DISCUSSION ON DEVELOPMENT OF CERTIFIED PUBLIC ACCOUNTING

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Discussions on the amendments required to the laws and regulations that govern the services provided by certified public accountants have been going on for years. Actual changes in the legislation began in the USA following the big financial fraud scandals in 2002. The European Commission also decided to implement similar changes. Such changes have a direct impact on the business environment of all companies, and especially, on that of small audit companies which face the need to look for ways how to adapt to the new conditions. The aim of the paper is to summarise the findings of research activities performed over the past years and to identify the most important trends that can be used for further research concerning the best business model for small audit companies. The sustainability of small audit companies is important in light of the necessity to have economically effective competition.

This research is based on the review of literature. It was concluded during the course of the review that the accounting profession needed to be changed in order for it to meet public expectations. The most important factors are strengthening of the independence of auditors and improvement of the quality of audit work, including specification of criteria for the assessment of quality. Further sustainable development strategy should be prepared and implemented in order to ensure appropriate competition and to avoid market concentration with just a few big companies.

Keywords: certified public accountant, independence of auditors, assessment of the quality, small audit companies.

JEL classification: M480, M420, M10

Introduction

Accounting as a profession is really ancient. Starting from the very beginning of economic activities people had to register their assets, control expenditures, and calculate the gain. Accounting may be considered a kind of a horizontal profession. Its development depends very much on the development of other industries and businesses, the same way that legal and human resource development is dependent on the needs of other industries. They cannot be analysed in isolation from other events on the global market. As other industries, accounting usually underwent significant changes after crises, a financial collapse or big fraud scandals. The last of such scandals took place in 2002, the so-called Enron scandal which drew public attention to the professional accounting and caused a number of significant changes. The public understood the importance of reliability of the information disclosed in the financial statements and what grave consequences the manipulation of financial data could cause.

The new requirements for professional accountants, especially for the auditors of financial statements, brought about serious difficulties to the existence of small audit companies. An ever increasing market share is being taken by the Big 4 companies as they are able to meet the required level of independence and the requirement of double review. The European Commission and other public organisations have pointed out that market concentration with only four audit companies would not ensure the required competence and may impair the overall quality of work.

A number of research activities have been conducted in the area of professional accounting in order to improve the quality of the professional accountants’ work, increase public confidence, and understand the stakeholders’ expectations. The authors of the article investigated the main ideas and summarised the common and different conclusions in order to identify the best solution for the development of non-Big 4 companies.

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The aim of the paper is to summarise the findings of the research activities performed over the past years and to identify the most important trends that can be used for further research concerning the best business model for small audit companies. This research is based on the review of literature.

In accordance with this aim, the following research tasks were defined:
- to characterise the historical background and current environment in which accounting profession has been developed;
- to analyse and summarise the results of scientific research with the purpose to identify factors which can influence the success of the profession most of all;
- to reveal problems typical for small audit companies and define the direction of possible further research.

Analysis, synthesis, and the logical and constructive methods were used to tackle the research tasks. Information and data from different scientific papers and legislative acts have been analysed in the research paper.

Research results and discussion

1. Historical background

If one refers to the history, the key points of development of accounting profession relate with the financial crisis and big fraud scandals. Doron M.E. (2009) in his paper described the evolution of the certified public accounting during the period of 1927-1962. According to him, the evolution that took place in the abovementioned period caused consequences to the beginning of the 21st century. He did not use any mathematical methods but organised his research as storytelling. According to Doron M.E. (2009), this is the best way to investigate events of the real life and the motivation of people.

In the 1920s, audit reports on the annual financial statements were addressing basically the needs of creditors, while later it was decided that an audit report could also be used to protect the interests of small shareholders. After McKesson-Robbins audit scandal in 1939, it was decided to strengthen the oversight over the profession and certification of certified public accountants. Around World War II, professional accounting companies changed their business model basically to operating as small practitioners. After World War II professional accountants began looking for additional possibilities to generate revenue and, thus, turned to the consulting business (Doron M.E., 2009).

