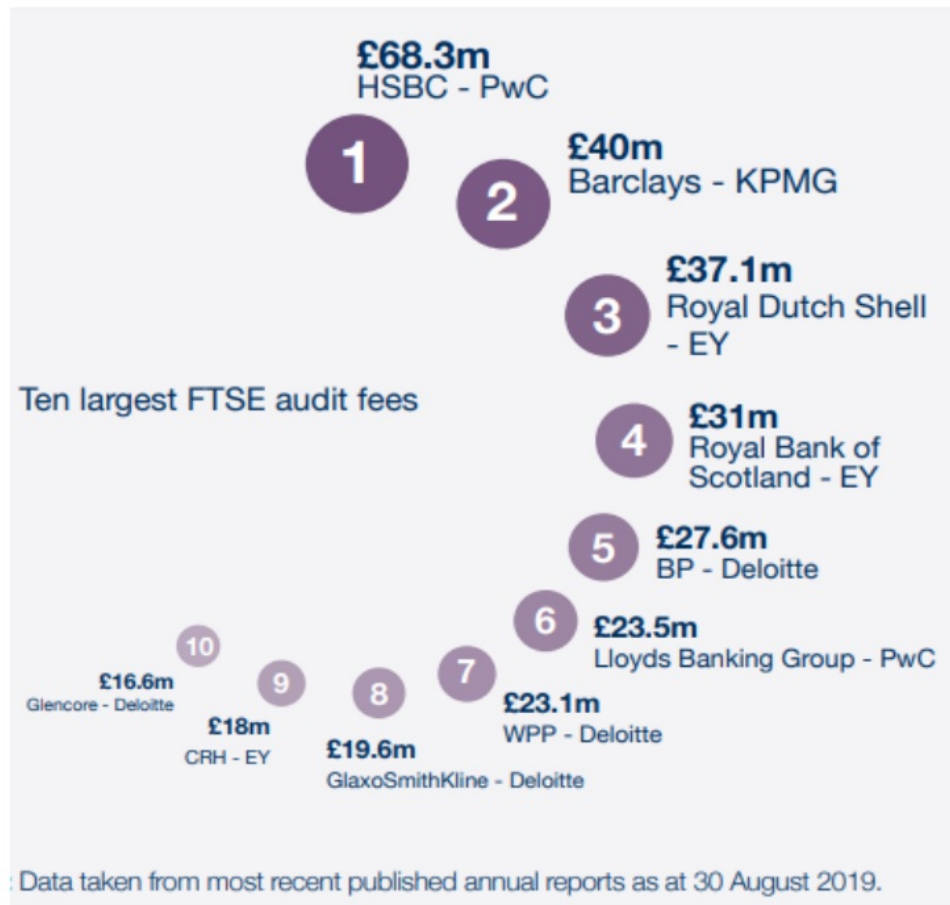
In addition, some audit committees are established simply because it is a regulatory requirement which requires fulfilment. Members of the audit committees are confined under management power. However, as a remedy, the accountability of audit committees can be increased which will improve their effectiveness and empower them to better manage audit discrepancies. The committee can take full responsibility of the appointment and remuneration of external auditors which will ultimately be monitored by the new audit regulator. This can be a major progress in enhancing the independence of auditors as power will not be concentrated in the hands of directors solely.

The audit sector in the UK is in need of reforms to address the issue of audit failures and raise the standards of corporate governance. The FRC should be replaced with a new independent audit regulator which will have the responsibility and authority to regulate the whole external audit process. The mandatory joint audit must be adopted to break the market concentration which as such will lead to greater knowledge sharing among accounting firms and improve the quality of audits. Furthermore, parliament must legislate stricter rules to prohibit the provision of certain NAS to audited entities which can undermine the independence of auditors. The implementation of a Sarbanes Oxley-style regime in the UK must also be considered as it has proved to be successful in the USA. Hence, this can strengthen the auditors' independence and produce high quality audits.

The audit profession still remains an admirable and rewarding career. Parliament and regulatory bodies must act now to bring reforms in the audit sector otherwise the public will lose faith on the reliability and authenticity of financial statements.

