

CORPORATE SOCIAL RESPONSIBILITY SERIES



# Auditor Independence

Auditing, Corporate  
Governance and  
Market Confidence

ISMAIL ADELOPO

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and Market Confidence

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GOWER

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# Auditor Independence

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# Corporate Misbehaviour and Corporate Governance

As the modern firm or corporation we know today evolved, the information gap created by the separation of corporate ownership from management produced the demand for both internal and external forms of control and monitoring (Weir et al., 2002; Walsh and Seward, 1990). This has been achieved internally through the Board of directors and externally through the report of the external auditors. Auditors' reports certify the accounts of stewardship prepared by the management for the shareholders. Agency Theory applied to corporate behaviour has been unequivocal about the array of conflicts of interest that tend to manifest themselves where ownership is separated from management (Berle and Means, 1932). These conflicts affect diversification decisions, investment decisions, remuneration decisions and management behaviour during takeover and anti-takeover situations (Denis et al., 2002). The objective function in these scenarios has been said to be how to minimize agency cost and consequently maximize the return to residual claimants (Jensen and Meckling, 1976).

However, recent times have seen huge and perhaps unprecedented waves of corporate misbehaviour. These have adversely affected confidence in the market system, and key players in the market have had to respond quickly and with an approach indicating competence and a broad understanding of the causes, as well as an apt appreciation of the solutions to the problems arising. The restoration of confidence in the market system, following the adverse consequences of corporate failures and financial crises is critical.

A cursory glance at Corporate Governance guidelines produced in the wake of these events, especially the corporate failures of ENRON and other colossal organizations, suggests a significant anticipated role for Audit Committees. Although Audit Committees have been in existence, at least in the UK, since the 1970s, they have not been nearly as prominent (Collier, 1993) and have not

enjoyed as much legitimacy as is the case now (Rezaee, 2009). According to the Cadbury Report (1992), Audit Committees should be important governance mechanisms that protect the interests of the shareholders, ensure transparent reporting and improve audit quality. Despite this confidence, there are doubts expressed by some academics about the ability of an Audit Committee to perform these anticipated roles (Menon and Williams, 1994; Sommer, 1991; Spira, 2003). There are no definite and authoritative assertions regarding their effectiveness, either from academic perspectives or from the professionals' or regulators' viewpoints. This book examines auditor independence in the context of Corporate Governance by focusing on the role of the Audit Committee in UK listed companies. It provides an important missing link in the discussions regarding the auditing profession and its role in financial crises and, of course, how it might recover from the negative image created as a result of the profession's complicity in failures of Corporate Governance.

On the theme of the Audit Committee and its activity, it is imperative to consider precisely how the Audit Committee relates to the external auditors and how its activities may affect auditors' independence. There have also been suggestions that the Audit Committee should act as a buffer between the auditors and the executive directors and thereby enhance their independence (Cadbury, 1992; Smith, 2003). This has become even more important since the remuneration, appointment, and the selection of the type and scope of services bought from the external auditors, previously decided by the management, have come within the remit of the Audit Committee. Later in the book the relationship between the Audit Committee and the external auditor with respect to the level of economic bonding between the external auditor and their audit clients and the impact of the Audit Committee upon this will be examined.

The book also contributes to the debate on the joint provision of audit and non-audit services by auditors to their audit clients and the impact of Audit Committees on these. The arguments in support of joint provision suggest that there may be economies of scope and knowledge spillover from one service to the other. On the other hand, an alternate view suggests that the joint provision of audit and non-audit services by auditors to their audit clients may threaten auditor independence. This is because auditors may end up auditing their own work, or become too familiar with their clients' systems to the extent of being involved in their management, and the level of economic bonding may become so high as to compromise independence. However, the debate is broader than this. In chapter five of the book, the author reports the result of an empirical study on the nature of interactions between Audit Committees and

Auditor Independence. Consequently, the book provides a basis for readers to appreciate the type of relationship that currently exists between the Audit Committee as a tool of Corporate Governance and auditor independence. This involves a review of developments in the roles and responsibilities of the Audit Committee as a Corporate Governance mechanism. The book also empirically examines the determinants of the committee's activity and diligence, analyzes the impact of an effective Audit Committee on auditor independence and finally evaluates the relationship between audit and non-audit fees.

