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ITS REGULATION IN THE EU AND IN TURKEY:  
A Way to Convergence?*

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**UNDERSTANDING EXTERNAL AUDITING  
AND ITS REGULATION IN THE EU AND IN  
TURKEY:  
A Way to Convergence?**

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**H. Kubra Kandemir (LL.M)**

**A thesis submitted for the Degree of Doctor of Philosophy**



**Durham Law School**

**Durham University**

**September 2014**

**UNDERSTANDING EXTERNAL AUDITING AND ITS  
REGULATION IN THE EU AND IN TURKEY:  
A Way to Convergence?**

**H. Kubra Kandemir**

**Abstract**

The purpose of this study is to discuss the role of external auditing in corporate governance and in financial markets by exploring audit regulation in the EU and in Turkey. This study contributes to the existing literature by providing a law perspective on audit regulation both in the EU and in Turkey. This study also contributes to the convergence analysis in EU laws on auditing (and between EU and Turkish laws on auditing) through a comparative analysis.

This thesis has three main themes. The first theme concerns with the role and function of external auditing. In this respect this thesis identifies the role of auditing in different corporate governance systems and its function in today's financial markets. The second theme relates to the audit regulation, in particular in the EU. This thesis examines the EU audit reform initiatives with respect to preliminary issues in the audit market. In addition, it critically analyses whether these reform proposals could provide further harmonisation in the EU. The central and the last theme of this thesis is convergence. It submits that integration of financial markets can lead to a convergence of auditing. Turkey, as a candidate country for the EU, seeks to benefit from the integration of financial markets. In the pursuit to be part of the international financial markets and to be a member of the EU, Turkey has reformed its law in line with EU law. This thesis questions however, whether these regulatory attempts have resulted (or can result) in convergence between the EU and Turkish laws.

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## LIST OF ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
APB	Auditing Practices Board (UK)
ASB	Accounting Standards Board (UK)
BCBS	Basel Committee on Banking Supervision
BDDK	Banking Regulation and Supervision Agency
BIG FOUR	Deloitte, PwC, EY, and KPMG
CFA	Chartered Financial Analyst
CPA	Certified Public Accountant
Deloitte	Deloitte Touché Tohmatsu
EPDK	Energy Market Regulatory Authority (Turkey)
EU	European Union
EY	Ernst & Young
FCA	Financial Conduct Authority (UK)
FPC	Financial Policy Committee (UK)
FRC	Financial Reporting Council (UK)
FSA	Financial Services Authority (UK)
FSAP	Financial Services Action Plan (UK)
FSMA	Financial Services Market Act 2000 (UK)
FTSE	Financial Times Stock Exchange (UK)
GAAP	Generally Accepted Accounting Principles (US)
GAAS	Generally Accepted Auditing Standards (US)
IAASB	International Auditing and Assurance Board
IAPC	International Auditing Practices Committee
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ISE	Istanbul Stock Exchange (now Borsa Istanbul)

ISQC	International Standard on Quality Control
KGK	Public Oversight Authority of Turkey
KPMG	Klynveld Peat Marwick Goerdeler
LLP	Limited Liability Partnership
OECD	Organisation for Economic Co-Operation and Development
OECD-Principles	OECD Principles of Corporate Governance
OFT	Office of Fair Trading (UK)
PIEs	Public-interest-entities
PIOB	Public Interest Oversight Board (US)
PRA	Prudential Regulatory Authority (UK)
PwC	PricewaterhouseCoopers International
SAS	Statements on Auditing Standards (US)
SMMM	Certified Public Accountants (Turkey)
SOX	Sarbanes-Oxley Act of 30 July 2002 Public Company Accounting Reform and Investor Protection Act (US)
SPK	Capital Markets Board of Turkey
TCC	Turkish Commercial Code
TDS	Turkish Auditing Standards
TDSK	Turkish Auditing Standards Board
TFEU	Treaty of the European Union
TL	Turkish Liras
TMS	Turkish Accounting Standards
TMSF	Saving Deposits Insurance Fund (Turkey)
TMSK	Turkish Accounting Standards Board
TURMOB	Chamber of Accountants of Turkey
YMM	Sworn-In Certified Public Accountant (Turkey)

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## **Declarations**

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H. Kubra Kandemir

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# INTRODUCTION

## 1. BACKGROUND AND OBJECTIVE OF THE RESEARCH

The uncertainty of the quality of products is inherent in the business world.<sup>1</sup> It is the usual scenario where the seller has more knowledge about the quality of the service (or good) than the buyer. Limited information about the quality of the service (or good) would damage the confidence and trust of the buyer. Auditing, as a form of control and verification of the quality of information, has emerged to deal with such informational asymmetry.<sup>2</sup> The purpose of financial audit is, therefore, to provide the users with confidence in financial statements.<sup>3</sup> Beyond financial auditing, the trend towards auditing can also be seen in the example of medical audits, environmental audits and ethical and social audits.<sup>4</sup>

Financial auditing (or external auditing) is considered as the template for other types of audits since its origins go back to the early forms of corporations in the 13<sup>th</sup> century.<sup>5</sup> From then onwards, external auditing has been used as a control mechanism over the agents of the company.<sup>6</sup> Investors are likely to be misinformed about the quality of the information in financial statements due to company management's intentional or wrongful misrepresentation.<sup>7</sup> The primary role of external auditors is to obtain reasonable assurance on the accuracy of the accounts by reporting an opinion to the shareholders as to whether the accounts prepared by the management provide a true picture of the company's financial situation.<sup>8</sup>

The role of external auditing and auditors received significant attention from regulators when the Enron scandal hit the markets more than a decade ago. Back

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<sup>1</sup> George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) *Quarterly Journal of Economics* 488.

<sup>2</sup> Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

<sup>3</sup> ISA 200, para. 3.

<sup>4</sup> Michael Power, *The Audit Society: Rituals of Verification* (OUP, New York 1997), p. 3.

<sup>5</sup> Ross L. Watts and Jerold L. Zimmerman, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' (1983) 26(3) *Journal of Law and Economics* 613.

<sup>6</sup> *Ibid.*

<sup>7</sup> *Ibid.*

<sup>8</sup> ISA 200, para. 11.

then, auditors were blamed for failing to detect and report the fraud in the company.<sup>9</sup> More recently, during and after the global financial crisis of 2008, auditors and their role in financial markets have again been widely debated. After the collapse of major financial institutions, auditors were accused of failing to give warning signals to the markets, and not issuing going concern reports before the collapse of the large banks.<sup>10</sup> The expectations of the users of the audit reports are much higher than the auditors' role and responsibilities defined under the professional standards and related laws. This situation results in an expectations gap that is widened in a time of crisis. Thus, this thesis aims to clarify the role of external auditing and auditors' responsibilities and liabilities according to professional standards and laws, and to identify whether they actually failed in their role.

Similar to the regulatory developments back in the early 2000s, the global financial crisis has been a wake-up call for the law reforms in the EU. As a response to the crisis, the EU issued a Green Paper on Audit Policy in 2010.<sup>11</sup> Subsequently, in November 2011, the European Commission issued proposals for a Directive amending the Directive 2006/43/EC<sup>12</sup> and a proposal for a new Regulation on the specific requirements for statutory audits of PIEs.<sup>13</sup> The primary objective of these reforms is to strengthen the external audit mechanism and to reassure confidence in financial markets. According to the Commissioner, Michael Barnier, there were weaknesses in the audit market, and the aim of these regulatory initiatives is to “*change the status quo in the market*”.<sup>14</sup> The EU lawmakers aimed to change the current structure of the audit market and create a more integrated audit market through more harmonised rules. In this respect, this paper aims to provide a critical analysis both of existing EU laws and proposals on auditing, to question whether

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<sup>9</sup> John C. Coffee, Jr., ‘Understanding Enron: “It’s About the Gatekeepers, Stupid”’ (2002) 57 *The Business Lawyer* 1403.

<sup>10</sup> Prem Sikka, ‘Financial Crisis and the Silence of Auditors’ (2009) 34 *Accounting, Organizations, and Society* 868.

<sup>11</sup> European Commission Green Paper Audit Policy: Lessons from the Crisis Brussels, 13.10.2010 COM(2010) 561 final.

<sup>12</sup> European Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts Brussels, 30.11.2011 COM(2011) 778 final.

<sup>13</sup> European Commission Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities Brussels, 30.11.2011 COM(2011) 779 final.

<sup>14</sup> Michael Barnier, European Commission’s Internal Market Commissioner, September 2011.

they are sufficient to deal with the issues in the audit market, and establish whether they can contribute to the further EU harmonisation in auditing.

As well as in the other areas of law, globalisation has influenced the regulation of auditing. This thesis argues that as today's financial markets become closer through globalisation; such approximation is also possible for auditing regulation. Integration of financial markets has helped audit firms to grow globally and provide services all around the world. This has resulted in a wider application of uniform standards in auditing globally, i.e. ISAs.<sup>15</sup> Turkey, as a candidate country for the EU, aspires to be a part of and to benefit from the integration of financial markets. In this respect, Turkey adopted the globally accepted auditing standards and reformed its commercial law and capital markets law to harmonise with EU laws on auditing. The primary motivation of the law reforms in Turkey is to become a full member of the EU alongside the objective of being a part of the global financial markets. This thesis will examine further whether approximation of the laws through the EU membership process can lead to an actual convergence between the EU and Turkish laws. The example of Turkey will help to illustrate how the globalisation and integration of financial markets leads to the convergence of audit regulation.

This thesis takes the EU and Turkish laws and International Standards on Auditing (ISAs) as the main source of reference when examining the role, function and liabilities of auditors. The laws on auditing will be studied under the theme of convergence. In the EU, there are some areas have been left unregulated, for instance the auditor liability rules. The EU has left this issue to be regulated by Member States. In order to understand the liabilities of auditors for loss caused by their wrongful or negligent acts, this thesis particularly examines UK law to provide an example of perspectives within the EU, and questions the auditors' civil liability as determined under the law. The examination of the UK law will illustrate that even within the EU we do not see convergence on auditor liability rules. This is an important indication for the discussions on a possible convergence between EU and Turkish laws on auditing.

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<sup>15</sup> International Standards on Auditing (ISAs) received a global recognition from 126 jurisdictions, including all the EU Member States –except Croatia who joined the EU recently and not included in the IFAC's compliance program- adopted ISAs. See IFAC Member Body Compliance Program Basis of ISA Adoption by Jurisdiction, August 2012. See also Chapter III, Section 3.2.2.

In the light of these concerns, this thesis determines its main purpose as to provide a discussion on the role of external auditing from a law perspective by exploring its regulation in the EU and in Turkey in terms of convergence. Thus, it has three fundamental themes: it first examines the role of auditing and the preliminary issues that have dominated the discussions in the field of auditing. In this respect, Chapters I and II are the introductory chapters on the role and function of auditing in corporate governance and in financial markets. The second theme is audit regulation. Chapter III will provide a discussion on audit regulation theory. Within this context, the critical evaluation of audit regulation and reforms in the EU will be detailed in Chapter IV. One of the main messages of this thesis is that audit regulation follows an international route. In this context, the last theme concerns convergence. As a subject study, this thesis questions whether there is convergence between Turkish and the EU laws on auditing. Studying the Turkish experience would be helpful to test the impact of globalisation on convergence of auditing.

## **2. METHODOLOGY OF THE RESEARCH**

The analysis presented in this thesis comes from a wide range of sources, including primary and secondary sources, such as laws and regulations, cases, and academic literature. Not only legal literature is considered, but reports and studies from the European Commission, governmental institutions of the UK and Turkey (namely the FRC and SPK), and international independent institutions, such as IFAC are also used within the text. The analysis in this thesis also includes political and economic factors and their effects in the regulation of auditing and its application.<sup>16</sup> The analysis on regulation theory in Chapter III uses concepts from accounting and political sciences. Chapter VI analyses on auditing development in Turkey and on the adoption of the EU law benefit from both the perspectives of political economy and political science literature.<sup>17</sup> This thesis therefore adopts an interdisciplinary approach to legal analyses. In addition to the analysis of positive legal rules, this thesis examines how the law is applied in practice, primarily in Chapter VII.

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<sup>16</sup> See Chapter III, Section 3, for the economic and political factors that affect the regulation of auditing in the general context.

<sup>17</sup> See Chapter VI, Section 1, for the financial development and EU membership process of Turkey that has influenced the audit regulation in Turkey.

Comparative methods are adopted in some parts of this thesis, particularly in Chapter VII. Chapter VII examines the possibility of a convergence of auditing between EU and Turkish laws. The determinants of convergence are conceptualised in accordance to the forces for and obstacles of convergence. Harmonisation with the EU law and important economic factors are determined to explore the forces for convergence. This will suggest that internationalisation of the economy and adoption of the EU law might lead to convergence in auditing as they prompt integration of markets and the use of uniform standards.<sup>18</sup>

With regards to the obstacles, Chapter VII considers Bebchuk and Roe's<sup>19</sup> path dependency theory. Within this context, the Turkish situation will be evaluated in terms of its institutional structure and capacity to receive the imported law. In addition, Berkowitz *et al*'s<sup>20</sup> transplant effect theory is adopted to question the reasons for the institutional impediments in Turkey.<sup>21</sup>

Under this theoretical framework, Chapter VII presents and discusses a conceptual framework for the convergence between the EU and Turkish laws on auditing. Accordingly, four levels of convergence are taken into consideration, including the effects of harmonisation (and globalisation), differences in the law in action, the effects of path dependencies (and culture), and functional dissimilarities. These will be examined respectively both with respect to the law on the books and law in practice. In terms of practice, difficulties of the application of rules will be examined with respect to inadequacies in institutional setting (e.g. the capacity of the courts) and culture.<sup>22</sup>

For the purpose of this thesis, the primary source of law is EU law. However, US laws are referred to within the text wherever this is thought to be necessary and appropriate. UK laws are also examined in detail in this thesis when there is no common application of a specific regime at the EU level, in particular in the auditor

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<sup>18</sup> See Chapter VII, Section 2.1.

<sup>19</sup> Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Governance and Ownership' (1999) 52 *Stanford Law Review* 127.

<sup>20</sup> Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'Economic Development, Legality, and the Transplant Effect' (2003a) 47 *European Economic Review* 165. See also Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'The Transplant Effect' (2003b) 51 *The American Journal of Comparative Law* 163.

<sup>21</sup> See Chapter VII, Section 2.3.

<sup>22</sup> See Chapter VII, Section 2.4.

liability regime. Turkish laws on auditing are also within the scope of this thesis, especially for the purposes of Chapter VI and for the comparative chapter: Chapter VII.

‘External auditing’, or ‘auditing’ refers to statutory auditing conducted by an independent certified auditor.<sup>23</sup> Audits of listed companies are the main concern of this thesis. Banking regulation is not included in the scope of this thesis due to the word constraints. However, audits of banks are referred in the text a few times, especially when examining the role of auditors in the global financial crisis in Chapter II and examining the Imar Bank case in Chapter VI.

### **3. MOTIVATIONS FOR THE RESEARCH**

Many studies in the field of business have been conducted in the external auditing area; however, a more legal approach was necessary to explore deeply the regulation of auditing and the primary role and function of auditors and external auditing in corporate governance and in financial markets that determined under professional standards and laws. This research is motivated by the debates during and after the global financial crisis, and therefore partially aims to explore whether auditors failed in their role and how the law actually imposes a duty and liability on auditors regarding that role.

External auditing and audit firms benefit from the integration of financial markets, e.g. large audit firms take advantage of their global networks.<sup>24</sup> This research is also motivated by globalisation and its effects on audit regulation. This being so, this thesis aims to explore whether globalisation can lead to a convergence of auditing within the EU, as well as between the EU and Turkish laws.