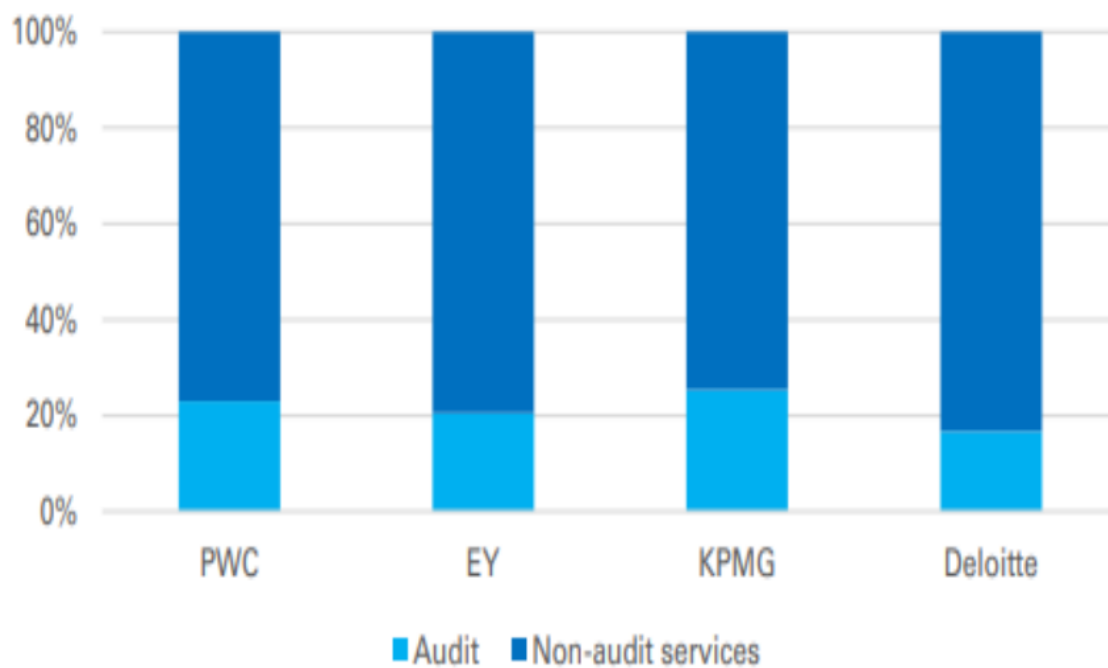
Appendices

Appendix One: Top ten companies with the largest audit fees.³⁵⁴



³⁵⁴ FRC, 'Developments in Audit' (FRC 2019) 38 A1.8.

Appendix Two: Aggregate revenue obtained by each Big Four firm.³⁵⁵



³⁵⁵ CMA, 'Statutory audit services market study' (CMA 2019) Provision 2.35.

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IFRS Standards
International Accounting Standards
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UK Government, 'Sir John Kingman Independent review of the Financial Reporting Council' (UK Government 2018)

UK Government, 'Sir Tony Redmond Independent review of the effectiveness of external audit' (UK Government 2019)

Marked Research Proposal³⁵⁶

UNIVERSITY OF PORTSMOUTH

**Proposed Title: A critical analysis of auditors' independence
and responsibilities in corporate governance.**
*in the
UK?*

Name: Baboo Kunalsing Askurn

Student number: UP947668

Course: LLM Corporate Governance and Law/Grad CG (FT)

Supervisor: Dr Joanne Atkinson

Word count: 1960

³⁵⁶ Submitted on 2nd March 2020.

Introduction

The demise of Arthur Andersen and other financial scandals have raised pertinent questions on the independence and responsibilities of auditors in informing different stakeholders such as investors and the general public of the realities of corporate malpractice. Sections 485 and 489 of the CA 2006¹ require both public and private companies to appoint an auditor unless the directors decide otherwise. Auditor's independence refers to 'the reliability, integrity and the objective approach in the audit profession'². However, the auditor's independence is materially impaired if he fails to exercise unbiased judgment or has been significantly influenced for a particular gain to distort the financial figures and quality of the audit. A lack of independence will generally lead to an impractical audit report which will mainly affect investors who may not be willing to inject further capital in the company. Concerns and deficiencies in corporate governance mechanisms have led to the development of regulatory reform which requires adherence to the 'International Code of Ethics for Professional Accountants'³ and the 'FRC Ethical Standard for Auditors'⁴. However, the potential loss of independence is undermining transparency following the rise in financial scandals. In the absence of effective regulatory and corporate governance regimes, the audit profession is still a widely acknowledged role in the world. Therefore, this research proposal shall examine the independence and responsibilities of auditors as a correlate to financial scandals and corporate governance.

A clear introduction

Importance of the topic

There are various challenges which can compromise an auditor's independence in the auditing profession. Concerns are expressed regarding the manner in which an auditor receives and evaluates information. Accounting firms may strongly be influenced by a client company to provide reference favourable opinions in the audit report in order to maintain a healthy working relationship between both parties despite the existence of corporate governance standards. The economic

¹ CA 2006, sections 485 and 489.

² (-), 'Auditor Independence' (*The Institute of Chartered Accountants in England and Wales's website*, 2 June 2016) <<https://www.icaew.com/technical/ethics/auditor-independence/auditor-independence-approach>> accessed 1 March 2020.