Although the objective of the author is to make this book accessible and helpful to users across the spectrum, it is likely that, as a result of a number of limitations, the requirements of some readers may not be met. This is not due to laxity on the part of the author, but is for reasons with which the audience are likely to identify. Corporate Governance and auditor independence are sensitive issues which companies are very reluctant to disclose information about. Companies may view some information, that some readers of this book consider to be quite unthreatening, as confidential. Such differences in perception bear on many issues, including for instance the structure of Board meetings, and communication and power structures within the Board. From the auditors' perspective, the sensitivity might extend to issues such as the frequency of their meetings with members of the Audit Committee, their assessments of the impact of the Audit Committees on internal control, audit services and risk management within the organization. The topic itself imposes a number of limitations on its investigation, essentially because of the sensitivity of the issues involved. The internal administration and working of an organization may provide it with competitive advantage and to discuss issues on these or related themes freely in an interview or through questionnaires requires significant caution so as not to compromise an organization's existence and performance. The sensitivity attached to Corporate Governance and performance impeded access that would have enabled the author to conduct a qualitative study, such as interviews with Board-level personnel in the organizations or through using a focus group approach. The author's efforts at the beginning of his research, and through to the end to gather evidence through qualitative means in order to bolster the findings reported in the study (Curran and Blackburn, 2001), was largely unsuccessful, mainly due to lack of access (Saunders et al., 2007; Bryman and Bell, 2007).

The use of secondary data provided an opportunity to search for a more genuine and intrinsic relationship between the variables. This afforded the author the benefits of a greater focus on analyzing the available data more closely in a

way that would enhance the achievement of his objectives. However, selecting the right combination of variables to proxy for unobservable phenomena is always a problem in empirical quantitative research. For example, others may question the choice of the proxy to measure committee activity and diligence; equally, the measure of economic bonding between the client and the auditor may also be criticized. It is therefore important to mention up front that these measures are the best available observable proxies of the variables. In most quantitative investigations, the effects and methods of handling measurement error in the dependent variables have been well documented (Maddala, 2001). Lastly, the constraint of resources in terms of time cannot be overemphasized. It is extremely difficult to set a time line for a study such as this; however, finishing the book within a reasonable time was also crucial. The speed and nature of changes in the corporate environment can make a modest effort stale and inconsequential, as new events and situations emerge. The effect of globalization on the spread of corporate practices and, of course, corporate misbehaviours and the contagious effects of these, is truly phenomenal. This globality at times plays an unhelpful role in relation to giving meaning to and interpreting events and situations. It provides a veritable ground on which to perpetuate irony and exaggerate implications. Some issues disguised as new problems are found on closer examination to be inherently the same problems as have already been seen, in somewhat different form. Despite the fluid nature of problems and the environment that perpetuates them, coupled with the lack of will and at times understanding on the part of those confronting them, the author has been able to shine important lights on a number of very pervasive issues that might be regarded as 'wicked problems'.