### **4. CONTRIBUTIONS TO KNOWLEDGE**

This research contributes to corporate governance literature by exploring the role, function and the regulation of auditing from the perspective of law. Existing

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<sup>23</sup> Statutory audit is defined as an audit -required by law- of annual or consolidated accounts of a company by an auditor who is qualified to be an auditor and approved by a professional authority.

<sup>24</sup> See Chapter II, Section 2.4.

literature on auditing has mainly been conducted from a business perspective. Although there are many doctoral theses on the subject of auditing in other departments, research in law schools largely disregards auditing. The existing studies primarily covered the principles,<sup>25</sup> practices,<sup>26</sup> and doctrines<sup>27</sup> of auditing. However, the regulation of auditing has only been tangentially addressed by existing literature.<sup>28</sup> The studies on audit regulation only examined political aspects of auditing regulation, and therefore failed to cover audit regulation from a wider perspective.<sup>29</sup>

Similarly, the regulation of auditing has not been extensively examined in Turkey. Auditing literature in Turkey has only detailed the substance and practices of auditing.<sup>30</sup> Studies were mostly conducted with regards the education of auditors and the development of the audit profession.<sup>31</sup> Recently, there was some literature published after the enactment of the new Turkish Commercial Code.<sup>32</sup> These studies only provided an introduction to the issues by explaining the qualification

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<sup>25</sup> David Flint, *Philosophy and Principles of Auditing: An Introduction* (Macmillan, London 1988); Graham W. Cossarat, *Modern Auditing* (John Wiley & Sons, England 2000); P Brenda Porter, Jon Simon, and David Hatherly, *Principles of External Auditing* (2nd, John Wiley & Sons 2003).

<sup>26</sup> Lawrence Robert Dicksee, *Auditing: A Practical Manual for Auditors* (Gee & Co., London 1892).

<sup>27</sup> Robert Kuhn Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, Chicago 1961).

<sup>28</sup> Ralf Ewert, 'Audit Regulation, Audit Quality, and Audit Research in the Post-Enron Era: An Analysis of Non-audit Services' in Christian Leuz, Dieter Pfaff, and Anthony Hopwood (eds), *The Economics and Politics of Accounting* (OUP, New York 2004). See also Ian P. Dewing and Peter O. Russell, 'Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Development Before and After Enron' (2004) 42(2) *Journal of Common Market Studies* 289.

<sup>29</sup> Christopher Humphrey and Peter Moizer, 'Understanding regulation in its global context' in Reiner Quick, Stuart Turley and Marleen Willekens (eds), *Auditing, Trust, and Governance: Regulation in Europe* (Routledge, London 2008). See also Ian P. Dewing and Peter O. Russell, 'UK fund managers, audit regulation and the new Accountancy Foundation: towards a narrowing of the audit expectations gap?' (2002) 17(9) *Managerial Auditing Journal* 537.

<sup>30</sup> Adnan Donmez and Ayten Ersoy, 'Bağımsız Denetim Firmaları Bakis Acisiyle Türkiye Bağımsız Dis Denetim Sisteminin Degerlendirilmesi' (2006) 36 *Kis Bilig* 69.

<sup>31</sup> Umit Guenme and Aylin Arsoy, 'Türkiye'de Cumhuriyet Doneminde Muhasebe Egitimi' (2006) 76 (*Ozel Sayi*) *Mali Cozum Dergisi* 308; Serafettin Sevim, Tansel Cetinoglu, and Niyazi Kurnaz, 'Avrupa Birliđi Müzakereleri Sürecinde AB 8. Yönergesi Kapsamında Türkiye'de Denetim ve Denetçilik Mesleğinin Durumu: AB müzakereleri gelişim için bir fırsattır?' (2006) Ocak-Mart *Mali Cozum*; Masum Turker, 'Türkiye'de Muhasebe Denetim Faaliyetlerinin Gelisimi' (2006) 89 *Dayanisma Dergisi*, Izmir Serbest Muhasebeci Mali Musavirler Odasi Dergisi.

<sup>32</sup> Mustafa Yavuz, 'Yeni Turk Ticaret Kanunu'na Gore Bağımsız Denetçilerin Hukuki Sorumluluđu' (2012) 230 February *Yaklasim*. See also Umit Guenme, Gulsun Isseveroglu, and Yasemin Ertan, 'Audit and Oversight of Audit in terms of Commerce Law of Turkey' (2011) 2(1) *Business and Economics Research Journal* 109.

requirements for auditors under the new Code.<sup>33</sup> Hence, the existing literature in Turkey fails to provide a deeper analysis on audit regulation.

Motivated by these gaps in the literature, this thesis aims to provide a legal analysis on audit regulation both in the EU<sup>34</sup> and in Turkey<sup>35</sup>. This thesis therefore contributes to existing literature by examining the preliminary issues on auditing: in particular, the role and responsibilities of auditors, their liabilities, and the audit market structure from a law perspective.<sup>36</sup> The main contribution of this thesis is the comparative analysis of the EU and Turkish laws on auditing in terms of convergence.<sup>37</sup> The results of this analysis contribute to the convergence debates in the EU. Also, the results can provide important knowledge for scholars and lawmakers with regards audit market structure and its regulation in the EU and in Turkey.

## **5. STRUCTURE OF THE RESEARCH**

Chapter I opens with a discussion on the role of external auditing in corporate governance. The main objective of this discussion is to question whether the demand for auditing differs in different corporate governance systems. The first chapter also questions the role of auditing in financial markets in terms of ensuring trust and market confidence.

Chapter II shows how auditing works in today's financial markets and identifies the dual role of auditors as detectives and gatekeepers. This chapter also explores the structural and functional problems of auditing with a close examination of the Big Four audit firms and their role in the global financial crisis. Analyses in this chapter provide material for the discussion on EU laws on auditing in Chapter IV that deals with the regulatory remedies for the prevailing problems of auditing.

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<sup>33</sup> Erdogan Arslan, 'Yeni Turk Ticaret Kanunu'na Gore Denetçinin Niteligi' (2011) March-April Mali Cozum 73.

<sup>34</sup> See Chapter IV for the EU audit policy and laws.

<sup>35</sup> See Chapter VI for audit regulation in Turkey.

<sup>36</sup> See Chapter IV for a critical analysis on the regulatory measures for the preliminary issues on auditing.

<sup>37</sup> See Chapter VII.

Chapter III questions why we need audit regulation and seeks to explain audit regulation by detailing the motivations of and justifications for it. This chapter shows the triadic structure of audit regulation that overlaps across financial markets law, company law, and competition law. It also shows the role and incentives of state and private regulators in audit regulation and how these actors might have influenced audit regulation. The findings of this chapter are critical to understanding the EU audit policy and laws on auditing as addressed in Chapter IV.

Chapter IV identifies the factors that have affected EU audit policy and laws from Enron to date. In this respect, the chapter provides a critical analysis on the EU Directive 2006/43/EC and its effect on harmonisation in auditing in the EU. These analyses establish a picture of the current structure of the law on auditing in the EU. The other contribution of this chapter is the critical analysis of the EU's law proposals on statutory auditing: the Directive proposing to amend the Directive 2006/43/EC and the Regulation proposal on statutory audits of PIEs. This chapter supplements Chapter II by critically evaluating the regulatory remedies on the preliminary issues in auditing, namely the expectations gap, auditor independence, and high concentration.

Chapter V shows to whom and under which conditions auditors are liable. This chapter questions auditor liability from the perspectives of ISAs, EU law, and UK law. This chapter represents auditors' legal responsibilities regarding knowingly or negligently misstating in or omitting required information from prospectuses. An understanding of liability rules is important in comprehending the role of auditors in financial markets. On the one hand, increased liability rules are important for the protection of investors, and hence it is crucial for efficient functioning of the financial markets. On the other hand, unlimited liability to the public at large imposes risk, especially on the audit services market of large listed firms, where only a few firms operate. Regulators, therefore, must consider the consequences of liability rules when they define the scope of liability. The discussions in this chapter contribute to the debates begun in Chapter II, especially on the high concentration in the audit market and its consequences.

Chapter VI provides an analysis of the law reforms on auditing in Turkey from socio-political and economic perspectives. In this respect, this chapter shows that the

main motivations for the law reforms are the objective of achieving EU membership (through harmonisation of Turkish law with the EU *acquis*) and to become a part of the global financial market (through strengthened governance structure of firms and improved legal environment). This chapter examines whether Turkey has successfully harmonised its law on auditing with EU law. The analysis in this chapter of Turkey's legal and financial development and its audit market structure are important to understand the convergence analysis in Chapter VII. Therefore, this chapter provides the background for the next chapter.

Chapter VII explores the possibility of convergence of auditing between the EU and Turkish law. First, it identifies forces for convergence. In this respect, it suggests important economic factors, such as internationalisation of the economy, and legal harmonisation as the drivers for convergence. Second, it discusses potential methods of convergence. Third, it analyses the feasibility of convergence based on Bebchuk and Roe's<sup>38</sup> path dependency theory and Berkowitz *et al*'s<sup>39</sup> transplant effect theory. Lastly, it describes a conceptual framework for convergence under the four levels of convergence, including the effects of harmonisation (and globalisation), differences in the law in action, the effects of path dependencies (and culture), and functional dissimilarities. The chapter concludes by examining whether there is convergence in form or in function. These results are important in terms of identifying difficulties in adoption and application of the rules from a transplant country perspective (i.e. Turkey). The results could prove useful for subsequent research on the EU and in Turkey in terms of further convergence studies.

Lastly, Chapter VIII provides a general conclusion of the thesis. This chapter presents a review of the thesis as well as concluding on the main findings in respect of the initial research questions.

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<sup>38</sup> Bebchuk and Roe (n 19) p. 157.

<sup>39</sup> Berkowitz *et al* (2003a) (n 20) p. 167.

# CHAPTER I: THE ROLE OF AUDIT IN CORPORATE GOVERNANCE

## INTRODUCTION

In the Cadbury Report, the term ‘corporate governance’ was defined in a narrow view, namely as “*the system of corporate governance by which companies are directed and controlled.*”<sup>1</sup> As firms have changed to include more participants in their activities, the definition of corporate governance is destined to become broader. Moreover, definitions might differ with regards the angle from which the problems in corporate governance might be viewed. This chapter will try to identify the best definition of corporate governance to suit the research subject of this thesis.

Agency theory submits that a governance mechanism is needed in a company because there is a risk that managers of the company might pursue their own interests rather than shareholders’.<sup>2</sup> External auditing can be used as a monitoring mechanism to mitigate the agency cost.<sup>3</sup> However, what if there is a different agency problem? It is argued that external auditing has a central role in dispersed systems;<sup>4</sup> thus, the following will question whether auditing has a governance role in concentrated systems.

This chapter is structured as follows. The first section starts with the definition of corporate governance. From the perspective of control and monitoring, some core theories, namely agency theory, transaction cost theory, and the stakeholder theory of corporate governance will also be explained in the first section. The aim is to question the need for corporate governance mechanism in a company and how external auditing finds its function in this mechanism. The second section

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<sup>1</sup> Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) 1 December 1992, para. 2.5.

<sup>2</sup> Adolf A. Berle, Jr. and Gardiner C. Means, *The Modern Corporation and Private Property* (Macmillan, New York 1932).

<sup>3</sup> Ross L. Watts and Jerold L. Zimmerman, ‘Agency Problems, Auditing, and the Theory of the Firm: Some Evidence’ (1983) 26(3) *Journal of Law and Economics* 613.

<sup>4</sup> John C. Coffee, Jr., ‘A Theory of Corporate Scandals: Why the USA and Europe Differ’ (2005) 21(2) *Oxford Review of Economic Policy* 198.

investigates the relationship between corporate governance and audit and adopts the view that the audit process has a close tie with the accountability dimension of corporate governance. The third and final section examines insider and outsider corporate governance systems and questions whether the demand for audit differs in these systems. The principal aims of this chapter are to identify the role of audit in corporate governance and determine its role in different systems of corporate governance systems (i.e. outsider and insider systems) and in financial markets.

## 1. GENERAL FRAMEWORK OF CORPORATE GOVERNANCE

### 1.1. Definition of Corporate Governance

The Cadbury Report<sup>5</sup> defines corporate governance as “(...) *the system by which companies are directed and controlled.*” Yet, this definition is not comprehensive in terms of encompassing the role of corporate governance in a company. According to the OECD Principles, corporate governance plays a role in the company in terms of the “(...) *distribution of rights and responsibilities among different participants and in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.*”<sup>6</sup> Although this definition points out every participant in a company and their responsibilities and rights, it falls short of explaining company objectives and who determines them.

Sternberg defined corporate governance as the ways of controlling a company to ensure that corporate actions, agents and assets are used to achieve the corporate objectives set by shareholders.<sup>7</sup> Tricker, by contrast, emphasized the needs of accountability and control mechanisms in a company, in addition to the concerns relating to the day-by-day operations.<sup>8</sup>

Given these different approaches to the definition of corporate governance, this chapter suggests that corporate governance can be defined as the system of directing

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<sup>5</sup> Cadbury Report (n 1) para 2.5.

<sup>6</sup> OECD Principles of Corporate Governance 1999 (revised in 2004).

<sup>7</sup> Elaine Sternberg, *Corporate Governance: Accountability in the Market Place*, (2<sup>nd</sup> edn, The Institute of Economic Affairs 2004).

<sup>8</sup> Robert Ian Tricker, *Corporate Governance: Practices, Procedures and Powers in British Companies and Their Boards of Directors* (Gower 1984).

the company in accordance to the specified objectives by its shareholders alongside ensuring accountability of actions and decisions of management, not only to shareholders, but also to any other groups who have a stake in the company.

Although no single corporate governance definition is valid for every country, existing definitions are mostly based on some common terms, such as accountability. Accountability is referred to as the responsibility of the company management to the company's shareholders (or owners) and other stakeholders for carrying out defined objectives and duties and other rules and standards.<sup>9</sup> The meaning of accountability for a company's directors to its shareholders is that directors should be ready to give response to company shareholders with regards achieving company objectives and the use of company resources and assets.<sup>10</sup>

## **1.2. Theories of Corporate Governance**

The discussion in this thesis will be based on the accountability dimension of corporate governance in particular. Thus not all theories, but rather a selection of corporate governance theories, will be evaluated here: agency theory, transactions cost theory, and the stakeholder theory.

### ***Agency theory***

Agency theory is based on the assumption that the ownership and control in the company is separated.<sup>11</sup> In other words, owners of the company delegate a professional manager to make decisions regarding the operation of the company. From the perspective of a neoclassical theory of the firm, no governance structure is needed even if there is a separation of ownership and control, because all individuals (e.g. shareholders and managers) would pursue the same goals.<sup>12</sup> For example, suppose the main activity of the company is determined as seeking to maximize the market value of the company. In this respect all individuals in the company would work in accordance with this main activity and, there would therefore be no conflict of interest between shareholders and managers.

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<sup>9</sup> OECD Glossary <http://stats.oecd.org/glossary/detail.asp?ID=4757> accessed 12/03/2012.

<sup>10</sup> Sternberg (n 7) p. 41.

<sup>11</sup> Berle and Means (n 2) p. 119.

<sup>12</sup> Oliver Hart, 'Corporate Governance: Some Theory and Implications (1995) 105 The Economic Journal 678.

However, agency theory argues that managers tend to pursue their own goals whilst there is lack of monitoring by shareholders.<sup>13</sup> Berle and Means firstly introduced this problem as the ‘agency problem’, which derived from the ‘separation of ownership and control’.<sup>14</sup> Accordingly, agency theory states that in order to control managers on the behalf of shareholders, there should be a governance mechanism.