³ (-), 'The International Code of Ethics for Professional Accountants' (*International Federation of Accountants' website*, 12 Sept 2018) <<https://www.ifac.org/knowledge-gateway/building-trust-ethics/discussion/international-code-ethics-professional>> accessed 1 March 2020.

⁴ (-), 'Revised Ethical Standard 2019' (*Financial Reporting Council's website*, 15 July 2019) <<https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/current-ethical-standards>> accessed 1 March 2020.

consequence of a negligent audit is usually associated to lack of skill, diligence and care on behalf of the auditor⁵. Auditors have faced various criticisms in recent years due to the failure to identify financial issues at some of the world renowned companies⁶. A study conducted by the Financial Reporting Council in 2018 found that there has been a downturn in the quality of audit across the 'Big four auditors – PwC, KPMG, Deloitte and Ernst & Young'⁷. Hence, this may negatively affect shareholders' reliance on audit opinions and it contests the integrity and objectivity of the audit process. In addition, an accounting firm may charge audit fees which is below the market rate and eventually compensate the shortfall by offering non-audit services such as deals advisory, tax, management and legal services⁸.

Research objectives

- To discuss the provision of audit and non-audit services to client companies.
- To investigate the link that exists between auditors' independence and financial scandals.
- To assess the effectiveness of corporate governance standards in ensuring auditors' independence. *Discuss the recommendations in the UK Corporate Governance Code.*
- To analyse the impact of audit fees and rotation on the quality of audit.
- To examine the factors which can affect the effectiveness of audit committees.
- To make a comparative analysis between the United Kingdom and other commonwealth countries on measures taken to substantiate corporate governance standards in the auditing field. *which countries in particular?*

⁵ Simon Finley, 'Auditor liability: 'fair and reasonable' punishment?' (2008) 1 ACCA - Technical Articles.

⁶ Jasper Jolly, 'Decline in quality: auditors face scrutiny over string of scandals' (*The Guardian*, 1 Feb 2019) <<https://www.theguardian.com/business/2019/feb/01/decline-in-quality-auditors-face-scrutiny-over-string-of-scandals>> accessed 1 March 2020.

⁷ Ibid.

⁸ (-), 'The Importance Of Auditor Independence' (*Pearse Trust*, 23 Nov 2016) <<https://www.pearse-trust.ie/blog/the-importance-of-auditor-independence>> accessed 15 February 2020.

⁹ (-), 'Auditor Independence' (*The Institute of Chartered Accountants in England and Wales's website*, 2 June 2016) <<https://www.icaew.com/technical/ethics/auditor-independence/auditor-independence-approach>> accessed 1 March 2020.

Preliminary dissertation structure

The study consists of four chapters as outlined below:

A logical structure

Chapter One: Auditor independence

This chapter provides an insight into the research. It considers the importance of auditor independence and identifies the threats arising from audit and non-audit services. It further examines the relevant academic literature and fundamental principles regarding the auditor-client relationship including an overview of the audit profession and the big four audit firms. The correlation between auditors' independence and financial scandals is discussed taking into account the integrity and reliance of auditors.

Chapter Two: Auditor remuneration and audit quality

The purpose of this chapter is to determine auditors' remuneration and analyse its impact on audit quality. It reviews the literature and other appropriate sources leading to a thorough discussion in the identification of gaps between both. The demand for audit, audit quality attributes, audit rotation and effectiveness will also be examined in this chapter.

Chapter Three: The effectiveness of audit committee

This chapter analyses the role and effectiveness of audit committees in corporate governance. It explores the factors that both enable and inhibit the audit practice. The agency theory and institutional theory will be discussed as a basis of the current research.

Chapter Four: Audit regulatory reforms

The focus of this chapter is to explore the various auditor independence regulations and corporate governance mechanisms when performing an audit. The effectiveness of regulatory reforms from both local and international bodies will be discussed taking into account the different theories, principles and magnitude of the benefits. A comparative analysis will be made regarding the law in the United Kingdom and other commonwealth countries.

Literature review

Reports: The relationship between audit and non-audit services

Historical research has found that the link between audit and non-audit services is enigmatic¹⁰. The provision of non-audit services by auditors is controversial with the view that these consultancy services are offered as an inducement to client companies because they are contemplated to be more profitable¹¹. In July 2019, the FRC reported that '27 percent of FTSE350 audits needed improvement'¹². The 'loss leader' argument stipulates that 'there is a negative relationship between audit fees and non-audit fees'¹³. Generally, this means that a lower audit fee is charged by the accountancy firm in order to obtain a foothold in the client's organisation and eventually negotiate for higher rates by providing non-audit services to the client company. This will be used to offset the losses incurred on the audit fees¹⁴. Therefore, this is deemed to be a threat to auditor independence. It must be noted that in the banking sector, 70 percent of the fees that are paid to auditors come from non-audit services¹⁵. Moreover, in 2000, the big four received 50% of their income from non-audit services compared to 13 percent in 1981¹⁶. However, following a seminal study on knowledge spillovers¹⁷, it is found that conducting an audit will more likely improve the quality of non-audit services delivered to the same client. In this case, the negative relationship does not essentially undermine auditor independence.