Prior to the Enron scandal in 2002, there was no support to the presumption that consulting work could impair the independence of the auditors of annual financial statements. Arthur Andersen’s dealing with Enron officers demonstrated that the combination of both roles could lead to similar occasions elsewhere and that forced the government of the USA to take appropriate actions (Doron M.E., 2009).

Sarbanes-Oxley Act (the so-called SOX) approved by the US Senate in July of 2002 was the reaction to Enron and also Tyco International, Adelphia, Peregrine Systems, WorldCom, and some other fraud cases. The document stipulated the responsibility of the Board and certain additional requirements regarding certified public accountants (www.soxlaw.com). The SOX is mandatory for the SEC registrants; however, it is relevant to the European and other companies which are somehow related with the US registered companies. The SOX idea was implemented also in several European (German, France, and Italy) and other countries (India, Australia, South Africa etc).

The European Commission took over the idea and decided that significant changes in the public financial accounting were needed. Several directives were amended. The main ideas and analysis of the situation is described in “Green Paper. Audit Policy: Lessons from the Crisis” (relevant to EEA), issued 13 October 2010 – called Green Paper. It states: “Audit, alongside supervision and corporate governance, should be a key contributor to financial stability as it provides assurance on the veracity of the financial health of all companies. This assurance should reduce the risks of misstatement, and in doing so, reduce the costs of failure that would otherwise be suffered by the company’s stakeholders as well as by the broader society.” (Green Paper, 2010). The first paragraph of the Paper includes the question how auditors could issue a “clean opinion” to those financial institutions that fell into financial difficulties and even bankruptcy during 2007-2009. It put in doubt the current legislation and called for a number of amendments in it.

Latvia should respect the EU regulation and adapt the acts of legislation approved by the Council. Yet, the current Latvian government is just discussing how to implement the EU requirements and legislation. Latvian audit professionals have already implemented the most important requirements based on international legislation and International Standards on Auditing.

The Parliament of Latvia has to make a decision how the directives should be integrated in the national legislation. According to the directives, some actions related with reducing the administrative burden have also to be implemented alongside stronger requirements to audit companies. For instance, mandatory audit of annual financial statements should be required only for large companies. According to the Directive 2013/34/EU of 26 June 2013 large companies are those with net turnover exceeding EUR 40 million, total assets exceeding EUR 20 million, and the average number of employees exceeding 250 (2 of 3 conditions). For Latvia, it means that less than 0.1% of companies will be required to have their financial statements audited. Latvia should find a balance between the reduction of the administrative burden and the requirement to increase the credibility and transparency of the financial statements.

The FEE (The Federation des Experts Comptables Europeens or Federation of European Accountants, 2012) distributed the policy statement regarding the amendments in the 4th and 7th directives where it agreed that changes in
the legislation were needed but stressed that the accounting could not be considered an administrative burden. It should be regarded as an “essential tool” for continuing the business and protecting the public interests (Fee Statement, 2012).

It follows from the information disclosed in Table 1 that the SOX and the Green Paper are similar in many aspects. The main changes in the requirements concern the independence and quality of the work of auditors and increasing of the responsibility of the management.

2. Relevance of the topic

More than 10 years after the implementation of SOX is an appropriate period of time to evaluate the efficiency of this reform. The European Commission decided to implement some of the SOX ideas also in Europe seeking to reduce the administrative burden. It may force audit companies, especially the small ones, to change their business model significantly and to find ways to survive in such an environment. At the same time, the European Commission emphasises the importance of small and medium companies as they comprise the largest part of the European economy.

In spite of different kinds of discussions, credible financial reporting plays a crucial role in the success of companies and also in the economy as a whole. Management of the company is basically free to make decisions and the only limitation to such decisions is the accounting information. Therefore, the quality of accounting data is very important (Dobrin M., 2010).