The author's study leading to this book started in April 2005, when the global economy was just settling down from news of the successive collapses of various corporate giants. This chain of events started first with the high-profile collapse of ENRON in December 2001 and this was quickly followed in June 2002 by WorldCom and then others. Further, the debate surrounding harmonization of accounting standards which had been going on for some time came to a seemingly significant climax in June 2000. This is because, on this date, the Commission of the European Communities issued a communiqué to the Council and European Parliament to the effect that all listed companies would be required to prepare their consolidated accounts in line with an International Accounting Standard (IAS) from 2005 onwards (Elliot and Elliot, 2005). These events may have been responsible for the tendency to present a global response to the global corporate crises of the early twenty-first century, starting in 2001. This was the result of the sense of there being a well and truly

global economy and the fact that harmonization and integration of accounting and auditing practices were, by then, at the top of the agenda for most accountancy professionals and their professional bodies. However, by 2007, it was the UK mortgage giant, Northern Rock, that led the second wave of twenty-first century corporate mishaps. Northern Rock's problems were traced back to the subprime mortgage market in the US. The rumbles continued and by 2008 the effects had become clear and the full impact of the 'Credit Crunch' had emerged. A number of high-profile corporations were either bailed out by their national governments, collapsed or bought out by other companies. These events constituted a significant threat to the study in a number of ways. For instance, the changing landscapes surrounding corporate activity during the periods of the study have necessitated changes in the methodology, the focus and scope of the analyses as well as in the interpretation of the results from the study.

## **The Structure of the Book**

Each chapter contributes particular insights to the wider issues addressed in the whole book. In the following chapter, the author provides a broad but detailed background for the subsequent analysis. This includes a thorough review of the definition of Corporate Governance, an analysis of the Corporate Governance mechanism and historical context for the development of the discourse on this subject.

In Chapter 3, the author provides important information on the evolution and impact of regulation on the auditing profession and Corporate Governance in the UK. Professional guidance on ethics and professionalisms is examined, along with the attitude of professional accounting and auditing associations. The implications of these for investment safety and market confidence in the UK are analyzed in a detailed review of relevant literature. In Chapter 4, the author discusses the role of theory in amplifying corporate phenomena and understanding interactions within and between organizations. Theories shape meanings and help analyses of concepts and their implications (Riahi-Belkaoui, 2000). Different authors and commentators have used a number of theoretical frameworks to study the nature of the governance relationship that subsists in the corporate environment. This chapter discusses the various theories that have shaped the meanings of Corporate Governance and that are used in the book to achieve its objectives. The focus is on the suitability and relevance of the theories, rather than their deployment in the literature. This is to ensure that

the real essence of the theories is captured and the value they have added or could potentially provide for our understanding of Corporate Governance and its interactions with the auditing profession are adequately accounted for and appreciated in the discourse on these subjects. Chapter 5 presents the author's empirical analyses on Audit Committees and auditor independence and reports the findings. It draws out the specific implications of the findings in the context of the particular discourse in this book and their general applicability to broader issues within which the discourse in the book is situated. In the final chapter, the author discusses policy challenges and makes recommendations regarding these and some pathways for future research.

# 2

## Defining Corporate Governance – The Background

### Introduction

The objective of this chapter is to provide a background to issues addressed in the book by examining the definitions of Corporate Governance and its internal and external control mechanisms, and then to give a historical perspective on the development of Corporate Governance in the UK. The discussions in this chapter enable the author to provide a broader perspective of the various debates around Corporate Governance and auditor independence and they set the stage for further discussion relating to the theoretical underpinnings of those debates.

### Corporate Governance: Towards a Definition

The logical point from which to start the discussion on Corporate Governance is to present an understanding of the antecedents of the corporation. This can be traced as far back as the Middle Ages (between the fifth and fifteenth centuries), the period of the Renaissance (between the late fifteenth century and early eighteenth century) and the Great Industrial Revolution (in the late eighteenth century and early nineteenth century). Modern firms are historically a product of a small quasi-governmental arrangement often chartered by the 'Crown' to undertake a specific trading purpose. In other words, the modern firm evolved from a financing arrangement, whereby a group of people with similar interests 'acting as one body', embarked on a substantial trade expedition that could not be sponsored by a single individual due to the huge capital investment required. Some of these trade missions included the Dutch East India Company, the British East Indian Company and the Hudson's Bay Company (Morck, 2006).