According to agency theory, the managers of the company are delegated as ‘agents’ by the owners (or shareholders) of the company, who are referred to as ‘principals’. The characteristic feature of agency theory is that a conflict of interest may arise between owners (principals) and the management (agents) caused by the so-called ‘principal-agent problem’ or ‘agency problem’.<sup>15</sup>

In a governance system where the principal-agent problem exists, a conflict of interests arises where shareholders seek to maximize the shareholder value whereas managers pursue their own personal objectives. For example, managers have a tendency to focus on short-term profits instead of long-term shareholder wealth maximization.<sup>16</sup> In addition, managers may over pay themselves,<sup>17</sup> or use company assets for their own benefits, such as treating themselves to holidays through the company resources.<sup>18</sup> Therefore a mechanism is needed within the company to monitor the activities of company managers. According to Watts and Zimmerman, auditing is designed to fulfill the exactly this role.<sup>19</sup> They argue that audit is a kind of monitoring activity that increases the value of the firm because a successful audit would reduce opportunistic behavior costs (e.g. agency costs).<sup>20</sup>

In the absence of shareholder monitoring via independent auditors, managers tend to act in their own interests and exploit company assets. This situation will eventually

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<sup>13</sup> Alternatively, the stewardship theory is based on the assumption that the managers of the company are motivated to act in the best interest of their principals. Yet, this paper will not include a discussion on stewardship theory. For a discussion on the stewardship theory, see James H. Davis, David Schoorman, and Lex Donaldson, ‘Toward a Stewardship Theory of Management’ (1997) 22 *Academy of Management Review* 20.

<sup>14</sup> Berle and Means (n 2) p. 119.

<sup>15</sup> Jill Solomon, *Corporate Governance and Accountability*, (3<sup>rd</sup> edn, John Wiley & Sons 2004) p. 17

<sup>16</sup> It is known that in most cases managers’ compensation is related to the short-term profits. Also see *ibid.*

<sup>17</sup> Hart (n 12) p. 681.

<sup>18</sup> Solomon (n 15) p. 18.

<sup>19</sup> Watts and Zimmerman (n 3) p. 615.

<sup>20</sup> *Ibid.*

cause the reduction of shareholder value, referred to as ‘residual losses’<sup>21</sup>. As a consequence, there is a need for control over and monitoring of management by shareholders - and this can be done via external auditing.

In today’s world, agency theory is much more valid than the neoclassical theory of the firm. The limited liability concept encourages small shareholders to invest in companies because they would not be liable for the debts of the company, but only for the value of their shares in the company. This opportunity encourages investors to buy small shares from companies. As a consequence, the number of companies with a large number of owners with small shares has increased. These small shareholders have no or little incentive to control the management due to monitoring costs.<sup>22</sup>

Although the agency problem is likely to occur in today’s modern companies, it can appear differently in different systems. The first form occurs between small shareholders and managers due to conflicts of interest arising, in particular, as a result of information asymmetries. Both in the UK and US, the structure of public companies is based on dispersed ownership where there are numerous small shareholders.<sup>23</sup> Even though they have some residual control rights, such as voting rights, the day-to-day decision-making process is delegated to a board of directors and ultimately to a manager.<sup>24</sup> In other words, professional managers are appointed to manage the company instead of the owners themselves. In companies where the ownership is widely dispersed, conflict may arise because managers have direct access to information that small shareholders do not. Hence, conflict is likely to arise between the managers and shareholders.

The second type of agency problem exists because of the conflict that can arise between small shareholders (the minority) and controlling shareholders (the majority). This problem mainly exists in continental European companies. Turkish companies also present a typical example of controlling shareholders. In Turkey, controlling shareholders are mostly family members, and the manager of the company is generally appointed by the controlling shareholders.<sup>25</sup> In this situation, it

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<sup>21</sup> Solomon (n 15) p. 18.

<sup>22</sup> Hart (n 12) p. 681.

<sup>23</sup> See Section 3.1 below.

<sup>24</sup> Hart (n 12) p. 681.

<sup>25</sup> Melsa Ararat, “Comply or Explain” Without Consequences: The Case of Turkey’ available at SSRN [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1599831](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1599831) accessed 23/10/2013.

is likely that the company manager (appointed by the controlling shareholders) will pursue the interest of their 'owners' and therefore, exploit the rights of minority shareholders. Hence, the second type of agency problem occurs naturally because of the potential conflicts between minority shareholders and controlling shareholders.

### ***Transaction cost theory***

Transactions cost theory argues that the contract between the company management and owners of the company is incomplete due to numerous costs involved in writing a perfect contract.<sup>26</sup> These costs can be summarized as search and information costs (the cost of thinking what any future possible event might occur during the contract period); bargaining and decision costs (the cost of negotiations about the contract); policing and enforcement costs (the cost of enforcement by a judge in case of any dispute).<sup>27</sup> Due to these high costs, in practice, contracts are incomplete. In other words, not all circumstances could have been specified in a contract. At this level, corporate governance might have a role dealing with the issues that have not been specified initially.<sup>28</sup>

As a matter of fact, both agency theory and transaction cost theory considers that managers are opportunistic in a self-interested manner. Likewise, both theories take the view that managers should be accountable to the board of directors on the behalf of shareholders.<sup>29</sup> On the one hand, from the perspective of agency theory, corporate governance is limited, to the relationship between a company and its shareholders. On the other hand, stakeholder theory adapts a broader view on corporate governance and sees the relationship between a company and a broad range of other stakeholders. This theory will be discussed next.

### ***Stakeholder theory***

In contrast to agency theory, stakeholder theory suggests that corporate objectives should be determined in the interest of a wider stakeholder group in addition to shareholders. Most importantly, stakeholder theory is based on accountability to a

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<sup>26</sup> Oliver E. Williamson, 'Transaction-Cost Economics: the Governance of Contractual Relations' (1979) 22(2) *Journal of Law and Economics* 233.

<sup>27</sup> Hart (n 12) p. 680.

<sup>28</sup> *Ibid.*

<sup>29</sup> Philip Stiles and Bernard Taylor, *Boards at Work: How Directors View Their Roles and Responsibilities* (OUP, New York 2001).

broader stakeholder group rather than focusing solely on shareholders.<sup>30</sup> Broadly, stakeholders can be defined as anybody who has a valid stake in the company, and therefore include shareholders, employees, suppliers, customers, creditors and communities that associate with company's operations.<sup>31</sup>

Shankman argued that stakeholder theory developed as a result of agency theory, which can be seen as a narrow form of stakeholder theory.<sup>32</sup> Modern corporate governance integrates both shareholder value creation and stakeholder value protection. In other words, an integrated approach to a corporate governance model advocates not only increasing shareholder value, but also protection of the rights and interests of all those who have a stake in the company.

Theories of corporate governance differ in terms of their definitions of problems and approaches to them. For example, agency theory might take a narrow view in terms of accountability by locating the shareholders' interests in the center, whereas stakeholder theory might take a broader view and advocate wider accountability, including to stakeholders. One could take a broader perspective still and advocate not only increasing shareholder value, but also protection of the rights and interests of all those who have a stake in the company.<sup>33</sup> Either way, there can still be control problems in a company. The next section will question whether auditing has a role in corporate governance in terms of accountability.

## 2. THE RELATIONSHIP BETWEEN AUDIT AND CORPORATE GOVERNANCE

### 2.1. Accountability through Disclosure

Accountability in corporate governance means that directors of the company have responsibilities including as regards the use of company resources and any other concerns, such as the achievement of the company objectives.<sup>34</sup> Managers are

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<sup>30</sup> R. Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pitman 1984).

<sup>31</sup> John F. Farrar, Nigel Furey, Brenda Hannigan, and Philip Wylie, *Farrar's Company Law* (4<sup>th</sup> edn, Butterworths, London 1998).

<sup>32</sup> Neil A. Shankman, 'Reframing the Debate between Agency and Stakeholder Theories of the Firm' (1999) 19(4) *Journal of Business Ethics* 319.

<sup>33</sup> Zabihollah Rezaee, *Corporate Governance and Ethics* (Wiley & Sons, New York 2009).

<sup>34</sup> Sternberg (n 7) p. 45.

accountable to shareholders via the board of directors. In this respect, the management is obliged to prepare and present financial reports periodically to the board of directors. Accountability can thus be ensured via Annual General Meetings and votes, takeovers, contractual responsibilities of directors, or the periodical reporting of financial statements.<sup>35</sup>

Although each of these governance functions can be seen as a mechanism ensuring accountability, disclosure of annual financial statements is regarded as the most appropriate way to ensure such accountability.<sup>36</sup> The role of external auditing in accountability is to assess whether the financial statements prepared by the management present true information about the financial situation of the company.<sup>37</sup> External auditors<sup>38</sup> are usually appointed by the board of directors. Hence, an external audit can be considered as a part of the control mechanism of corporate governance.<sup>39</sup> As it has been said, external auditing emerged from the needs of control and accountability.<sup>40</sup> In order to ensure the accountability of management to shareholders and other stakeholders, a supervision mechanism is required which necessarily involves external auditing.<sup>41</sup> The auditors' role is to assure the quality and reliability of financial reporting. An independent auditor's role is significant to a company in terms of providing an external and objective assurance to the board and shareholders regarding the reliability of financial statements.<sup>42</sup>

A statutory audit is important, especially for public-interest entities (PIEs).<sup>43</sup> This is because PIEs and their investments involve a wider range of investors usually including cross-border investors. Also, for the efficiency of financial markets, it

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<sup>35</sup> Ibid p. 47.

<sup>36</sup> Ibid.

<sup>37</sup> Mahmoud Ezzamel and Robert Watson, 'Wearing Two Hats: the Conflicting Control and Management Roles of Non-Executive Directors' in Kevin Keasey, Steve Thompson, and Mike Wright (eds), *Corporate Governance: Economic and Financial Issues* (OUP, New York 1997).

<sup>38</sup> 'The auditor' is here referred to the statutory auditor and he (or she) could be either an individual or a firm.

<sup>39</sup> Jeffrey Cohen, Ganesh Krishnamoorthy, and Arnold M. Wright, 'Corporate Governance and the Audit Process' (2002) 19(4) *Contemporary Accounting Research* 573.

<sup>40</sup> Michael Power, *The Audit Society: Rituals of Verification* (OUP, New York 1997), p. 14.

<sup>41</sup> Kevin Keasey and Mike Wright, 'Issues in Corporate Accountability and Governance: An editorial' (1993) 23(91A) *Accounting and Business Research* 291.

<sup>42</sup> OECD Principles (n 6) Chapter V; Cadbury Report (n 1) at 36 para.5.1.

<sup>43</sup> The EU Recommendation on Auditor Independence of 2002 gives a definition of public-interest entities as follows: "Entities which are of significant public interest because of their business, their size, their number of employees or their corporate status is such that they have a wide range of stakeholders". See Commission Recommendation of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles 2002/590/EC OJ L 191/22.

should be ensured that investors have reliable information regarding the business activities of the PIEs, and this can be done via audited financial statements. In this respect, the principle concern of this thesis is the audit of listed companies.

## 2.2. The Role of External Auditors

Financial reporting as a disclosure mechanism can be used as an effective tool for investors to evaluate the financial position of a company and to decide whether to invest or not. Financial reporting provides ‘a snapshot’ of the company, constituted of financial verifications. Nevertheless, it is evident that financial reporting has been used to mislead shareholders in a number of cases, such as by Enron<sup>44</sup> in the US, in Parmalat<sup>45</sup> in Italy, and Imar Bank<sup>46</sup> in Turkey. In order to fulfill its role, the information included in the financial reporting must be accurate. External audit is therefore developed to ensure the credibility of financial statements.

It is required that financial statements (company and consolidated accounts) present a true and fair view of accounts.<sup>47</sup> Some argue that the role of auditors is only to ensure that financial statements are fairly presented and include true information.<sup>48</sup> Others also expect auditors to discover and report breaches of contract, such as fraudulent practices.<sup>49</sup> However, such a role is not determined as the principle duty of auditors by professional auditing standards, i.e. ISAs.<sup>50</sup>

Previously, directors, managers, or even shareholders were the ones who were accused of being responsible for company failures.<sup>51</sup> For instance, in 1992, as a response to failure of large corporations, such as Polly Peck, British and

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<sup>44</sup> George J. Benston and Al L. Hartgraves, ‘Enron: What happened and what we can learn from it’ (2002) 21 *Journal of Accounting and Public Policy* pp. 105–27. See also Chapter II.

<sup>45</sup> Robert Wearing, *Cases in Corporate Governance* (Sage 2005), p. 95.

<sup>46</sup> See Chapter VI, Section 1.2.

<sup>47</sup> Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings OJ L 224/1., OJ L 224/1, Recital 4.

<sup>48</sup> Sternberg (n 7) p. 71.

<sup>49</sup> Watts and Zimmerman (n 3) p. 615.

<sup>50</sup> ISA 240 gives the primary responsibility to the company management in terms of fraud detection. Also in *Re Kingston Cotton Mill Co. Ltd* (No: 2) [1896] 2 Ch. 279, Lord Justice Lopes stated that detection of fraud is not the job of auditors because they are not to be detectives. See Sternberg (n 7) p. 71.

<sup>51</sup> Sternberg (n 7) p. 71.

Commonwealth, Parkfield, and Coloroll the UK Cadbury Report was issued.<sup>52</sup> At that time, the report emphasized the importance of auditing.<sup>53</sup> Yet, its recommendations on board arrangements (e.g. the existence of non-executives) received more attention from the public. It was because the directors' responsibility was already accepted as crucial and it was believed the primary focus should be on the duties and responsibilities of directors.<sup>54</sup> It was not until Enron that external auditing and auditors received attention. After the collapse of Enron and the subsequent failure of its auditor, Arthur Andersen, many developments in corporate governance focused on external auditing and audit committees, not only in the US but also in the UK.<sup>55</sup>

### 2.3. External Auditing and 'Trust and Market Confidence'

The credibility of financial statements is crucial, not only for current shareholders, but also for those who have intentions to invest. As submitted, shareholders consider financial auditing as criteria by which to assess the performance of managers, thereby using it as a control mechanism over management.<sup>56</sup> Investors also rely on audited financial statements when they are about to make investment decisions. Without auditing, shareholders and investors would be unaided in seeking to assess the credibility of financial statements, and would likely be subject to information asymmetries. Moreover, if those financial statements did not provide accurate information, investors would not have the confidence to make investments. It is stated that auditing in general is prompted by a deficiency of trust.<sup>57</sup> In other words, auditing would not be needed if trust were ensured. Financial auditing is thus needed in order to reassure trust in financial markets.

Therefore, in addition to the monitoring function in corporate governance, external auditing also plays an essential role in terms of ensuring confidence and trust in financial markets via the verification of financial accounts. It is said that auditors are

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<sup>52</sup> J. E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (OUP 1993).

<sup>53</sup> Cadbury Report (n 1) para.5.1.

<sup>54</sup> Sternberg (n 7) p. 71.

<sup>55</sup> See US Sarbanes-Oxley Act (2002) on the independence of external auditors and UK Smith Report (2003) on the role of audit committees. See also Chapter IV, for regulatory responses to the Enron scandal.

<sup>56</sup> See Section 1.2 above.