According to the research performed by Ajibolade S.O., Arowomole S.S.A., and Ojikutu R.K. (2010), the quality of management accounting is directly dependent on the success of the company. The company’s ability to adapt to changes in the business environment is also directly related with the level of detail that the management accounting sustains.

3. Independence of certified public accountants

The most important new requirement related with the strengthening of independence of statutory auditors is periodic rotation of auditors and separation of audit and non-audit services (Green Paper, 2010). These requirements have not yet legally come into force. The requirement of mandatory rotation of auditors has not been very popular but the requirement of separation of audit and non-audit services has already been implemented in many countries.

The SOX has already been implemented by the SEC registered companies and their subsidiaries since July 2002. Research about Enron was performed by Baker S.R. in 2002. In his opinion, the reason for Enron’s collapse was deregulated public private partnership in the USA, and the SOX will not solve the main problem – public assurance of credible and transparent financial statements.

Nevertheless, the above mentioned topic has been popular among scientists of different countries. Acpom U.N. and Domkpah Y.U. (2013) have mentioned in their article that the public opinion about the auditor’s independence is based more on their perception of audit independence than on actual independence. As a result of their research, the authors concluded that both - auditors and non-auditors - are dependent on economic factors – the proportion of audit fee versus total revenue of the company and increasing competition.

The perception of the auditor’s independence was investigated by Daniels B.W. and Booker Q. (2009). They concluded that bank loan officers perceived auditor rotation as a policy that helped identify misstatements in the annual financial statements, while audit professionals feel that long-term relationships with clients helps them better understand business risks and perform the audit in a more efficient way.

One of the most important conclusions in the article is that there is a gap between the audit professionals’ opinion on what the public expects and the real public expectations.

Myers J.N. and Palmrose Z-V. (2003) in their research on the pre-SOX period did not find any evidence that the auditor’s rotation could have a positive impact on the quality of the audit work. Moreover, according to them the rotation has a negative impact on the audit efficiency and leads to the

<table>
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<tr>
<th>Key changes</th>
<th>SOX, 2002</th>
<th>Green Paper, 2009</th>
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<tr>
<td>Certificate issued by signing officer and</td>
<td>Yes</td>
<td></td>
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<td>attestation of it by auditors</td>
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<td>Periodic rotation of statutory auditors</td>
<td>Yes</td>
<td>Yes</td>
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<td>Easily understandable presentation of material</td>
<td>Yes</td>
<td>Yes</td>
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<td>information in AFR</td>
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<td>Separation of audit and non-audit services</td>
<td>Yes</td>
<td>Yes</td>
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<td>Criminal penalties for altering documents</td>
<td>Yes</td>
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<td>Reduced dominance of the Big Four</td>
<td>Yes</td>
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<td>Simplified requirements for SMEs</td>
<td>(Relevant</td>
<td>Yes</td>
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<td></td>
<td>only for companies with value over USD 700 million)</td>
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<td>Additional public supervision</td>
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Source: authors’ summary based on www.soxlaw.com and Green Paper, 2010
increase of audit fees. Non-core errors tended to decrease in line with the length of tenure, while core errors increased over the years of tenure. Aslan O. (2012) also did not find any evidence that the rotation could strengthen the auditor’s independence.

The impact of the implemented mandatory requirement for the rotation of audit partners on the quality of audit opinion was evaluated by Monroe G. and Hossain S. (2013) who discovered that a periodic rotation after five or more years had a positive effect on the probability that auditors would issue a going concern qualified opinion to the financially distressed companies.

Dodor J.B.K. and Darby M.A. (2013) revealed that the rotation could not provide absolute assurance of independence because the audit teams were members of the same network and they were bound to meet each other under some circumstances. However, the rotation of audit companies appeared to ensure higher independence than that of team members of the same audit company. These authors recommend that further research activities take into account two different factors – market based and behaviour based factors.