However, part of that process of evolution, precisely the period between the thirteenth to the later part of the nineteenth century, witnessed landmark developments that continue to have significant impacts on our perceptions and understandings about and the operation of the modern corporation. For instance, we can trace the modern stock market back to the resistance against the attempt by the shareholders to liquidate the Dutch East India Company, based on the argument that its formation was for a limited time and purpose, and, since it had achieved its set objectives, it had outlived its usefulness and should therefore liquidate. The appointed 'Board of governors' resisted this move and successfully challenged it in court. Those investors who were keen on selling their shares in the company had the right to do so. This thus became the antecedent of the modern day stock market that facilitates the sales and purchase of shares. Furthermore, the ability of shareholders to sell their holdings in the company rather than liquidating it ensured perpetuity for the firm. This is because, not only were the shareholders able to sell their holdings in the enterprise, there were many more people interested in contributing to new trade expeditions who thus bought into these corporations and indeed into many other forms of trade and business endeavour. Some of these commercial endeavours were unsuccessful, for example the South Sea Company, speculation in whose stocks caused the famous Bubble in 1720 (Crowther and Martinez, 2007). However, the sponsors and shareholders in these companies became liable to the extent of the total losses. This was seen to be unfair and this perception may have contributed to the series of events that eventually gave rise to the Limited Liability Act of 1855 which provided that shareholders in such companies should be liable for the debts of the company only to the extent of their initial investments (Hickson and Turner, 2005).

However, while these important developments were unfolding, it was becoming ever more important to understand the structure and operation of the firm. It was therefore not surprising that Berle and Means's (1932) study enjoyed huge acceptance. Their work provided substantial insight into the interactions within organizations. They suggested that there is a separation between the owners of businesses and their management and that this separation requires that there should be a formal contract and bond between the two parties. Their explanations further suggested that this separation is, in part, due to the expansion in corporations' size and, as businesses become bigger, owners are less likely to be involved in the day-to-day running of the 'new' organization. Their observations should have drawn attention to the issues of governance in organizations, but Corporate Governance escaped the spotlight until the studies by Jensen and Meckling (1976) and Fama (1980) on the possibility of



conflicts of interest between the shareholders and management representing the Principals and the Agents respectively that launched discussions on Corporate Governance. Even then, the term was rarely mentioned or used in analyses. It was not until 1983 that it featured as the title of a paper in *Perspectives on Management* (Earl, 1983). In 1984, the term appeared as the title of a report to the American Law Institute and in the same year as a book title in the UK with the caption ‘Corporate Governance – Practices, Procedures and Powers in British Companies and Their Boards of Directors’ by R.I. Tricker.

However, discussions of Corporate Governance have now gained in popularity due to the increase in high-profile corporate collapses, which have brought it into the spotlight. In other words, the conflicts of interests in organizations, management recklessness and greed, corporate dishonesty and ethical breakdowns, weak internal control and poor risk assessments are some of the factors that may have caused corporate failures and have been the herald of Corporate Governance discourse. Despite the recent fluent and widespread use of the term, it has no generally accepted definition (Razaei, 2009), due, perhaps, to the fact that the term cuts across disciplines. It is widely used both professionally and in its academic sense. It is now a commonly used term in management, law and behavioural sciences, similar to its fluent use in Humanities. It lends itself well to the private and business world, just as it is relevant to issues regarding public affairs and the business of governments. Other terms used with Corporate Governance include ‘transparent reporting’, ‘corporate accountability’ and ‘corporate honesty’ among many others. However, just as it is with many other concepts (for example, accounting efficiency, effectiveness, communication) and especially with a term that is capable of many uses and applications, it is increasingly difficult to present a generally accepted definition of Corporate Governance. It means different things to different people depending on discipline and context. The following quotation captures how difficult it is to agree a meaning and scope of the concept:

*Some commentators take too narrow a view, and say it (Corporate Governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges ... Corporate Governance as a subject, as an objective, or as a regime to be followed for the good*