<sup>57</sup> Power (n 40) pp. 2-3.

the guardians of ‘trust’ when they present the public with a true picture of the company.<sup>58</sup> It can be stated that this role of external auditing contributes to their public interest role.<sup>59</sup>

### **3. THE ROLE OF AUDITING IN DIFFERENT CORPORATE GOVERNANCE SYSTEMS: Insider and Outsider Systems**

There are various factors that may have shaped corporate governance systems, such as socio-economic, political, and historical factors. So, it may not be fully accurate to seek or make precise categorizations. Yet, categorizations based on differences and similarities might be useful to understand components of different systems and to clarify the weakness and strengths of a system towards the opponent. This section therefore aims to identify whether the role of auditing differs across different corporate governance systems, and if so, to evaluate these differences.

Ownership structures and market capitalization will be taken as the main determinants for categorization. Based on the categorization of differences in ownership structures, two different categories of corporate governance systems, namely the outsider and insider systems of corporate governance, will be identified. Thereafter, it will be questioned whether the governance function of auditing differs between these different systems.

#### **3.1. Insider and Outsider Systems**

In insider systems, the majority of the shares are owned and controlled by a small group of shareholders.<sup>60</sup> It is often family members or a lending bank that is the controlling shareholder. One of the main characteristics of the insider system is that there is a strong and close relationship between the company directors and owners, whose relationship is built on trust.<sup>61</sup> It is sometimes even the case that the directors

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<sup>58</sup> Susan P. Shapiro, ‘The Social Control of Impersonal Trust’ (1987) 93(3) *American Journal of Sociology* 623.

<sup>59</sup> For the public interest objective of audit regulation, see Chapter III, Section 3.2.1.

<sup>60</sup> A. Naciri, *Corporate Governance around the World* (Routledge 2008).

<sup>61</sup> H. Short *et al.* ‘Corporate Governance, Accountability and Enterprise’ (1998) 6(3) *Corporate Governance* 151; J. Franks and C. Mayer, ‘Ownership and Control of German Corporations’ (1994) 14(4) *Review of Financial Studies* 943.

and owners of the company are the same people.<sup>62</sup> Therefore, core agency problems (conflicts between small shareholders and company managers due to asymmetric information) are reduced in concentrated systems.<sup>63</sup> However, because of the influence of dominant shareholders on company directors and the close relations between directors and dominant shareholders, the rights of minority shareholders may be disregarded. Therefore, an agency problem occurs between minority shareholders and controlling shareholders due to the possible exploitation of minority shareholders' rights.<sup>64</sup> Low levels of transparency of financial transactions and limited access to information regarding a company's operations are characteristic features of insider systems.<sup>65</sup> France and Germany show the characteristics of insider corporate governance system often with higher ownership structures and weak investor protection.<sup>66</sup>

Conversely to the outsider system, the insider system of corporate governance focuses on the long-term performance of the company, whereas in outsider systems, ownership is highly dispersed and the majority of shares are held by institutional shareholders who consider mostly short-term income, known as short-termism.<sup>67</sup>

Outsider corporate governance systems are affiliated with financial institutions or institutional shareholders as outside shareholders.<sup>68</sup> Because the company shares are dispersed, control of the company usually rests with the management, resulting in agency problems.<sup>69</sup> This system is also referred as a market based governance system (or the Anglo-Saxon or Anglo-American system) wherein financial organizations depend on financial markets for their financing, with an emphasis on the shareholder wealth maximisation.<sup>70</sup> In outsider systems, the influence of institutional

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<sup>62</sup> Solomon (n 15) p. 149.

<sup>63</sup> Gül Okutan Nilsson, 'Corporate Governance in Turkey' (2007) 8 *European Business Organization Law Review* 195.

<sup>64</sup> B. Burcin Yurtoğlu, 'Ownership, Control and Performance of Turkish Listed Firms' (2000) 27 *Empirica* 193.

<sup>65</sup> Solomon (n 15) p. 149.

<sup>66</sup> Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54(2) *Journal of Finance* 471 p. 496.

<sup>67</sup> Short *et al* (n 61) p. 154.

<sup>68</sup> Solomon (n 15) p. 150.

<sup>69</sup> See Section 1.2 above.

<sup>70</sup> Naciri (n 60) p. 11.

shareholders on company management is significantly high.<sup>71</sup> For instance, the majority of shares in UK listed companies, nearly 60%<sup>72</sup> are held by institutions (i.e. pension funds, insurance companies, unit and investment trusts).<sup>73</sup> Similar to the UK, the US also has a dispersed ownership structure, mostly involving institutional investors, financial institutions, and individuals.<sup>74</sup> However, the rise of institutional shareholders in outsider corporate governance systems might result in differences in ownership structures. In fact, it is said that outsiders (institutional shareholders) in the UK are becoming more like insiders (dominant shareholders).<sup>75</sup> Therefore, there is no clear separation of ownership and control, even in outsider systems.

### 3.2. Function of Auditing in Different Systems

As submitted, there is no fine line categorization for corporate governance systems, as different systems may come closer as the financial markets get more integrated. Nevertheless, auditing might have a different function in different systems due to the different characteristics in those systems.

In market-based systems (outsider systems), companies are more likely to be subject to agency costs due to asymmetric information.<sup>76</sup> In outsider systems, managers' incentives are to overstate the earnings to increase the share prices (e.g. Enron).<sup>77</sup> Here, external auditing can function as a monitoring mechanism on the management and can help to reduce the agency cost by mitigating information asymmetry.<sup>78</sup> The role of auditing in outsider systems is to more check on managers.

On the contrary, in banking-governance systems<sup>79</sup> (insider systems) where the equity markets are less developed and the banks are the primary source of capital, auditing

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<sup>71</sup> Especially in the UK within the development in the last 40 years, individual shareholders are become less important while the importance of institutional shareholders is rising. See Solomon (n 15) p. 148.

<sup>72</sup> According to Short *et al.*, this number is 70%. See Short *et al.* (n 61) p. 159.

<sup>73</sup> See the Hampel Committee, Final Report (January 1998) p. 40 para. 5.1.

<sup>74</sup> Christine A. Mallin, *Corporate Governance* (3<sup>rd</sup> edn OUP, New York 2010) p. 43.

<sup>75</sup> Solomon (n 15) p. 150.

<sup>76</sup> Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

<sup>77</sup> Coffee (n 4) p. 203.

<sup>78</sup> Hollis Ashbaugh and Terry D. Watfield, 'Audit as a Corporate Governance Mechanism: Evidence from the German Market' (2012) 2 *Journal of International Accounting Research* 1.

<sup>79</sup> Banking governance systems described as the systems where the ownership structure is highly concentrated and institutions' financing depends mostly on banks as in the case in Germany and Japan. See Naciri (n 60) p. 11.

is considered less as a monitoring device. In these systems, controlling shareholders – whose wealth largely depends on firm performance – are eager to monitor the management and have direct monitoring access over it.<sup>80</sup> This situation enables insiders (controlling shareholders) to have enough power and incentives to ensure that the management does not exploit the corporate resources.<sup>81</sup> However, the domination of majority shareholders results in another agency problem. In these systems, minority investors have limited or no access to the financial information and are likely to be subject to expropriation by the controlling shareholders.

It is said that the incentives to commit fraud are different in insider corporate governance systems, where controlling shareholders have a tendency to make use of the corporate assets for their personal benefits.<sup>82</sup> This was notably seen in the Imar Bank<sup>83</sup> scandal in Turkey. Large private benefits of control, for example illegally transferring assets to other corporations, can be seen as a proof of weak corporate governance. Investors would be reluctant to invest in those companies. Thus, here - with greater problems of private benefits of control – companies may have incentives to improve their corporate governance to attract outside investors. It can be claimed that high-quality audits would tell an outsider investor that the financial reporting is credible and the information asymmetry is reduced that will provide less room for managers' opportunistic behaviours.<sup>84</sup>

### *Auditing in concentrated systems*

Coffee claimed that external auditing play a more critical role in dispersed ownership structures.<sup>85</sup> But it can also be shown that external auditing plays a role in insider systems wherein the protection of minority shareholders from private benefits (financial or non-financial) extraction by majority shareholders is essential. Having dominant shareholders holding the majority of the control in their hands could make corporate governance less effective. In such companies financial reporting may remain vague while controlling shareholders expropriate the corporate resources at

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<sup>80</sup> Jensen and Meckling (n 76) pp. 312-3.

<sup>81</sup> Ibid.

<sup>82</sup> Coffee (n 4) p. 204.

<sup>83</sup> For the study of Imar Bank case, see Chapter VI, Section 1.2.1.

<sup>84</sup> Omrane Guedhami and Jeffrey A. Pittman, 'Ownership Concentration in Privatized Firms: The Role of Disclosure Standards, Auditor Choice, and Auditing Infrastructure' (2006) 44(5) Journal of Accounting Research 889, p. 895.

<sup>85</sup> Coffee (n 4) pp. 200-4.

the expense of minority shareholders.<sup>86</sup> The existence of independent directors on the board might be a remedy to mitigate the costs of this kind of agency problem. However, alternative governance mechanisms may be required, especially where the legal environment is weak (e.g. where there is a lack of sufficient legal rules and enforcement mechanisms).<sup>87</sup>

One may argue that, in the expectation of the expropriation remains undiscovered, controlling shareholders may choose to appoint a lower-quality auditor for the audit of their financial statements.<sup>88</sup> In the contrary, companies with concentrated ownership may believe that they would need high-quality audits in order to convince minority shareholders and outside investors that corporate governance and financial statements are credible so that they can make investment in the company.<sup>89</sup> Minority shareholders and potential investors would like to see that the ability of controlling shareholders to expropriate the corporate assets is limited. Controlling shareholders in turn, are well aware of that they should limit their ability of expropriation.<sup>90</sup> High-quality audits as an external corporate governance mechanism can be used as a solution to this agency problem so that investors can be ensured that their investment is secured in the company.<sup>91</sup> Empirical studies also support this claim as it was found that companies who in needs of external capital tend to choose to appoint Big Five<sup>92</sup> auditors.<sup>93</sup>

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<sup>86</sup> Joseph P. H. Fan and T. J. Wong, 'Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia', (2005) 43(1) *Journal of Accounting Research* 35, p. 44.

<sup>87</sup> Transparency in accounting practices can be used as a governance mechanism to reduce the risk of expropriation of corporate assets by controlling shareholders and can protect outside investors. See Guedhami and Pittman (n 84) p. 894.

<sup>88</sup> Fan and Wong (n 86) p. 42.

<sup>89</sup> Salim Darmadi, 'Ownership Concentration, Family Control, and Auditor Choice: Evidence from an Emerging Market' February 2012, p. 13, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1999809](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1999809) accessed 28/08/2014

<sup>90</sup> *Ibid*, pp. 28-9.

<sup>91</sup> Jensen and Meckling acknowledged that external audit plays an important role in reducing asymmetric information and mitigating agency problems between management and owners as well as between majority and minority shareholders. See Jensen and Meckling (n 76) pp. 323-5.

<sup>92</sup> Big Five refers to the Big Four audit firms and Arthur Andersen. See also Chapter II, Section 2.4.

<sup>93</sup> Fan and Wong (n 86) p. 44; P. Copley, J. Gavier, and K. M. Gaver, 'Simultaneous estimation of the supply demand of differentiated audits: evidence from the municipal audit market' (1995) 33(1) *Journal of Accounting Research* 137; W. B. Johnson and T. Lys, 'The market for audit services: evidence from voluntary auditor changes' (1990) 12(1-3) *Journal of Accounting and Economics* 281.

For example, Fan and Wong found a positive relationship between agency problems and Big Five auditor choice.<sup>94</sup> They found that East Asian firms that are subject to greater agency problems are more likely to hire Big Five auditors than firms subject to smaller agency problems.<sup>95</sup> Choi and Wong presented similar findings with a more international perspective using firm-level data collected from 39 countries.<sup>96</sup> They questioned the strength of legal environments in the governance role of auditors. Their study reported that external auditors might serve a more significant governance function in weak legal environments compared with strong legal environments.<sup>97</sup> The demand for high-quality audits for bonding effect is more related to weak legal environments than in strong legal environments because in the latter there are other mechanisms for investor protection.<sup>98</sup> Therefore, companies with concentrated ownership structures, which operate in weaker legal environments (i.e. less developed legal institutions), would look for alternative governance mechanisms to persuade small equity owners to invest in their companies. At this point, high-quality audits could be used as a sign of good corporate governance in concentrated ownership structures since it can be a tool to mitigate the agency problem between controlling shareholders and minority shareholders.<sup>99</sup>

In line with the above findings, external auditing plays a similar governance function in Turkish listed firms where the governance pattern reflects concentrated ownership structures with weak protection of minority shareholders.<sup>100</sup> A recent study<sup>101</sup> found a positive relation between ownership concentration and the likelihood of Big Four audit firm demand amongst Turkish listed firms. In Turkey, firms with a less independent board of directors and high ownership concentration demand higher

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<sup>94</sup> They used the comparison of controlling owners' level of voting rights with the owners' cash flow rights for the proxy of agency problem. See Fan and Wong (n 86) p. 39.

<sup>95</sup> Larger audit firms are generally perceived to be more independent. For the audit quality of the Big Four firms, see Chapter II, Section 5.2.

<sup>96</sup> See in general Jong-Hag Choi and T. J. Wong, 'Auditors' Governance Functions and Legal Environments: An International Investigation' (2007) 24 *Contemporary Accounting Research* 13.

<sup>97</sup> *Ibid* p. 13.

<sup>98</sup> *Ibid* pp. 15, 31.

<sup>99</sup> Fan and Wong (n 86) p. 66.

<sup>100</sup> Melsa Ararat, Hakan Orbay, and B. Burcin Yurtoglu, 'The Effects of Board Independence in Controlled Firms: Evidence from Turkey' July 2010 p. 3 available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1663403](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663403) accessed 28/08/2014. See also Istemi Demirağ and Mehmet Serter, 'Ownership Patterns and Control in Turkish Listed Companies' (2003) 11 *Corporate Governance* 40.

<sup>101</sup> This study gathered data from non-financial firms listed in the Istanbul Stock Exchange (ISE) in 2005-2009. See Yasemin Zengin Karaibrahimoğlu, 'Is Corporate Governance a Determinant of Auditor Choice? Evidence from Turkey' (2013) 13(2) *Ege Academic Review* 273.

quality auditors to reduce the information asymmetry between controlling shareholders and minority shareholders.<sup>102</sup> The same study reported that firms might demand high quality audits as a substitution for or as complementary to weak corporate governance structures.<sup>103</sup> Based on the substitution analysis, a strong corporate governance structure (i.e. effective internal monitoring) might substitute for higher quality audits and thus demand lower-quality auditors.<sup>104</sup> However, a good corporate governance structure is not an alternative to quality audits and this should and could not eliminate the demand for audit quality. Instead, it is more likely that firms demand higher quality audits to complement and support the internal governance structure. The needs of insurance and signalling would foster firms to demand higher quality audits.<sup>105</sup> As a result, firms would be able to provide insurance to the investors about the credibility of financial reports and to give signal that corporate governance system is sound.<sup>106</sup>

This chapter submitted that external auditing might differ in systems where markets have different characteristics and different legal systems. On the one hand, in market-based systems where the legal environment is stronger, external auditing is only one of the monitoring mechanisms where there are additional monitoring devices available. In other words, the need of external auditing in terms of monitoring is shared with other controlling mechanisms (e.g. the presence of non-executive directors in the board). On the other hand, in insider corporate governance systems where other monitoring mechanisms and the legal protection of investors are weak, the demand for high quality audits is mostly originated from the needs of giving insurance and signalling to investors about the accuracy of the information in the financial statements. In conclusion, these analyses may imply that although the original demand might differ, external auditing does have an important governance function in dispersed systems as well as in concentrated systems.

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<sup>102</sup> Ibid p. 281.

<sup>103</sup> Ibid p. 275.

<sup>104</sup> Ibid pp. 273-4.