The Brydon report¹⁸ clearly states that the accountancy firm must ensure that there is a separation between the team who negotiates the audit fees and the team who conducts the audit. In 2018, KPMG announced that it would stop the provision of non-audit services to FTSE 350 companies

¹⁰ David Hay, 'Non-Audit Services and Auditor Independence' (2006) 33(5) *Journal of Business Finance & Accounting* 715, 717.

¹¹ Benito Arrunada, *The Economics of Audit Quality* (Springer Science & Business Media 2013) 109.

¹² (-), 'Statutory audit services market study' (*Competition & Markets Authority*, 18 April 2019) <https://assets.publishing.service.gov.uk/media/5cb74577e5274a7416b64f01/final_summary_report.pdf> accessed 18 Feb 2020.

¹³ Ismail Adelopo, *Auditor Independence: Auditing, Corporate Governance and Market Confidence* (Routledge 2016) 102.

¹⁴ *ibid.*

¹⁵ Krishnan Loganathan, 'Examining the threat to auditors' independence' (2019) 30(2) *International Company And Commercial Law Review* 103, 117.

¹⁶ *Ibid.*

¹⁷ Krishnan Gopal, 'Further evidence on knowledge spillover and the joint determination of audit and non-audit fees' [2011] 26(3) *Managerial Auditing Journal* 230, 247.

¹⁸ Sir Donald Brydon, 'Report of the independent review into the quality and effectiveness of audit' (*UK Government's website*, 9 Dec 2019) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/brydon-review-final-report.pdf> accessed 24 Feb 2020.

in order to eliminate the possibilities of conflict of interest¹⁹. The firm was thoroughly criticised for its audit of Carillion²⁰ and presently earns less income from non-audit services compared to its competitors. In 2017, KPMG earned £198m in audit and £79m in non-audit fees²¹. It is argued that disclosure should be made to stakeholders if there is a conflict of interest between audit and non-audit services. Alternatively, there should be a prohibition to auditors to provide non-audit services to audit clients²².

The role and effectiveness of the audit committee is highly criticised as a result of the financial crisis. In the PCBS report²³, auditors were described 'as cheerleaders for questionable reporting in bank accounts'²⁴. The internal audit team was blamed for not being reliable and unbiased. The European Commission Green Paper came with similar conclusions in 2010²⁵. Furthermore, the PCBS report argued that the responsibilities of the risk compliance and internal audit had become vague.

Statutes and regulations

There are various regulations regarding the responsibilities and independence of auditors. The Companies Act 2006 sets out the role of the audit committee with regards to auditor appointments, rotation and competitive tendering. In addition, the Bribery Act 2010 provides details on the major offences of paying or receiving a bribe. It must be noted that the Act can be utilised as a defence if organisations can prove that they have taken relevant measures to prevent any wrongdoings²⁶.

which
sections?

Again, be more
specific
here.

¹⁹ Jasper Jolly, 'KPMG to drop non-audit services for its FTSE 350 clients' (*The Guardian*, 8 Nov 2018) <<https://www.theguardian.com/business/2018/nov/08/kpmg-to-drop-non-audit-services-for-its-ftse-350-clients>> accessed 2 March 2020.

²⁰ Daniel Thomas, 'Where did it go wrong for Carillion?' (*The BBC News*, 15 Jan. 2018) <<https://www.bbc.co.uk/news/business-42666275>> accessed 2 March 2020.

²¹ Jasper Jolly, 'KPMG to drop non-audit services for its FTSE 350 clients' (*The Guardian*, 8 Nov 2018) <<https://www.theguardian.com/business/2018/nov/08/kpmg-to-drop-non-audit-services-for-its-ftse-350-clients>> accessed 2 March 2020.

²² Krishnan Gopal, 'Further evidence on knowledge spillover and the joint determination of audit and non-audit fees' [2011] 26(3) *Managerial Auditing Journal* 230, 247.

²³ Parliamentary commission on banking standards, 'Changing banking for good' (*Parliament's UK*, 1 June 2013) <<https://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf>> accessed 2 March 2020.

²⁴ Jake Green, 'Corporate governance in financial institutions' (2017) 146(1) *Compliance Officer Bulletin* 1, 30.

²⁵ Claudio Flores, 'New trends in auditor liability' (2011) 12(3) *European Business Organisational Law Review* 415, 436.