Blandon J.G. and Bosch J.M.A. (2013) analysed the Spanish market in which 90% audits are performed by Big 4 companies. They identified a “honeymoon effect” – the first year auditors very rarely issue qualified opinions as it can lead to conflicts and losing the contract. At the same time, long-term relationships can also lead to losing the quality of the auditors’ work if large volumes of non-audit services such as consultations are provided in addition to audit services.

Lennox C.S. and Park C.V. (2007) in their research unearthed another threat to the auditors’ independence. The results of their research show that Big 4 alumni as chief financial officers (CFO) are more likely to choose the previous employers as an auditor than other audit companies. There is a negative correlation between a qualified opinion on the going-concern issues and alumni as CFO. According to them, this risk can be mitigated by audit committees.

The discussion about the impact of non-audit services on the independence is also a popular topic among researchers. Patel A. and Prasad P. (2013) found during their research that non-audit services mostly had an opportunistic reason. Big 4 companies are less likely to provide non-audit services to their audit clients than non-Big 4 companies. According to the research, the provision of non-audit services is more typical for the beginning of tenure.

Kohler A.G. and Ratzinger-Sakel N.V.S. (2012) found that there was no correlation between audit and non-audit fees which means that non-audit services in Germany do not impair the auditor’s independence. Knechel W.R. and Sharma D.S. (2013) examined whether non-audit services provided benefits to audit clients and also indicated that according to their research non-audit services did not impact the efficiency and quality of the audit work.

Joint provision of audit and non-audit services has been investigated by Paterson J.S. and Valencia A. (2011). They found that nonrecurring audit services such as tax compliance checks benefit the clients, while regular non-audit services such as tax consulting impaired audit independence. Doron M.E. (2009) in his article emphasises that the Enron case just encouraged the changes which were already due - to separate audit and non-audit services.

Doron M.E. (2009) also supports the idea of dividing economies into “common law” and “code law”. The companies whose shareholders and investors do not have access to inside information are more interested in an independent audit opinion about the fairness and truthfulness of the financial statements because the financial statements is the main source of information for their investment decisions (the USA, Australia, the UK, and Canada). Though, shareholders who are members of the Board are aware of internal processes and the financial position and are more interested in support from the external auditors in the areas where they do not have internal expertise, for instance, in the measurement of fair value of assets, valuation of derivatives etc.

4. Evaluation of the quality of work

Quality is the next issue which is discussed in relation with the reformation of the audit profession. The quality of the audit work has been the primary focus of a number of research activities. The main conclusion is that there is no common understanding concerning the criteria for the quality of audit. Audit professionals believe that high quality audit work is one performed in compliance with Standards and laws, while stakeholders of the annual financial statements expect that the statutory audit is the guarantee that there are no material misstatements in the annual financial statements (Husein F.E., MohdHanefah M., 2013).

Ryu T.G., Uliss B., Roh C.-V. (2009) chose the correctness of the going concern assumption as a criterion for the assessment of the quality of audit work. According to their research, the average accuracy rate decreased from 51.9% before the SOX to 44.4% after it. Non-Big 4 companies improved the accuracy rate as it was extremely low before the SOX. Big 4 issued the “right” opinion after the SOX even in fewer cases. The authors concluded that the implementation of the SOX did not have an effect on the quality of the audit opinion. Actually, the average 50:50 probability of credibility of an audit opinion means that there is no economically justifiable reason to pay for such a service.

Different authors have investigated the most significant determinants which influence the quality of audit work. The majority of the authors have found IT skills to be crucial for auditors – Chen J., Damtew D. (2013), Bressler L. (2013), Spalding A. (2012), Poopool N. and Chantinok K. (2013),Okab R. (2013).

Planning is defined as the second most important skill in a number of articles, for instance, Chanruang S., Ussahawanitchakit P. (2011) think that good planning
influences also the reputation of auditors, Eheridge C.E. (2013) says that making the best decision about the audit scope depends on the auditor’s planning skills, and the importance of the planning skills is also emphasised by Popa A.F., Vilsanoiu D. and Dobre F.S.G.D. (2012).