<sup>105</sup> Ibid p. 275.

<sup>106</sup> Ibid.

## CONCLUSION

This chapter critically questioned the role and function of external auditing both in dispersed and in concentrated systems. It noted that the external auditing demand in dispersed systems is originated by its monitoring function over management. In concentrated systems, firms demand external auditing as a complement and support for their internal governance structure because of the needs of giving insurance and signalling to investors about the quality of their financial reports and gain public confidence.

The main conclusion of this chapter is that external auditing has a governance function both in dispersed and concentrated systems. As a result, there is demand for auditing in both systems. It is noteworthy to state that legal systems' differences are not substantial, as shown by La Porta *et al.*<sup>107</sup> It is true that there are distinctive components of different legal systems, but they mainly derive from the differences in historical development.<sup>108</sup> Moreover, these models may converge to some extent at points.<sup>109</sup> In this respect, the use of external auditing in different systems should not be regarded as a major difference, since external auditing directs international markets and thus has highly benefited from globalisation. As a result, an approximation is possible for auditing. A discussion on the convergence of auditing will be elaborated in Chapter VII. Apart from the approximation of systems, the integration of financial markets has increased the demand for external auditing. Increased numbers of cross-listings between countries has resulted in a demand for financial reports and auditing. Therefore, the demand for auditing in the financial markets and its importance in firms' corporate governance systems has been increasing. As this chapter has shown, the demand for auditing might differ in different systems; whether there are differences in terms of its function will be investigated in the next chapter. The next chapter will investigate how audit works in today's financial markets with a close examination of the role of auditors in the global financial crisis.

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<sup>107</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 'Law and Finance' (1998) 106(6) *The Journal of Political Economy* 1113. For counter arguments, see Priya Lele and Mathias M. Siems, 'Shareholder Protection: A Leximetric Approach' (2007) 7 *Journal of Corporate Law Studies* 17.

<sup>108</sup> K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (translated by Tony Weir, 3<sup>rd</sup> edn, OUP 1998). See also Chapter VII, Section 1.

<sup>109</sup> See Chapter VII for convergence analysis.

# CHAPTER II: HOW DOES EXTERNAL AUDIT WORK TODAY?

## INTRODUCTION

Since the 1200s, and the early development of firms, auditing has existed.<sup>1</sup> External auditing was first used to check on managers on behalf of shareholders, in the manner of detectives.<sup>2</sup> As a result, auditors used to serve the interest of the shareholders only. However, there have been significant changes in terms of auditors' role and their function. Users of audited reports have been extended beyond shareholders. Today, external auditing is necessarily important for investors, but also depositors, regulators, suppliers, creditors, and anybody who is likely to use audited financial reports, thus assigning a public role to auditors as gatekeepers of sorts.<sup>3</sup>

The previous chapter showed that external auditing is an important component in corporate governance. This chapter aims to examine the purpose of external auditing in today's financial markets and to further identify the dual role of auditors as detectives and gatekeepers. Moreover, the conceptual and structural problems in external auditing (e.g. auditor independence, expectations gap, and the concentration in the market) will be examined.

This chapter will proceed as follows: the first section will start with the general framework of external auditing. It will identify the function of auditing in the governance structure of a company. In the second section, it will be examined how the role of auditors has changed and how this affects today's audit profession. In this context, the conceptual and structural problems of auditing will be examined. This section will also question the concentration in the audit market in the light of the new form of external auditing. The third and last section will examine the role of auditors

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<sup>1</sup> Ross L. Watts and Jerold L. Zimmerman, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' (1983) 26(3) *Journal of Law and Economics* 613.

<sup>2</sup> Amy Shapiro, 'Who Pays the Auditor Calls the Tune: Auditing Regulation and Clients' Incentives' (2004) 35 *Seton Hall Law Review* 1029.

<sup>3</sup> *Ibid* pp.1036-7. See also John C. Coffee, Jr., *Gatekeepers: The Professions and Corporate Governance* (OUP, 2006).

in the global financial crisis. During and after the global financial crisis, auditors, namely the Big Four, have been accused of failing in the role of issuing accurate going concern opinions. This section will examine whether this accusation was fair. In this respect, the Big Four's audit quality and their going concern reporting accuracy will be examined.

## **1. GENERAL FRAMEWORK OF EXTERNAL AUDITING**

### **1.1. The Scope of Audit**

External auditing refers to the relationship where corporate management hires an independent external auditor to review and approve annual financial statements. Annual financial statements include the balance sheet and the related statement of income, retained earnings and cash flow for the completed fiscal year.<sup>4</sup> Financial audit is the process of checking the accuracy of these annual financial statements and compliance with the related accounting standards.<sup>5</sup>

In the EU, it is a legal requirement that listed companies' financial statements should be audited by an independent external auditor.<sup>6</sup> Member States' competent authorities approve statutory auditors (natural persons) or audit firms (legal persons) to perform statutory audits at the national level.<sup>7</sup> For instance, in the UK, only statutory auditors recognized by supervisory bodies, such as the Institute of Chartered Accountants of England and Wales (ICAEW), are allowed to perform statutory audits of public companies.<sup>8</sup> In general, the statutory audits of PIEs are provided by the audit firms rather than individual statutory auditors. Auditors have to

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<sup>4</sup> Joshua Ronen, 'Corporate Audits and How to Fix Them' (2010) 24(2) *Journal of Economic Perspectives* 189.

<sup>5</sup> Accounting standards refer in the US, to Generally Accepted Accounting Principles (US GAAP), in the UK to the Generally Accepted Accounting Practice (UK GAAP), and in the EU to the International Financial Reporting Standards (IFRS).

<sup>6</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87; Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013).

<sup>7</sup> Companies Act 2006, s. 489.

<sup>8</sup> *Ibid.*, s. 1212.

apply certain standards (e.g. IFRS, ISAs, auditors' code of ethics<sup>9</sup>) when they perform audits of publicly listed companies. In addition, they are subject to regulatory supervision of public oversight authorities, e.g. PCAOB in the US and FRC's Audit Quality Review (the former Audit Inspection Unit) in the UK.

The audit process is constituted of three main stages. In the first stage, the auditor gains understanding of the audited company and its activities through assessment of accounting system and internal control mechanism.<sup>10</sup> This stage involves evaluation of internal controls in detail, as to whether the transactions and account balances are parallel to company records and whether there are any material misstatements. If the auditor is satisfied with the accuracy of internal control records from the evidence gathered from stage one, he (or she) continues with the second and final stage, to issue the audit report. However, if the auditor finds additional risk factors, such as asymmetric records with the transactions and internal control reports, then the scope of the audit is reset.<sup>11</sup> In the third and final stage, the auditor issues an audit report to provide information to shareholders and other third parties. The auditor's opinion on the financial statements is meant to provide a reasonable assurance on whether financial statements are free from material misstatement caused by fraud or error, and whether they are in accordance with the related accounting standards and laws.<sup>12</sup> The auditor's opinion should also note any circumstances that may affect the financial stability of the audited entity.

If the auditor is satisfied with the audit evidence, and that the financial statements give a true and fair view, and they are prepared (in compliance with the relevant accounting standards and legislation), he (or she) issues an unqualified audit report.<sup>13</sup> If unqualified, this audit report is a 'clean' audit report. The auditor may also decide to issue a qualified audit report due to misstatements in the financial statements or because he (or she) was unable to obtain sufficient evidence about the accuracy of the financial statements. Before issuing a qualified audit report, the auditor needs to modify the opinion in the report.<sup>14</sup> There are three types of modified opinions: a

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<sup>9</sup> IFAC, 'Code of Ethics for Professional Accountants' 2010.

<sup>10</sup> Brenda Porter, Jon Simon, and David Hatherly, *Principles of External Auditing* (2<sup>nd</sup>, John Wiley & Sons 2003) p. 149.

<sup>11</sup> Ronen (n 4) p. 191.

<sup>12</sup> ISA 700, para 10. See also Porter *et al* (n 10) p. 149.

<sup>13</sup> ISA 700, para. 16.

<sup>14</sup> *Ibid*, para.17.

qualified opinion, an adverse opinion, and a disclaimer of opinion.<sup>15</sup> If there are material misstatements, but there is nothing pervasive to the financial statements, the auditor issues a ‘qualified opinion’.<sup>16</sup> This is still a clean opinion. If the misstatements are material and pervasive to the financial statements, the auditor expresses an ‘adverse opinion’<sup>17</sup>. This is an unclean audit opinion. Lastly, the auditor may issue a disclaimer of opinion when he (or she) is unable to obtain sufficient appropriate audit evidence regarding the accuracy of financial statements.<sup>18</sup> The auditor disclaims the audit opinion because of the risk that undetected misstatements could have a material and pervasive effect on the financial statements.

## 1.2. Dual Role of Auditors: Detectives and Gatekeepers

The history of auditing dates back to the early development of joint stock companies.<sup>19</sup> In the UK, this occurred with the enactment of the first Companies Act (Joint Stock Companies Act) of 1844, which recognized audit for English companies on a voluntary basis.<sup>20</sup> The Companies Act of 1900 required audit for the first time; however, it did not define any rules to determine an auditor as qualified to perform audits.<sup>21</sup> Thereafter, auditing did not develop as a profession in the UK until 1948.<sup>22</sup> Before then, directors or officers appointed by shareholders performed the audits of early joint stock companies.<sup>23</sup> In line with its development, the objective of auditing has evolved over time.

### *Auditors as Detectives (Public Watchdogs)*

During the late 1890s, in the early days of auditing, the objective of an audit was to check the consistency of internal records (book-keeping of company transactions) of the company.<sup>24</sup> This role mainly involves the detection of fraud and material errors in

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<sup>15</sup> ISA 705. Para 2. See also Porter *et al* (n 10) p. 376. Qualifying auditor’s report regarding the going concern uncertainty will be examined in Section 3.1 below.

<sup>16</sup> ISA 705, para 7.

<sup>17</sup> *Ibid*, para 8.

<sup>18</sup> *Ibid*, para 9.

<sup>19</sup> As it was translated from the original Medieval Latin text, in 1200, a constitution of English merchant guild (an early example of association of traders) at Ipswich had a provision for annual audit. See Charles Gross, *The Guild Merchant* 4 (1890) in Watts and Zimmerman (n 1) p. 616.

<sup>20</sup> Watts and Zimmerman (n 1) p. 628.

<sup>21</sup> Porter *et al* (n 10) p. 22.

<sup>22</sup> Graham W. Cosserat, *Modern Auditing* (John Wiley & Sons, England 2000) p. 5.

<sup>23</sup> Watts and Zimmerman (n 1) p. 624.

<sup>24</sup> Cosserat (n 22) p. 6.

the accounts.<sup>25</sup> As a result, auditors were only responsible to the company that they audited.<sup>26</sup> The role of the detective-auditor was mainly to serve the owners of the company by confirming the consistency of internal records with the company transactions and to make sure that the treasurer was not cheating the owners.

The fraud detection role of auditors was also acknowledged in case law in the UK. The two cases of *London and General Bank* and *Kingston Cotton Mill Co Ltd.* restated an audit's objectives of detecting fraud and error.<sup>27</sup> However, these cases also stated that auditors could not be expected to detect every fraud and error<sup>28</sup> since they are watchdogs but not detectives or bloodhounds; they do have to show reasonable skill and care in their work, however.<sup>29</sup>

### *Auditors as Certifiers (Gatekeepers)*

In the 1970s, by the time of the development of the securities markets, small investors needed more information regarding the fairness of financial information included in companies' statements. Auditors were asked to approve information to be disclosed to a third party, namely to shareholders, investors or in general, to the public. Correspondingly, the objective of auditing moved from fraud detection towards ensuring the credibility of financial statements.<sup>30</sup> From that time, providing assurance services was recognized as the primary role of auditors, while detection and prevention of fraud were assigned to the internal control mechanism designated by the management.<sup>31</sup>

By the 1990s, the business risk approach was adopted in auditing.<sup>32</sup> The business risk approach holds that audit failures<sup>33</sup> are not generated because of undetected fraud or error, but because of the uncontrolled operational risks in a company.<sup>34</sup> Accordingly, in order to reduce the business risk, auditors started to focus on the provision of

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<sup>25</sup> Lawrence Robert Dicksee, *Auditing: A Practical Manual for Auditors* (Gee & Co., London 1892).

<sup>26</sup> Shapiro (n 2) p. 1034.

<sup>27</sup> For further analysis on these cases, see also Chapter V, Section 3.1.

<sup>28</sup> *In Re London and General Bank* (No: 2) [1895] 2 Ch. 673.

<sup>29</sup> *In Re Kingston Cotton Mill Co. Ltd* (No: 2) [1896] 2 Ch. 279.

<sup>30</sup> D. R. Carmichael, 'The Assurance Function-Auditing at the Crossroads' (1974) 138(3) *Journal of Accountancy* 64.

<sup>31</sup> Porter *et al* (n 10) p. 27.

<sup>32</sup> *Ibid* p. 32.

<sup>33</sup> Audit failure refers to issue a clean audit opinion on financial statements that are materially misstated. See also Section 3.3 below.

<sup>34</sup> Porter *et al* (n 10) p. 33.

consultancy services<sup>35</sup> and they acknowledged their responsibility to provide an opinion as gatekeepers regarding a firm's ability to continue as a going concern.

### ***Modern time Auditors***

Today, auditors are seen as gatekeepers (or certifiers<sup>36</sup>), rather than detectives. From a gatekeeper's perspective, the objectives of modern auditing can be considered to be the provision of a review of the company's accounts, to examine financial statements to ensure they are free from material misstatements, omissions and misleading information, and to express an audit opinion including any concerns regarding a firm's ability to continue as a going concern.

Public companies are required to disclose financial information to the public once shares are offered, and for as long as they are traded on stock exchanges.<sup>37</sup> Auditors then review and certify the financial information disclosed to third parties. There are a number of users of this verified financial information: namely, the existing company shareholders, potential shareholders (investors), regulatory agencies, and any third party that might be involved in the operations of the company. Investors use the audited financial information to decide whether to make an investment in the company. Regulatory agencies seek the efficiency of financial markets through accessible reliable and sound financial information. All of this has the aim that stock prices reflect companies' present reliable information and that the market determine the correct prices of securities.<sup>38</sup>

However, this dual role of auditors might cause conflicts of interest. On the one hand, auditors have to perform an auditor-as-detective role to the company owners (existing shareholders). On the other hand, certifier auditors verify disclosed financial information and approve financial stability - whether it is financially sound to invest in the company. Though detective-auditing has a public watchdog role, certifying auditing may give auditors an incentive to please the client instead of protecting the interest of the public.

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<sup>35</sup> See *ibid.* See also Section 2.3 below.

<sup>36</sup> Shapiro (n 2) p. 1036.

<sup>37</sup> Directive 2004/109/EC (as amended) (n 6), Articles 4-6.

<sup>38</sup> Shapiro (n 2) p. 1041.

In certification auditing, public companies hire auditors to verify the disclosed financial information so that they can induce the potential investors to make investments in their companies. Here, there is a risk that the auditor might favor the company, even though the user of this information is a third party (potential investors). There is a risk that the auditor might become an advocate of the company, instead of acting like an impartial detective, and serving their public watchdog role.<sup>39</sup> This conflict of interest arises naturally because of the auditor-client relationship. There is a client-relationship between the auditor and the audited company, and auditors have an incentive to please their clients.<sup>40</sup> As a result, auditor independence may be impaired because auditors are paid by the audited company (the client).