²⁶ Anil Rajani, 'Bribery Act 2010: implications for accountants' (*Accounting's website*, 12 April 2011) <<https://www.accountingweb.co.uk/business/finance-strategy/bribery-act-2010-implications-for-accountants>> accessed 2 March 2020.

There are also regulations passed by professional accounting bodies such as the International Accounting Standards and the International Financial Reporting Standards which relate to the audit of financial statements. The ICAEW's code of ethics²⁷ require all its members to be objective in their professional duties. However, this code may often be ignored by auditors due to the threat of maintaining a close relationship with the client company. The Ethical Standard for Auditors issued by the Financial Reporting Council explores the principal-agent relationships and addresses the issue of conflicts of interests which may arise between the directors and auditors.

*The Corporate Governance
Code?*

Case Law

In the case of *Sports Direct International Plc v The Financial Reporting Council*²⁸, an appeal was made by Sports Direct against an order to disclose some documents to the FRC relating to the conduct of its former auditor, Grant Thornton UK LLP. Notice was given to the appellant under the Statutory Auditors and Third Country Auditors Regulations 2016 Sch.2. The investigation by FRC relates to the audit of Sports Direct's financial statements for the year ended 26 April 2016 whereby disclosure was not made regarding the relationship between an entity called Barlin Delivery Ltd and Sports Direct in the group's account. The court stated that disclosure of documents which are relevant to the pleaded issues must be made as per the ordinary civil procedure. This case explores the different stages to be followed when an auditor is accused of breaching the rules.

*any other
cases?*

Research methodology

The doctrinal, theoretical and comparative approach will be used for this research. The doctrinal methodology 'which is also known as black-letter law is research into legal concept and principle of all types of case, statutes and rules'²⁹. It focuses on the interpretation of appropriate primary and secondary sources of law and provide indications as to how the law may evolve. The

²⁷ (-), 'Auditor Independence' (*The Institute of Chartered Accountants in England and Wales's website*, 2 June 2016) <<https://www.icaew.com/technical/ethics/auditor-independence/auditor-independence-approach>> accessed 1 March 2020.

²⁸ [2020] EWCA Civ 177.

²⁹ Vijay Gawas, 'Doctrinal legal research method a guiding principle in reforming the law and legal system towards the research development' (2017) 3(5) *International Journal of Law* 128, 130.

theoretical approach 'determines a set of principles upon which the law should be based'³⁰. It justifies the research objectives by identifying the gaps or issues in existing research. On the other hand, comparative research 'compares the similarities and differences of laws in one country to that of another country'³¹. This research will make a comparative analysis of the laws in the United Kingdom and other commonwealth countries with respect to the corporate governance mechanisms in ensuring the independence of auditors. *You also need to justify why these countries are chosen for comparison in your dissertation.*

Research timetable

Action	Timeframe (Approx)
Preliminary research on the subject area.	End of May 2020 to beginning of June 2020.
Drafting of chapter one.	From 5 th June 2020 to 14 th June 2020.
Submission of chapter one to supervisor.	14 th June 2020 (Mid of June 2020).
Drafting of chapter two while supervisor reviews my chapter one.	15 th June 2020 to 26 th June 2020.
Submission of chapter two to supervisor.	26 th June 2020 (End of June 2020)
Review of chapter one after receiving comments from supervisor.	From 27 th June 2020 to 4 th July 2020.
Drafting of chapter three while supervisor reviews my chapter two.	From 5 th July 2020 to 16 th July 2020.
Submission of chapter three to supervisor.	16 th July 2020 (Mid of July 2020).
Review of chapter two after receiving comments from supervisor.	From 17 th July 2020 to 25 th July 2020.
Drafting of chapter four while the supervisor reviews my chapter three.	From 26 th July 2020 to 7 th August 2020.
Submission of Chapter four to supervisor.	7 th August 2020.
Review of chapter three after receiving comments from supervisor.	From 8 th August 2020 to 16 th August 2020.

³⁰ Lynne Taylor, 'Legal Writing: A Complete Guide for a Career in Law' (*Learn Law Life*, 21 Aug 2017) <<https://learnlawlife.co.nz/2017/08/21/writing-a-legal-research-paper-research-methodologies/>> accessed 17 Feb 2020.

³¹ (-), 'Approaching Foreign and Comparative Legal Research' (*The University of Melbourne's library guide*, 18 Feb 2020) <<https://unimelb.libguides.com/c.php?g=827279&p=5906166#s-lg-box-18751420>> accessed 2 March 2020.

Review of Chapter four after receiving comments from supervisor.	From 17 th August 2020 to 29 th August 2020.
Writing the conclusion, table of contents, list of tables and thorough proofreading. Revision of all the chapters.	From 30 th August 2020 to 4 th September 2020.
Final proofreading and dissertation submission on Moodle.	5 th September 2020. My aim is to complete the dissertation by end of August 2020.