The positive impact of the auditor’s ethics on the quality has been mentioned by Ussahawanitchakit P. (2012) and Abbott, Parker, Peterss (2012). The long-term nature of the relationship between the auditors and their clients is regarded to have a negative impact on the quality of audit (Abbott L.J., Parker S., Peterss G.F. 2012) or a neutral impact (Blandon J.G., Bosch J.M.A., 2013).

Fraud detection as an important factor for auditors is mentioned in articles written by Bressler L. (2012), and Bales K. and Fox T.L. (2012). The personality of the audit partner is considered to be important in an article by Zerni M. (2012). Pongsatitpat (2012) points out the importance of the quality review procedure.

Writing, presentation and communication skills are mentioned as important as well (Kermis G., Kermis M., 2012). The involvement of external experts in audit engagements according to Bratten B., Gaynor L.M., McDaniel L., Montague N.R. (2013) has a negative effect. Chen Y.-S., Hsu J., Huang M.-T. (2013) found that the quality of work is higher in big audit companies.

It is possible to find the most popular quality criteria by summarising the various research activities but it would be useful to determine the optimal combination of skills in order to define the necessary level of the auditor’s competence.

5. Importance of reputation in audit work

Professional certification and public supervision has been mentioned by a number of authors as a significant factor for the improvement of the overall quality. According to the research performed by Hutaibar K.A. (2011), the prestige of the profession and the resulting quality of work directly depends on the level of difficulty to get the qualification. It means that the stronger are the requirements for obtaining professional certificates the higher performance one can expect, the same as in medicine and lawyer profession. Cory S. and Huttenhoff T. (2013) also concluded that in addition to the bachelor’s degree professional accountants are required to pass exams and obtain a professional certificate in order to have appropriate qualification.

Some authors believe that accounting cannot remain conservative and exist independently of the real life and changing environment. It can even become radical during a crisis, the same as art (Galhofer S., Haslam J., 1996). Scandfield K. (2002) opinion is that the accounting standards ignore such valuable assets as knowledge, relationship, emotions, and time. Abdel-Rahim H.Y.M. (2013) writes about green accounting in Egypt which can be a relevant idea also for other countries. Green accounting is investigated also by Latvian academics (Bruna I., 2014). Social accounting is recommended by Friedrich P. (2012).

Many discussions are related with an understandable disclosure of the financial statements and auditors’ reporting (SOX, 2002; Green Paper, 2010; Movsisjana A., 2014).

6. Specific problems for small audit companies

The European Commission in its Green Paper emphasises the need to reduce the administrative burden for SMEs and stipulates the necessity to implement additional requirements for certified public auditors. These requirements influence the existence of small audit companies. On the one hand, increasing the threshold for mandatory audits of the annual financial statements reduces the market of audit companies and increases competition, on the other hand – increasing the requirements of quality review and independence increases costs and threatens the existence of small audit companies (Figure 1).

It is highly challenging for small audit companies to survive in such a business environment. However, it is not a “mission impossible” provided there is a clear business model.
Conclusions based on the review of literature and suggestions for further research.

1. There is a gap between public expectations and the auditors’ thoughts about what the public expects from them. Audit professionals should change their approach and step forward in the direction of public needs.

2. New requirements regarding strengthening of the independence of auditors according to different authors have a positive and negative influence on the efficiency and quality of the audit work and have to be investigated further.

3. Audit professionals and stakeholders have different views concerning the criteria for the assessment of the quality of the auditors’ work. The skills (not only technical but also soft skills) required for audit professionals should be defined and developed in line with changes in the business environment.

4. The profession of certified auditors needs to be changed significantly in order for it to meet the needs of the public and their clients. A new model of business operation should be created thereof.

Bibliography