In addition, conflict may arise because there are two different kinds of users of the audited financial reports. On the one hand, there are company owners who ask auditors to perform their auditor-detective role. On the other hand, potential shareholders rely on auditors as gatekeepers when making investment decisions. It is highly difficult for auditors to satisfy both users, given their different interests. As UK case law has recognized, it cannot be expected of auditors to detect every fraud and error in financial statements.<sup>41</sup> It is likely there would be undetected material misstatements in the financial statements even if the auditor showed reasonable skill and care. Moreover, capital markets become more sophisticated and complex every day. It is true that neither regulators nor auditors fully understand today's complex financial markets.<sup>42</sup> It gets more difficult for auditors to audit effectively and provide an assurance in such complex markets.<sup>43</sup> Eventually, one side of users' expectations (either owners of the company or investors) has to be compensated. This conflict is referred to the situation named expectations gap.<sup>44</sup>

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<sup>39</sup> Gregory J. Jenkins and D. Jordan Lowe, 'Auditors as Advocates for Their Clients: Perceptions of the Auditor-Client Relationship' (1999) 15(2) *The Journal of Applied Business Research* 73.

<sup>40</sup> In a study, a group of business students were assigned to be the auditors of a fictional company A. The other group assigned as auditors of another fictional company B that wants to take over the A. The figures of the sellers' auditors show higher value than the figures of the buyers' auditors. See also Shapiro (n 2) p. 1041. For auditor independence, see also Section 2.2 below.

<sup>41</sup> See *Re Kingston Cotton Mill Co. Ltd* (n 29).

<sup>42</sup> Nick Leeson, 'Bonus hunters, burn-outs and boffins-no wonder banks go belly-up' *Daily Mail Online* London, 15 September 2007.

<sup>43</sup> Prem Sikka, 'When it comes to the crunch' *The Guardian* 19 September 2007.

<sup>44</sup> Expectations gap will be given in greater details in Section 2.1 below.

## 2. EXTERNAL AUDITORS IN THE WAKE OF MODERN AUDITING PROFESSION

As the previous section showed, auditors are now expected to verify financial statements, but at the same time give an assurance regarding the financial sustainability of the entity. Regarding the latter role, audit firms provide consulting services, including risk assessment and management services. However, the law does not assign the latter role to external auditors.<sup>45</sup> This situation results in an expectations gap in relation to both the role of the auditors and the scope of the external auditing. In addition, the growing economic importance of consulting is likely to impair auditor independence. This section examines the auditing profession in light of the two main issues, which are auditor independence and the expectations gap.<sup>46</sup> In addition, the Big Four's dominance in the audit market will also be discussed in this section.

### 2.1. Ill-defined Role of Auditors: expectations gap

The previous section identified how the objective of external auditing has evolved through time.<sup>47</sup> The perception regarding the role of auditing has also changed over time. Auditors are not only asked to perform a detective-auditor role, but they are also called to consider the business risks which includes the assessment of whether an entity will fail to achieve its objectives.<sup>48</sup> However, there is a lack of clarity regarding the scope, role and objective of audit among the stakeholders. This situation creates an expectations gap between auditing in practice and stakeholders' expectations of auditing.

The first kind of expectations gap is derived from the scope of auditing. Although statutory audit concerns with the previous period-backward looking element of an audit (i.e. the verification of financial statements), it also includes the forward looking element of an audit (i.e. an opinion that the company remains going

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<sup>45</sup> The UK Companies Act 2006 requires auditors to include in the audit report whether the annual accounts give a true and fair view and have been prepared in accordance to the related law and accounting standards. See Companies Act 2006, s. 495(3)(a).

<sup>46</sup> The discussion on the possible regulatory remedies to these issues will be given in Chapter IV, Section 3.1.

<sup>47</sup> See Section 1 above.

<sup>48</sup> Kay W. Tatum and Stuart W. Turley, *Developments in the Audit Methodologies of Large Accounting Firms* (ABG, London 2000). See also Section 1.2 above.

concern).<sup>49</sup> There is a general perception among stakeholders that financial statements with unqualified audit reports guarantee the financial health of the entity.<sup>50</sup> However, audit opinion does not have to give such assurance regarding the future sustainability of the entity.<sup>51</sup> It is argued that this kind of expectations gap was at its widest during the global financial crisis.<sup>52</sup> The unexpected failure of big institutions might result in a more risk-oriented approach in auditing.<sup>53</sup>

With respect of the role of auditors, the expectations gap derived from the expanded role of auditors. Arthur Andersen's financial chicanery brought to notice the expanding role of auditors in terms of fraud detection. The number of collapses and major fraud incidents called for increased accountability and hence, changes in perceptions of auditors' role. Nevertheless, auditors are not primarily responsible for the prevention and detection of fraud; instead, this role falls to the management.<sup>54</sup> Auditors are required to show reasonable skill and care to detect and report fraud.<sup>55</sup> The term 'reasonable' causes ambiguity, however, and therefore results in a gap regarding the stakeholders' understanding of the duties of auditors.

The other expectations gap is derived from the natural inconsistency of the auditing model, where auditors are appointed and remunerated by the audited client. External auditors also have a role as public watchdogs.<sup>56</sup> In other words, auditors should serve the public interest via ensuring investors and public at large that financial statements are presented fairly. However, it is difficult to fulfill this role when they are hired and paid by the audited company and are therefore dependent upon company managers for audit fees. Shapiro explains this situation as "*dealing with two masters/wearing two hats*".<sup>57</sup> She argued that the structure of external auditing requires auditors to be

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<sup>49</sup> House of Lords Select Committee on Economic Affairs, *Auditors: Market Concentration and Their Role*, Volume: I Report, 30 March 2011 (House of Lords Report).

<sup>50</sup> The examiner of the Lehman Brothers bankruptcy stated: "*the investing public is entitled to believe that a 'clean' report from an independent auditor stands for something.*" See the report written by Anton Valukas -the examiner of the Lehman Brothers bankruptcy. All nine volumes of the report is available at <http://jenner.com/lehman/> accessed 08/11/2013.

<sup>51</sup> See Section 3.1 below.

<sup>52</sup> Peter Nyberg, *Report of the Commission of Investigation into the Banking Sector in Ireland Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland* March 2011 p. 55 available at <http://www.bankinginquiry.gov.ie/> accessed 06/11/2013/

<sup>53</sup> For audit failures, see Section 3.3 below.

<sup>54</sup> ISA 240. See also Chapter V, Section 1 for the responsibilities of auditors for detecting fraud.

<sup>55</sup> See *Re Kingston Cotton Mill Co. Ltd* (n 29). See also Section 1.2 above in this chapter.

<sup>56</sup> See Section 1.2 above.

<sup>57</sup> Shapiro (n 2) pp.1034, 1041.

hired and paid by the audited company while laws encumber auditors to serve the public's interests.<sup>58</sup> So, as argued, there is a natural inconsistency in the structure of auditing and the purpose of the law. In conclusion, it can be submitted that the scope, role and objective of auditing are ill-defined and are causing an expectations gap between auditors and the stakeholders.

## 2.2. Auditor-Client Relationship *versus* Independence

In capital markets, investors use a company's financial statements in determining their investments, so as to make the highest return on their investment with the lowest risk.<sup>59</sup> There is a possibility that managers will accidentally - or deliberately - misrepresent financial statements. Thus, external auditors are needed as independent outsiders to assure investors that financial statements prepared by the management are presented accurately.<sup>60</sup> Investors consider external auditing as an assurance regarding the reliability of financial statements only because external auditors have professional qualifications and knowledge and they are independent of the management. If auditor independence were impaired, their financial statements will no longer be trusted.

The professional qualification of an auditor is important for detection of misstatements and errors in the financial statements, so that the accuracy of the financial statements is ensured. DeAngelo defines audit quality as the auditor's ability both in discovering corruption in financial statements, and in reporting it.<sup>61</sup> An auditor is only able to detect fraud if he (or she) has the professional qualification(s), knowledge, and experience to perform an audit.<sup>62</sup> In other words, the competence of the auditor indicates the ability to detect misrepresentation in financial statements. The competence of auditors and their independence are closely related, and complement each other. Auditors' ability to report a breach or misrepresentation in financial

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<sup>58</sup> Ibid p.1044.

<sup>59</sup> Paul M. Healy and Krishna G. Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 *Journal of Accounting and Economics* 405.

<sup>60</sup> For the role of auditors, see Chapter I, Section 2.2.

<sup>61</sup> Linda Elizabeth DeAngelo, 'Auditor Size and Audit Quality' (1981) 3 *Journal of Accounting and Economics* 183 p.186.

<sup>62</sup> David Flint, *Philosophy and Principles of Auditing: An Introduction* (Macmillan, London 1988) p. 48.

statements depends on his (or her) independence.<sup>63</sup> If the auditor is not independent, he (or she) will have no incentive to express their competence to detect fraud. In turn, if an auditor is competent, they are eligible to be considered as independent.<sup>64</sup> Therefore, being a professional auditor requires being independent. In other words, in order to fulfill the role, auditor has to be independent.

Nevertheless, independence is an ambiguous concept; it is not easy to ensure. In the existing literature, auditor independence is analysed according to two concepts: independence ‘in fact’ and independence ‘in appearance’.<sup>65</sup> The former concept refers to the attitude of being impartial and objective, while the latter refers to the perception of independence by users of financial statements, namely shareholders and investors.<sup>66</sup> Auditor independence can be ensured in a number of ways. First, auditors, as certified public accountants, are subject to professional discipline and the oversight of national public bodies (e.g. the Conduct Committee,<sup>67</sup> part of the Financial Reporting Council (FRC) in the UK). Second, auditors are required by law to be independent meaning that there may not be any close ties to, or financial self-interests in, the audited company.<sup>68</sup>

Moreover, certain circumstances derived from the nature of the auditor-client relationship are likely to impair auditor independence. To begin with, auditors are not independent because they are hired and paid by the audited company (the client).<sup>69</sup> Audit reports should be reported to the shareholders because auditors’ actual clients are the users of the audited financial statements. However, the audit contract is signed between the auditors and the managers of the audited company who actually pay the auditors with the financial resources of the company. Audit firms are inherently commercialised institutions that seek to increase their profits and

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<sup>63</sup> David B. Citron and Richard J. Taffler, ‘The Audit Report under Going Concern Uncertainties: an Empirical Analysis’ (1992) 22(88) *Accounting and Business Research* 337 p. 344.

<sup>64</sup> Tom Lee and Mary Stone, ‘Competence and Independence: the Congenial Twins of Auditing?’ (1995) 22(8) *Journal of Business Finance & Accounting* 1169 p.1171.

<sup>65</sup> Nicholas Dopuch, Ronald R. King, and Rachel Schwartz, ‘Independence in Appearance and in Fact: an Experimental Investigation’ (2003) 20(1) *Contemporary Accounting Research* 79.

<sup>66</sup> *Ibid* p. 84.

<sup>67</sup> The duties of the Professional Oversight Board are assigned to the Conduct Committee.

<sup>68</sup> Directive 2006/43/EC (n 6), Article 22(2).

<sup>69</sup> The auditors for the health and safety sector are independent where the state to appoint and remunerate the auditors. See Prem Sikka, Steven Filling, and Pik Liew, ‘Audit crunch: reforming auditing’ (2009) 24(2) *Managerial Auditing Journal* 135.

market share<sup>70</sup> and therefore, they might forget their actual clients and become capitalist institutions simply trying to maximize their profits. As a result, there is a risk that they are not able to deliver independent audits when they are dependent upon company directors for their fees and have an incentive to please the company management, in order to secure their non-audit fees.<sup>71</sup> Ronen described this situation as “*structural infirmity*”.<sup>72</sup> Because auditors seek to please their client (i.e. the company management), it is possible that they might interpret in the interest of the company at every turn - for example, shredding ‘grey area’ judgments.<sup>73</sup> This situation might suggest that auditors would avoid disputes in order to be reappointed (or not to be dismissed).

Nevertheless, even if the auditor is independent ‘in fact’, they have to show this independence to the public. Being independent ‘in fact’ is an ambiguous concept and difficult to interpret in practice, because it depends upon auditors’ mentality in their audit work.<sup>74</sup> Even though it might not be possible to prove mental independence to the public (i.e. objectivity), there are a number of ways to evaluate the degree of independence ‘in appearance’. These are: auditors’ dependence on non-audit fees, the length of auditor tenure, and the competitive environment (choice of auditor).<sup>75</sup> The provision of consultancy services and dependence on non-audit fees may impair independence ‘in appearance’.<sup>76</sup>

The other element that has a direct impact on the auditor independence is the ‘familiarity threat’,<sup>77</sup> where the auditors have been involved for many years in audit engagements. This was the case with Enron. Arthur Andersen was assigned as the auditor of Enron for more than 50 years. The close relationship between the company and auditor caused negligence in the audit. It was found that Arthur Andersen

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<sup>70</sup> Ibid p. 138.

<sup>71</sup> Ronen indicated a saying to highlight the independence issue of auditors; ‘*whose bread I eat his song I sing*’. See Ronen (n 4) p. 189.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid p. 192.

<sup>74</sup> Chrystelle Richard, ‘Why an Auditor Can't Be Competent and Independent: a French Case Study’ (2006) 15(2) *European Accounting Review* 153 p.156.

<sup>75</sup> Donald F. Arnold Sr., Richard A. Bernardi, and Presha E. Neidermeyer, ‘The Effect of Independence on Decisions concerning Additional Audit Work: A European Perspective’ (1999) 18(2) *Auditing* 45.

<sup>76</sup> See Section 2.3 below.

<sup>77</sup> Familiarity threat may occur due to a long or close relationship with a client where in professional accountant becomes too sympathetic to the interests of the client. See IFAC, Code of Ethics (n 9) para. 100.12.

shredded significant documents right after the SEC started an investigation in the company.<sup>78</sup> It is claimed that shredding the documents must have indicated either being aware of incorrect audit opinions or purposefully not issuing any report about wrongdoings or risks detected.<sup>79</sup> As was the case in the Enron scandal, the long years of auditor tenure - the so-called 'familiarity threat' - could make auditors less skeptical because of an ongoing relationship with the client. Moreover, it is argued that the ongoing relationship between the auditor and the client may cause auditors failing to spot misrepresentation in financial statements because he (or she) would be looking from the perspective of their client.<sup>80</sup>

The last factor that may limit auditor independence is the executive management's influence on the choice of the auditor. This is often the case where the relationship between executive managers and dominant shareholders (namely families, banks, and institutional investors) is based on trust and confidence. As a result, important decisions, such as the appointment of auditors are discussed with management, and influence is therefore the inevitable.<sup>81</sup>

If auditing has a role in ensuring trust and market confidence, it should see the users of audited financial statements as the real clients rather than the company and its managers. However, as the next part will discuss, a new form of auditing might change the primary focus of the auditing profession as the economic importance of consulting has been increasing.

### **2.3. The New Form of Auditing: auditing *versus* consultancy**

Jeppesen argued that auditing is being "*reinvented*" as it is now extremely focused on adding value to the audit.<sup>82</sup> Value-added services include detecting, understanding, and analyzing the business risks that the audited firm is involved in, and building a strategy to manage and control those risks.<sup>83</sup> Value-added auditing is delivered in the form of consulting. Today, it is common that audit firms provide advisory services in

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<sup>78</sup> Jill Solomon, *Corporate Governance and Accountability* (3<sup>rd</sup> edn, John Wiley & Sons 2004) p. 37.

<sup>79</sup> Ronen (n 4) p. 192.

<sup>80</sup> Arnold *et al* (n 75) p.50. See also Denis A. Klimentchenko, 'Myth of Auditor Independence' (2009) University of Illinois Law Review 1275.

<sup>81</sup> Max Planck Institute, 'Auditor Independence at the Crossroads Regulation and Incentives' Max Planck Private Law Research Paper No. 12/1 (2012).