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Ethical opinion form for Faculty of Business and Law (BAL) taught undergraduate and postgraduate students (except MRes)

Instructions to student

This form should be completed by the student, referring to the Guidance Notes to accompany this form and the 'Research ethics – issues to consider' guide (also to be found as an appendix to the Guidance Notes). If you are not collecting primary data or data that are identifiable with individuals, then you should answer Qs 1-4, then Q11 and as many of the questions between Qs 12-20 as are relevant in your case. The completed form should then be passed to the supervisor prior to a review of the possible ethical implications of the proposed dissertation or project. Students should read the guidance that accompanies this form to help them complete it.

No primary data collection or recruitment of potential participants must be undertaken before a final version of this form has been approved.

If, following review of this form, amendments to the proposals are agreed to be necessary, the student should provide the supervisor with an amended version for endorsement.

If, following the completion of the review process, your supervisor and, where relevant, any independent reviewer is unwilling to grant you a favourable ethical opinion, you have a right of appeal to BAL Faculty Ethics Committee. If you wish to exercise this right, email the Faculty Ethics Administrator (email address available from your supervisor), stating your name, HEMIS no., the relevant unit and course, and briefly stating your grounds for requesting that BAL Faculty Ethics Committee review the decision. Attach your completed ethics form and any supplementary documentation and include any relevant correspondence about the case.

A final signed and dated version of this form must be bound in to however many copies of the dissertation you are required to hand in. The form MUST be signed and dated by both the student, the supervisor and, where required, any peer ethics reviewer. If the dissertation is submitted without a fully completed, signed and dated ethics form it will be deemed to be a fail. Second attempt assessment may be permitted by the Board of Examiners.

1. What are the objectives of the dissertation / research project?
 - To discuss the provision of audit and non-audit services to client companies.
 - To investigate the link that exists between auditors' independence and financial scandals.
 - To assess the effectiveness of corporate governance standards in ensuring auditors' independence.
 - To analyse the impact of audit fees and rotation on the quality of audit.
 - To examine the factors which can affect the effectiveness of audit committees.
 - To make a comparative analysis between the United Kingdom and other commonwealth countries on measures taken to substantiate corporate governance standards in the auditing field.

2. Does the research involve *NHS patients, resources or staff*? YES / NO (please delete as applicable).

No

3. Does the research involve MoD staff? YES / NO (please delete as applicable).

No

4. Do you intend to collect *primary data* from human subjects or data that are identifiable with individuals? (This includes, for example, questionnaires and interviews.) YES / NO (please delete as applicable)

No

5. How will the primary data contribute to the objectives of the dissertation / research project?

N/A

6. What is/are the *survey population(s)*?

N/A

7. a) How big is the *sample* for each of the survey populations, and b) how was this sample arrived at? (Please answer *both* parts of this question.)

N/A

8. How will respondents be a) *recruited* and b) *selected*? (Please answer *both* parts of this question.)

N/A

9. What steps are proposed to ensure that the requirements of *informed consent* will be met for those taking part in the research? If an Information Sheet for participants is to be used, please attach it to this form. If not, please explain how you will be able to demonstrate that informed consent has been gained from participants. N/A

10. How will *data* be *collected* from each of the sample groups?

N/A

11. a) How will *data* be *stored* and b) what will happen to the data at the end of the research?
(Please answer *both* parts of this question.)

(a) All data will be stored according to the University's policy.

(b) The dissertation will be stored according to the University's regulation but shall be made publicly available if required.

12. What measures will be taken to prevent unauthorised persons gaining access to the data, and especially to data that may be attributed to identifiable individuals?

The data will be stored on my personal computer and google drive account with password protected.

13. What steps are proposed to safeguard the *anonymity* of the respondents?

N/A

14. Are there any *risks* (physical or other, including reputational) *to respondents* that may result from taking part in this research? YES / NO (please delete as applicable).

If YES, please specify and state what measures are proposed to deal with these risks.

N/A

15. Are there any *risks* (physical or other, including reputational) *to the researcher or to the University* that may result from conducting this research? YES / NO (please delete as applicable).

If YES, please specify and state what measures are proposed to manage these risks.

No

16. Will any *data* be *obtained from a company or other organisation*? YES / NO (please delete as applicable) For example, information provided by an employer or its employees.

If NO, then please go to question 19.

Yes – only publicly available data such as reports will be used.

17. What steps are proposed to ensure that the requirements of *informed consent* will be met for that organisation? How will *confidentiality* be assured for the organisation?

N/A

18. Does the organisation have its own ethics procedure relating to the research you intend to carry out? YES / NO (please delete as applicable).

If YES, the University will require written evidence from the organisation that they have approved the research.