<sup>82</sup> Kim Klarskov Jeppesen, 'Reinventing auditing, redefining consulting and independence' (1998) 7(3) European Accounting Review 517.

<sup>83</sup> *Ibid* pp. 522-5.

addition to the traditional form of audit (i.e. the verification of financial statements). In fact, it has now become the case that, because the fees generated from the audit are lower, auditors are seeking to provide non-audit services to the same client<sup>84</sup> or to non-audit clients. This situation is called ‘lowballing’. Via lowballing, auditors seek to compensate for low audit fees through the provision of consultancy services for higher fees.

Offering consulting services to the same audit client (lowballing) was very popular back in the days of the Big Five.<sup>85</sup> For instance, by 2000, fees for advisory services constituted 50% of the revenue of the Big Five, whereas it was only 13% of revenue in 1981.<sup>86</sup> Enron’s auditor, Arthur Andersen, was highly dependent on such non-audit fees. Arthur Andersen received \$25 million for audit fees and \$27 million for non-audit fees in 2000.<sup>87</sup> The current situation in the EU audit market is not dissimilar. As of 2012, 32% of the total revenue (\$36.1 billion out of \$110.2 billion) of the Big Four firms is generated by advisory services.<sup>88</sup>

Consulting includes strategic management planning, internal audit outsourcing services, risk assessment business performance, and e-commerce to name but a few. Rather than technical differences, the most important aspect that distinguishes consulting from auditing is independence.<sup>89</sup> The joint provision of audit and non-audit services to the same audit client might jeopardize the auditor independence ‘in appearance’,<sup>90</sup> and hence can damage the audit quality.<sup>91</sup>

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<sup>84</sup> Max Planck Research Paper (n 81) p. 5.

<sup>85</sup> Big Five refers to the Big Four audit firms and Arthur Andersen. See also Section 2.4 below.

<sup>86</sup> Shapiro (n 2) p. 1046.

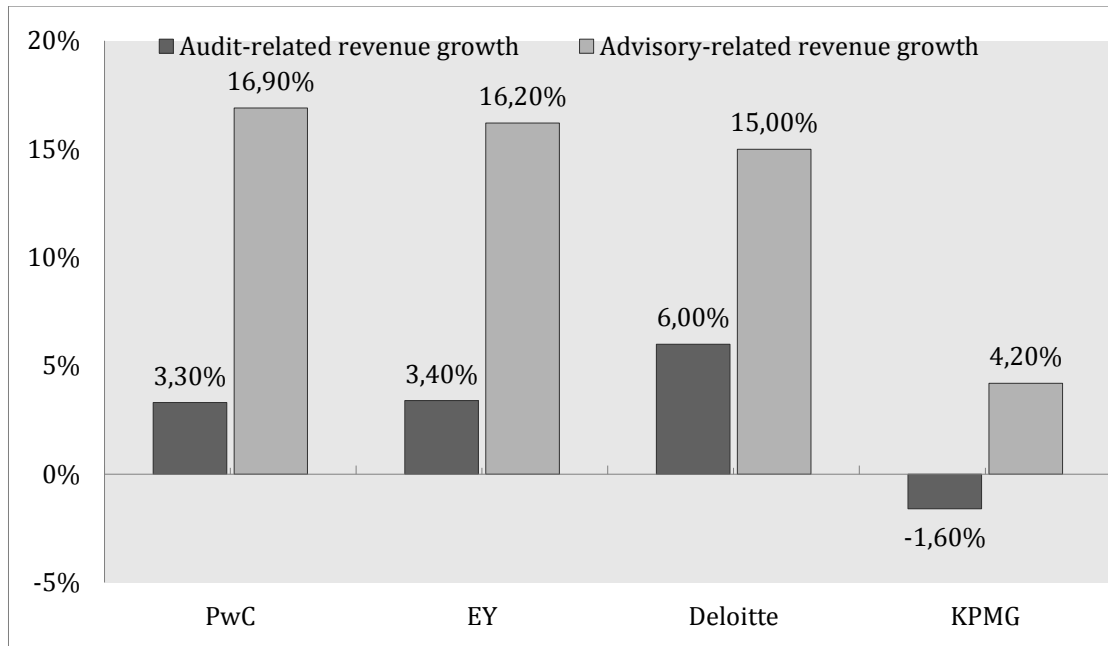
<sup>87</sup> George J. Benston and Al L. Hartgraves, ‘Enron: What happened and what we can learn from it’ (2002) 21(2) *Journal of Accounting and Public Policy* 105.

<sup>88</sup> The 2012 Big Four Firms Performance Analysis by Big4.com available here <http://www.big4.com/wp-content/uploads/2013/01/The-2012-Big-Four-Firms-Performance-Analysis.pdf> accessed 14/11/2013.

<sup>89</sup> Robert Kuhn Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, Chicago 1961) pp. 268-9.

<sup>90</sup> Ralf Ewert, ‘Audit Regulation, Audit Quality, and Audit Research in the Post-Enron Era: An Analysis of Non-audit Services’ in Christian Leuz, Dieter Pfaff, and Anthony Hopwood (eds), *The Economics and Politics of Accounting* (OUP, New York 2004) p. 239.

<sup>91</sup> Jeppesen (n 82) p. 525.



**Figure 2.1:** Big Four revenue growth from 2011 to 2012 (Source: data extracted from the 2012 Big Four Firms Performance Analysis by Big4.com)

The provision of non-audit services to an audit client, namely advisory services, builds an economic relationship with the client.<sup>92</sup> When the auditor gives advice on the business of the client, the auditor gains an interest in the financial success of the client.<sup>93</sup> There is therefore an economic interest for auditors in the provision of consulting services. Moreover, the economic importance of non-audit services has grown rapidly. As Figure 2.1 illustrates, revenues generated from advisory services grew more than audit-related services revenues in 2012 for all Big Four firms. As a result of the growing importance of advisory services, auditors became less dependent on reputations for high-quality auditing<sup>94</sup> and more dependent on their relationships with the client for the sake of consulting services.<sup>95</sup> This dependence is in hazardous for auditor independence.

There are mixed arguments regarding the effect of the provision of non-audit services on audit quality. Brown *et al* argued that the provision of non-audit services increases auditor dependence on non-audit fees and hence, undermines the audit

<sup>92</sup> Ibid.

<sup>93</sup> Mautz and Sharaf (n 89) pp. 268-9.

<sup>94</sup> John C. Coffee, Jr., 'Understanding Enron: "It's About the Gatekeepers, Stupid"' (2002) 57 *The Business Lawyer* 1403.

<sup>95</sup> Abraham J. Briloff, 'Accountancy and society a covenant desecrated' (1990) *Critical Perspectives on Accounting* 5.

quality.<sup>96</sup> However, Arrunada objected to this statement, arguing that neither audit quality nor independence is necessarily damaged by provision of non-audit services, since the provision of non-audit services may promote competition in the market.<sup>97</sup>

Publicly listed firms are now paying attention to the risk management services due to increased complexity of financial markets. As a result, external auditors are not only expected to verify financial statements but are now also expected to understand the client's business and internal control relative to risk assessment and control. The current structure of the audit profession makes audit and non-audit services undistinguishable, and therefore makes auditor independence an elusive concept that is hard to fully maintain.

The growing economic importance of consultancy services converts auditing into a new form of doing business. This new form of auditing builds a mutual economic interest between auditor and client. As results, auditors primarily consider the business demands of the clients, and consider less the interests of the users of financial statements.<sup>98</sup> However, this new form of auditing might result in independence issues. Auditor independence requires the absence of economic interests that could cause a conflict between auditor and client. Economic interest in an audited company makes it difficult for auditors to perform independent auditing: there is a risk of 'self-serving'. This framework does not suit the independence requirement of external auditing. To put it differently, consulting is not complementary to independence.

#### **2.4. The Big Four Audit Firms**

The market for audits of large and listed companies is dominated by the Big Four audit firms: PricewaterhouseCoopers International Limited (PwC), Deloitte Touché Tohmatsu Limited (Deloitte), EY (formerly Ernst & Young<sup>99</sup>), and Klynveld Peat Marwick Goerdeler (KPMG).

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<sup>96</sup> James R. Brown, Dino Falaschetti, and Michael J. Orlando, 'Auditor Independence and the Quality of Information in Financial Disclosures: Evidence for Market Discipline versus Sarbanes-Oxley Proscriptions' (2009) 12 American Law and Economics Review 39.

<sup>97</sup> Benito Arrunada, 'Audit Failure and the Crisis of Auditing' (2004) 5(4) European Business Organization Law Review 635.

<sup>98</sup> Jeppesen (n 82) p. 525.

<sup>99</sup> Ernst & Young simplified its name and became EY in July 2013.

The reason for this high concentration is the mergers between the largest audit firms that started in the late 1980s. During the 1980s, the audit market was highly competitive. In order to gain more market share, audit firms reduced the price for audit services (i.e. low-balling).<sup>100</sup> As a consequence, they focused on the provision of consultancy services in order to cover the loss that they incurred because of the low priced audit work.<sup>101</sup> The other way they sought to increase or maintain market share was consolidation with peers.<sup>102</sup> In this respect, the late 1980s and late 1990s saw major mergers between the biggest audit firms. The first two mergers in 1989 reduced the Big Eight to the Big Six.<sup>103</sup> Later, in 1998, Price Waterhouse and Coopers & Lybrand joined together.<sup>104</sup> Together with Arthur Andersen, KPMG, Ernst & Young and PWC formed the Big Five. Since the demise of Arthur Andersen in 2002, the concentration in the audit market is the highest ever as there are only four big audit firms left.

The Big Four audit firms are ‘big’ in terms of their revenues and the number of staff they employ.<sup>105</sup> For instance, the Big Four cumulatively employ more than 690,000 staff including 37,000 partners.<sup>106</sup> With regards revenue, the combined revenue for the four firms in 2012 was \$110.3 billion, despite the worldwide recession.<sup>107</sup> The Big Four audit firms are active in almost every country in the world, and audit the majority, if not all, of the world’s largest companies.<sup>108</sup> As of 2010, they had a 70% share of audits globally, while in the EU market they control 83% of the audits of the largest listed firms with FTSE 350 equivalent market capitalisation.<sup>109</sup>

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<sup>100</sup> Prem Sikka, ‘Some questions about the governance of auditing firms’ (2003) 1(2) *International Journal of Disclosure and Governance* 186.

<sup>101</sup> House of Lords Report (n 49) p. 13.

<sup>102</sup> OECD Directorate for Financial and Enterprise Affairs Competition Commission, *Competition and Regulation in Auditing and Related Professions* DAF/COMP 19 16 July 2010.

<sup>103</sup> In 1989, Ernst & Whinney merged with Arthur Young to form Ernst & Young and Deloitte Haskins & Sells merged with Touché Ross to form Deloitte & Touché. See Oxera, *Ownership rules of audit firms and their consequences for audit market concentration*, Prepared for DG Internal Market and Services, October 2007, para.1.2.1.

<sup>104</sup> OECD Report DAF/COMP (n 102) pp. 20-1.

<sup>105</sup> See Big Four Firms 2012 Performance Analysis (n 88) p. 3.

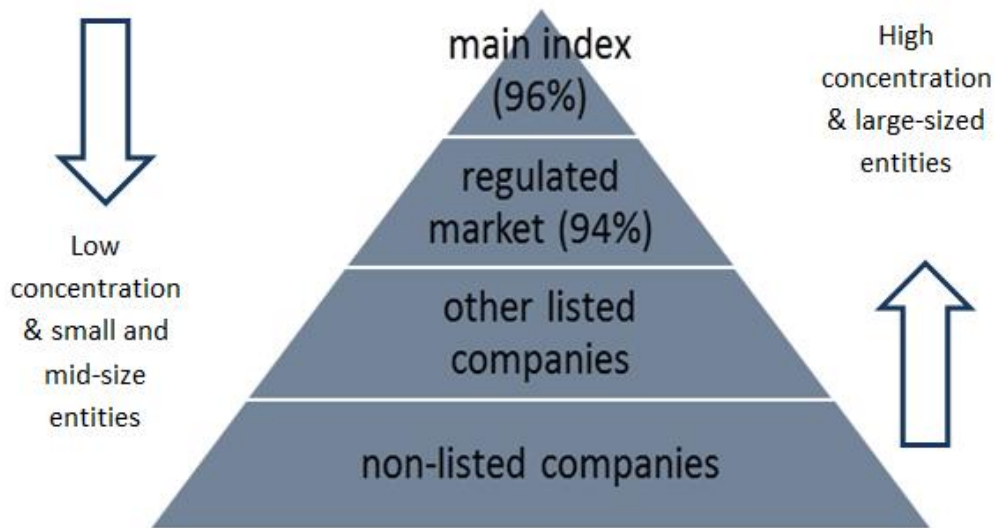
<sup>106</sup> *Ibid* p. 19.

<sup>107</sup> *Ibid* p. 3.

<sup>108</sup> According to information presented on the Big Four’s websites, PwC has 154, Deloitte has 136, EY has 152, and KPMG has 156 member firms globally.

<sup>109</sup> Nick Huber, ‘The concentration battle’ *International Accounting Bulletin* (London, May 2011) 6.

A study by ESCP Europe found that at EU level, the domination of the Big Four audit firms is apparent but may differ across different segments of the market.<sup>110</sup> For instance, the concentration level on the whole audit market (including audits of listed and non-listed companies) is lower than on listed companies. There are no data available on the EU average for non-listed companies. However, the UK findings represent an example for the EU. For instance, considering the whole audit market (audits of listed and non-listed companies) in the UK, the market share by turnover of the Big Four was 40% in 2009, while in the same year the concentration level on listed companies was 98%.<sup>111</sup>



**Figure 2.2:** EU average of the Big Four market shares (by turnover) on the different segments of the market (Source: data extracted from ESCP Europe<sup>112</sup>)

As Figure 2.2 illustrates, the concentration level is the highest for companies listed on the main index of national stock exchanges. In turn, the concentration level is lowest when the audited listed company sizes are small. To provide an example, 99%

<sup>110</sup> ESCP Europe, Study on the effects of the implementation of the *acquis* on statutory audits of annual and consolidated accounts including the consequences on the audit market Final Report by Joëlle Le Vourc'h and Pascal Morand Paris, 9 November 2011. These findings are in line with the Study by London Economics, 'The Economic Impact of Auditors' Liability Regimes' Final Report to EC-DG Internal Market and Services (MARKT/2005/24/F), September 2006.

<sup>111</sup> Study by ESCP Europe (n 110) pp. 96-9.

<sup>112</sup> *Ibid.*

of FTSE 100 companies in the UK were audited by the Big Four in 2009.<sup>113</sup> Thus, the dominance of the Big Four for the audits of listed companies is very high. It was found that the EU average market share of the Big Four audit firms by turnover, with regards all listed firms (including companies listed on main index of national stock exchanges and companies listed on regulated market of national stock exchanges), is above 90%.<sup>114</sup>

Overall, all of the European Member States (except Bulgaria<sup>115</sup> and France<sup>116</sup>) have high concentration levels on the audit market of listed companies. As a result, audit engagements with the largest listed companies seem a real challenge for non-Big Four audit firms. On the other hand, mid-tier audit firms may find themselves a place for the audits of smaller listed firms and non-listed firms as the domination of the Big Four over audits of these companies seems to be lower.