N/A

19. Will the proposed research involve any of the following (please put a ✓ next to 'yes' or 'no'; consult your supervisor if you are unsure):

- | | | | | |
|---|-----|--------------------------|----|-------------------------------------|
| • Vulnerable groups (e.g. children and adults unable to consent)? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Particularly sensitive topics? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Access to respondents via 'gatekeepers'? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Use of deception? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Access to confidential personal data (names, addresses, etc)? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Psychological stress, anxiety, etc.? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Intrusive interventions? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |

If answers to any of the above are "YES", please explain below how you intend to minimise the associated risks.

20. Are there any other ethical issues that may arise from the proposed research?

N/A

BAL TAUGHT STUDENT ETHICAL OPINION FORM v.4.2 2017

	Print name	Signature	Date signed
Student	Baboo Kunalsing Askurn	Baboo Kunalsing Askurn	01.02.2020

I / we grant a favourable ethical opinion:

Supervisor	<i>Fang Ma FM</i> 01/04/2020
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Peer reviewer (where applicable)	
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AMENDMENTS

If you need to make changes please ensure you have permission before recruiting any participants and any primary data collection. If there are major changes, fill in a new form if that will make it easier for everyone. If there are minor changes then fill in the amendments (next page) and get them signed before the primary data collection begins.

CHANGES TO ETHICS PERMISSION

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BAL TAUGHT STUDENT ETHICAL OPINION FORM v.4.2 2017

Print name

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Baboo Kunalsing Askurn - UP947668 - Research Proposal

GRADEMARK REPORT

FINAL GRADE

62/100

GENERAL COMMENTS

Instructor

This proposal is well written and clearly structured. It aims to evaluate auditors' independence and responsibilities in corporate governance. It is an interesting and current topic for a PG dissertation. The title should be further refined.

It shows evidence of preliminary research on the chosen topic. It demonstrates that you are aware of the key primary and secondary sources.

It is well supported by sources and most of the references comply with OSCOLA.

The methodology and chapter structure are clear but some statements are quite general. In terms of the content, the UK Corporate Governance Code should be discussed in more depth.

Overall, this is a solid dissertation proposal.

Fang Ma

PAGE 1

Text Comment. in the UK?

PAGE 2

Text Comment. A clear introduction

Text Comment. reference?

PAGE 3



Comment 1

combine these two footnotes into one - fn 8

Text Comment. Discuss the recommendations in the UK Corporate Governance Code.

Signed Ethics Form

Ethical opinion form for Faculty of Business and Law (BAL) taught undergraduate and postgraduate students (except MRes)

Instructions to student

This form should be completed by the student, referring to the Guidance Notes to accompany this form and the 'Research ethics – issues to consider' guide (also to be found as an appendix to the Guidance Notes). If you are not collecting primary data or data that are identifiable with individuals, then you should answer Qs 1-4, then Q11 and as many of the questions between Qs 12-20 as are relevant in your case. The completed form should then be passed to the supervisor prior to a review of the possible ethical implications of the proposed dissertation or project. Students should read the guidance that accompanies this form to help them complete it.

No primary data collection or recruitment of potential participants must be undertaken before a final version of this form has been approved.

If, following review of this form, amendments to the proposals are agreed to be necessary, the student should provide the supervisor with an amended version for endorsement.

If, following the completion of the review process, your supervisor and, where relevant, any independent reviewer is unwilling to grant you a favourable ethical opinion, you have a right of appeal to BAL Faculty Ethics Committee. If you wish to exercise this right, email the Faculty Ethics Administrator (email address available from your supervisor), stating your name, HEMIS no., the relevant unit and course, and briefly stating your grounds for requesting that BAL Faculty Ethics Committee review the decision. Attach your completed ethics form and any supplementary documentation and include any relevant correspondence about the case.

A final signed and dated version of this form must be bound in to however many copies of the dissertation you are required to hand in. The form MUST be signed and dated by both the student, the supervisor and, where required, any peer ethics reviewer. If the dissertation is submitted without a fully completed, signed and dated ethics form it will be deemed to be a fail. Second attempt assessment may be permitted by the Board of Examiners.

1. What are the objectives of the dissertation / research project?

- To examine the regulatory structure for auditing in the UK.
- To assess the impact of market concentration and remuneration of auditors on the quality of audit and auditors' independence.
- To investigate the relationship between the provision of audit and non-audit services on auditors' independence, with a particular attention on audit failures and financial scandals.

- To analyse the factors which can affect the effectiveness of audit committees.
- To discuss reforms in the audit sector which can improve the quality of audit and strengthen the auditors' independence.

2. Does the research involve *NHS patients, resources or staff*? YES / NO (please delete as applicable).

No

3. Does the research involve MoD staff? YES / NO (please delete as applicable).

No

4. Do you intend to collect *primary data* from human subjects or data that are identifiable with individuals? (This includes, for example, questionnaires and interviews.) YES / NO (please delete as applicable)

No

5. How will the primary data contribute to the objectives of the dissertation / research project?

N/A

6. What is/are the *survey population(s)*?

N/A

7. a) How big is the *sample* for each of the survey populations, and b) how was this sample arrived at? (Please answer *both* parts of this question.)

N/A

8. How will respondents be a) *recruited* and b) *selected*? (Please answer *both* parts of this question.)

N/A

9. What steps are proposed to ensure that the requirements of *informed consent* will be met for those taking part in the research? If an Information Sheet for participants is to be used, please attach it to this form. If not, please explain how you will be able to demonstrate that informed consent has been gained from participants. N/A

10. How will *data* be *collected* from each of the sample groups?

N/A

11. a) How will *data* be *stored* and b) what will happen to the data at the end of the research? (Please answer *both* parts of this question.)

(a) All data will be stored according to the University's policy.

(b) The dissertation will be stored according to the University's regulation but shall be made publicly available if required.

12. What measures will be taken to prevent unauthorised persons gaining access to the data, and especially to data that may be attributed to identifiable individuals?

The data will be stored on my personal computer and google drive account with password protected.

13. What steps are proposed to safeguard the *anonymity* of the respondents?

N/A

14. Are there any *risks* (physical or other, including reputational) *to respondents* that may result from taking part in this research? YES / NO (please delete as applicable).

If YES, please specify and state what measures are proposed to deal with these risks.

N/A

15. Are there any *risks* (physical or other, including reputational) *to the researcher or to the University* that may result from conducting this research? YES / NO (please delete as applicable).

If YES, please specify and state what measures are proposed to manage these risks.

No

16. Will any *data* be *obtained from a company or other organisation*? YES / NO (please delete as applicable) For example, information provided by an employer or its employees.

If NO, then please go to question 19.

No

17. What steps are proposed to ensure that the requirements of *informed consent* will be met for that organisation? How will *confidentiality* be assured for the organisation?

N/A

18. Does the organisation have its own ethics procedure relating to the research you intend to carry out? YES / NO (please delete as applicable).

If YES, the University will require written evidence from the organisation that they have approved the research.

N/A

19. Will the proposed research involve any of the following (please put a ✓ next to 'yes' or 'no'; consult your supervisor if you are unsure):

- | | | | | |
|---|-----|--------------------------|----|-------------------------------------|
| • Vulnerable groups (e.g. children and adults unable to consent)? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Particularly sensitive topics? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Access to respondents via 'gatekeepers'? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |
| • Use of deception? | YES | <input type="checkbox"/> | NO | <input checked="" type="checkbox"/> |

- Access to confidential personal data (names, addresses, etc)? YES ☐ NO ☒
- Psychological stress, anxiety, etc.? YES ☐ NO ☒
- Intrusive interventions? YES ☐ NO ☒

If answers to any of the above are "YES", please explain below how you intend to minimise the associated risks.

20. Are there any other ethical issues that may arise from the proposed research?

N/A

	Print name	Signature	Date signed
Student	Baboo Kunalsing Askurn	Baboo Kunalsing Askurn	08.10.2020

I / we grant a favourable ethical opinion:

Supervisor	Fang Ma 08/10/2020	Fang Ma
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Peer reviewer
(where applicable)

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Peer reviewer
(where applicable)

FINAL GRADE

72/100

GENERAL COMMENTS

Instructor

This dissertation explores the provision of non-audit services to audit clients in the UK with particular focus on auditors' independence and future reforms. This is a current and suitable topic for PG dissertation.

It is written in lucid English, with a clear, logical and coherent structure. It is well presented with clear headings and sub-headings.

The introductory chapter states the research objectives and chapter outline.

Chapter 1 provides the regulatory framework of audit in the UK. It focuses on the appointment and qualification of directors, effectiveness of audit reports as well as the roles and responsibilities of directors in auditing. This chapter is well supported by research sources.

Chapter 2 considers the impact of NAS on auditors' independence by examining the causes of financial scandals and audit failures. The arguments flow well and the are well supported.

Chapter 3 assesses the effectiveness of audit committees in strengthening auditor independence and Chapter 4 puts forward reform proposals including a comparative analysis between the UK and USA. The reform proposals are well analysed. The problems or drawbacks of these new proposals could be analysed in more depth.

This dissertation provides a comprehensive discussion of the major issues on auditor independence. It demonstrates depth and breadth of research. It effectively evaluates the relevant academic sources and reasoned conclusions are drawn based upon the supported arguments.

Overall, this is an excellent piece of research. It is well supported by a large body of primary and secondary sources. Compared with the previous draft chapters, this final draft has improved considerably in terms of the flow of arguments and analysis.

Well done!

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