### ***Results of the high concentration***

This high concentration results in limited choice for the audits of large listed companies. The Oxera Study<sup>117</sup> listed the barriers preventing new audit firms (e.g. mid-tier audit firms) breaking up the audit market for large and listed companies as follows. First, the largest listed firms have a tendency to choose Big Four audit firms and have no incentive to change their audit firm for long periods.<sup>118</sup> As a result, smaller firms have a reputational disadvantage against the Big Four who have sector expertise and advanced technology for the audit process. This argument is valid even when professional reputation is lost by a large audit firm (i.e. Arthur Andersen). For instance, it was found that after the demise of Arthur Andersen, only 2% of European

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<sup>113</sup> This figure is similar for other European countries as well. 100% of companies in the main indexes in Denmark, Estonia, Finland, Germany, Hungary, Malta, Netherlands, Slovakia, Spain, and Sweden stock exchanges audited by the Big Four audit firms in 2009. See *ibid* p. 109.

<sup>114</sup> The high concentration levels can be seen in specific industries as well. For instance, the concentration level of the EU audit markets for all listed companies is the highest for energy, finance, utilities, and telecommunication services. See *ibid* p. 106.

<sup>115</sup> In Bulgaria, the concentration level of the Big Four was very low, at 50%. The reason for this very low concentration is explained by the absence of consolidation activities until recently. See *ibid* p. 99.

<sup>116</sup> The market for all listed companies is moderately concentrated in France, where the Big Four have 81% of the market share. The joint audit system in France can be seen as a contributor to the low concentration level. See *ibid* p. 100.

<sup>117</sup> Oxera Study (n 103).

<sup>118</sup> For example, it was found that the average switching rates for the FTSE 100 and FTSE 250 are 48 and 36 years respectively. See House of Lords Report (n 49) para.28.

companies switched from a Big Four firm to a middle-tier firm, while 85% simply switched from one Big Four firm to another Big Four firm.<sup>119</sup>

Second, smaller audit firms have an insufficient capacity to meet the global demand compared with the Big Four, who have a huge number of audit partners and a geographical advantage.<sup>120</sup> Third, smaller firms might face barriers entering the market because of the costs of potential liability claims.<sup>121</sup> Auditors are required to have a minimum level of insurance coverage that only partially covers the liability risk.<sup>122</sup> Uninsured risk has to be covered by audit firms.<sup>123</sup> Larger audit firms are better able to self-insure the liability risk but this is a problem for smaller audit firms. As a result, investors would not be in favour of mid-tier audit firms when considering a potential liability claim.<sup>124</sup> Lastly, current ownership rules create barriers to the growth of smaller audit firms.<sup>125</sup> Article 3 of Directive 2006/43/EC requires that auditors hold a majority of the voting rights in an audit firm and that majority of auditors control the management board. This provision limits investors' influence on decision making in an audit firm. The reason of this ownership structure is to prevent conflicts of interest (in case an audit firm were publicly owned; shareholders could include persons affiliated with the audit clients<sup>126</sup>) and hence, to protect the independence of audit firms.<sup>127</sup>

### **Conclusions**

It follows that auditor independence is compromised because of the potential conflicts of interest deriving from the nature of the current structure of the audit profession. In addition, the audit market is currently in the hands of the Big Four and

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<sup>119</sup> London Economics Study (n 110) p. 74.

<sup>120</sup> Cumulatively, the Big Four employs more than 690.000 staff globally and they actively audit largest listed firms all around the world, including Americas, Europe, and Asia Pacific countries. See Big Four Firms 2012 Performance Analysis (n 88) p. 19.

<sup>121</sup> Oxera Study (n 103) pp.154-55. See also Chapter V for auditor liability.

<sup>122</sup> London Economics Study (n 110) p. 96.

<sup>123</sup> Ibid p. 92.

<sup>124</sup> Oxera Study (n 103) pp.154-5.

<sup>125</sup> Ibid.

<sup>126</sup> Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities [COM (2011) 778 COM (2011) 779 SEC (2011) 1385] SEC(2011) 1384 (Commission's Impact Assessment), p. 123.

<sup>127</sup> OECD DAF/COMP (n 102).

their businesses involve the provisions of both audit and non-audit services. There is a risk that the audit profession focuses more on consultancy services rather than audit work because the increasing revenues coming from consultancy services.

The audit firms have grown rapidly in the last decade and the concentration in the market has reached a peak. Large public companies depend on the services of the Big Four because of their reputational advantage. It seems that the audit failures witnessed during the global financial crisis have not had affected the reputation of these firms. However, this does not suggest that serious litigation costs or reputational losses would not affect the Big Four's business. It is argued that the Big Four rely on their relationship with their clients, rather than the quality of their works.<sup>128</sup> The services provided by one Big Four firm cannot be effectively differentiated from the services of another Big Four firm.<sup>129</sup> Large public companies tend to choose one of the Big Four firms not because of the quality of audits, but because of their reputation for good quality audits. As a result, rather than focusing on increasing the quality of their work, the Big Four firms look for other ways to compete with each other. They often rely on year-round tenures with the same client and aim to retain an existing client for as long as they can. In order to achieve this, they seek to please the client at every turn. Therefore, as long as they have a close and year-round relationship with their large clients, from whom a significant part of their revenue (in particular if mostly advisory related-revenues) is generated, even reputational damage might not have a negative effect on their business. However, as was evident with Enron, audit failures can lead to criminal sanctions and subsequently a loss of reputation and the demise of the firm (e.g. Arthur Andersen). Hence, auditors do have to consider potential reputational loss and liability claims at some point.<sup>130</sup> Therefore, it is not legitimate to argue that auditors would have an incentive not to report in cases of fraud (or to not issue a modified opinion).<sup>131</sup>

It is a fact that competition is restricted in the audit market, given the dominance of the Big Four audit firms. High competition in a market may promote service providers to produce better quality services.<sup>132</sup> However, it is not certain that the high

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<sup>128</sup> Klimentchenko (n 80) p.1276.

<sup>129</sup> The services provided by the Big Four are 'homogenous'. See *ibid.*

<sup>130</sup> For a recent civil litigation case for Ernst & Young, see Section 3.3 below.

<sup>131</sup> For the Big Four audit firms' audit quality, see Section 3.2 below.

<sup>132</sup> For the regulatory remedies for the high concentration, see Chapter IV, Section 3.3.

concentration *per se* means low- quality auditing. The next section will examine the role of auditors in the global financial crisis and the Big Four firms' audit quality, questioning whether they failed in their role.

### 3. AUDITORS' ROLE IN THE GLOBAL FINANCIAL CRISIS OF 2008

The global financial crisis had hazardous consequences not only on US markets, but also the European financial markets. The contagious failures of large financial institutions on both sides of Atlantic damaged confidence in the global financial market and subsequently, caused an economic recession around the world.<sup>133</sup> The crisis was labelled as the largest financial crisis since the 1930s Great Depression.<sup>134</sup>

One of the issues that have been debated during and since the global financial crisis of 2008 is the auditors' role (or failure) in warning market participants about financially distressed institutions and their liquidity and credit problems.<sup>135</sup> Concerns related to those issues were highlighted in a number of high-profile papers, namely the European Commission's Green Paper on Audit Policy,<sup>136</sup> the European Commission's Impact Assessment,<sup>137</sup> the European Commission's proposal for a regulation on statutory audits of PIEs,<sup>138</sup> the House of Lords Report on auditors' role and market concentration,<sup>139</sup> and the Sharman Inquiry<sup>140</sup>. In their report, the House of Lords Economic Affairs Committee accused auditors and regulators of not sharing enough information with each other before the collapse of the large financial institutions, and found auditors guilty of a "*dereliction of duty*" and

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<sup>133</sup> For an examination of the causes of the 2008 global financial crisis see John C. Coffee, Jr., 'What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis' (2009) 9 *Journal of Corporate Law Studies* 1.

<sup>134</sup> Thomas Clarke and Jean-Francois Chanlat, *European Corporate Governance: Readings and Perspectives* (Routledge 2009) pp. 9-10.

<sup>135</sup> Prem Sikka, 'Financial Crisis and the Silence of Auditors' (2009) 34 *Accounting, Organizations, and Society* 868.

<sup>136</sup> European Commission Green Paper Audit Policy: Lessons from the Crisis Brussels, 13.10.2010 COM(2010) 561 final.

<sup>137</sup> Commission's Impact Assessment (n 126).

<sup>138</sup> European Commission, Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities. Brussels, 30.11.2011 COM (2011) 779 final (Draft Regulation).

<sup>139</sup> House of Lords Report (n 49).

<sup>140</sup> Sharman Inquiry, Going concern and liquidity risks: Lessons for companies and auditors, Preliminary Report and Recommendations of the Panel of Inquiry, Financial Reporting Council (2010) London: UK.

“*complacency*”.<sup>141</sup> This section will question the role of auditors in the global financial crisis and whether they actually failed in their role, particularly in respect of issuing going concern opinions.

### 3.1. Going Concern Judgment

As already stated, the primary objective of external auditing is to report to shareholders whether the company’s financial statements are prepared in accordance with related law and whether those statements present a true and fair view regarding the financial situation of the company.<sup>142</sup> In addition, ISA 570 requires auditors to issue an opinion whether there is “*significant doubt*” about the company’s ability to continue as a going concern. In accounting, financial statements of a company are prepared on the ‘going concern assumption’; the assumption that a company will continue in operation long enough to achieve its objectives.<sup>143</sup> Going concern assessments are made by the directors of the company; auditors then provide their opinions on the entity’s ability to continue in operation. The role of auditors is to express their opinion if they have significant doubts about the company’s ability to continue in existence in the next fiscal year.

DeFond *et al* emphasised the significance of audit report in terms of warning shareholders and other stakeholders regarding a firm’s ability to continue as a going concern.<sup>144</sup> Disclosing going concern assessment helps stakeholders assess a company’s solvency and liquidity risks<sup>145</sup> wherein they are much more likely to recognise financial distress in advance.<sup>146</sup> Providing going concern opinions is critical for market participants such as shareholders and other stakeholders to realise firms’ financial conditions at a specific time of period. It is stated that auditors’ opinion on going concern uncertainty can be used to forecast the company’s

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<sup>141</sup> House of Lords Report (n 49) paras.161, 167. See also Adam Jones, ‘Auditors criticized for role in financial crisis’ *Financial Times* London, 30 March 2011.

<sup>142</sup> See Chapter I, Section 2.2 and Section 1 of this chapter.

<sup>143</sup> International Accounting Standards No.1 requires companies to prepare financial statements on a going concern basis unless a) the company’s owners has approved a plan of liquidation, or b) other forces impose the plan to liquidate and it is very unlikely that the company will remain a going concern in the future.

<sup>144</sup> Mark L. DeFond, K. Raghunandan, and K. R. Subramanyam, ‘Do Non–Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions’ (2002) 40(4) *Journal of Accounting Research* 1247.

<sup>145</sup> Solvency is the ability of the entity to meet its liabilities in full while liquidity is related to the short-term survival of the entity. See Sharman Inquiry (n 140) para.5.

<sup>146</sup> *Ibid* para.3.

failure.<sup>147</sup> As a result, unacceptable losses derived from the failure of the firm can be avoided.

On the contrary, there are a number of disadvantages to the requirement to issue going concern opinion. Firstly, there is no clear definition of the going concern concept. Bankruptcy failure is used as a proxy for determining a firm's going concern ability.<sup>148</sup> Similarly, phrases such as “*substantial doubt*” as in US auditing standards, or “*significant doubt*” as in ISA, do not have clear meaning. As a result, the interpretation of these phrases may differ and can cause a perception that auditors are not fulfilling their responsibilities (i.e. the expectations gap).

Secondly, modifying audit reports to issue going concern uncertainty can be costly for the audit client and for the auditor as well.<sup>149</sup> Auditors issue an unmodified (clean) report when they have detected and corrected all material errors and omissions so that the financial statements are fairly presented. However, in case they have a *significant doubt* that the company is no longer eligible to pay its debts for a period of at least 12 months from a balance sheet,<sup>150</sup> auditors modify audit report to going concern uncertainty.<sup>151</sup> Issuing a modified<sup>152</sup> (disclaimer of opinion or adverse opinion) going concern opinion can affect the stock value of the company and ultimately may cause the failure of the company. Therefore, clients generally prefer to receive standard, unmodified (clean) reports rather than modified audit reports.<sup>153</sup> Issuing a modified audit report on going concern uncertainty is also costly for auditors because after issuing modified going concern report, it is likely that the client would switch to another auditor,<sup>154</sup> which means that the auditor will be left without both audit and non-audit fees.<sup>155</sup>

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<sup>147</sup> Elizabeth Carson *et al*, ‘Auditor Reporting on Going Concern Uncertainty: a Research Synthesis’ (2012) available at <http://ssrn.com/abstract=2000496> accessed 12/11/2013.

<sup>148</sup> *Ibid* p. 34.

<sup>149</sup> *Ibid* p. 14.

<sup>150</sup> In the UK, the minimum 12-month period of ISAs is applied with a longer time period: the period from one annual report to the next (presumably management's franchise is renewed). See Sharman's Inquiry (n 140) para.81.

<sup>151</sup> US Auditing Standards (SAS) requires auditors to modify going concern opinions if there is *substantial doubt* about the ability of the firm to continue as a going concern for a *reasonable period of time*-not to exceed one year before the date of the financial statements being audited (No. 59).

<sup>152</sup> For types of audit opinions see Section 1.1 above.

<sup>153</sup> Thomas Kida, ‘An investigation into auditors' continuity and related qualification judgments’ (1980) 18(2) *Journal of Accounting Research* 506.

<sup>154</sup> Chee W. Chow and Steven J. Rice, ‘Qualified Audit Opinions and Auditor Switching’ (1982) 57(2) *Accounting Review* 326.

<sup>155</sup> Joseph V. Carcello and Zoe-Vonna Palmrose, ‘Auditor litigation and modified reporting on

It is said that recent financial audits are more risk-associated compared with the pre-Enron era.<sup>156</sup> As a consequence, auditors generally tend to issue going concern opinions because of the market and regulatory incentives.<sup>157</sup> Similarly, Cheffers *et al* found that modified audit opinions on going concern uncertainty has increased from 14% to 21% for all companies between the years 2002-2009.<sup>158</sup> Nevertheless, it can be questioned why auditors of the Big Four firms did not issue any going concern opinions for the firms that failed in the 2008 financial crisis.

### 3.2. Big Four Audit Firms' Audit Quality

There is no direct way to measure audit quality. Instead, empirical studies use proxy factors in order to label audits as being of low or high quality.<sup>159</sup> For instance, the size of the auditor is considered as a proxy for audit quality.<sup>160</sup> It is risky for larger audit firms if they misreport, as they may lose their good reputation. Hence, they are less likely to be influenced by management regarding the audit opinion. So, there is an assumption that larger auditors provide higher quality audits. However, this is not entirely accurate, since there were a number of audit failures that involved the Big Four auditors (e.g. Arthur Andersen for Enron, Ernst & Young for Lehman Brothers) which illustrate that larger audit firms do not always provide better quality audits.

Still, there are a number of reasons why the Big Four might be expected to provide high-quality audits. First, investment bankers and institutional investors suggest Big Four auditors for their own clients and investees.<sup>161</sup> Second, the Big Four auditors have greater a technological edge and experience in comparison with medium- and small-size audit firms.<sup>162</sup> The large size of Big Four audit firms enables them to spend more on technological and professional training in the audit profession, which

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bankrupt clients' (1994) 32(3) *Journal of Accounting Research* 1.

<sup>156</sup> Carson *et al* (n 147) p. 37.

<sup>157</sup> Marshall A. Geiger, K. Raghunandan, and Dasaratha V. Rama, 'Recent changes in the association between bankruptcies and prior audit opinion' (2005) 24 *Auditing: A Journal of Practice and Theory* 21.

<sup>158</sup> M. D. Whalen Cheffers and M. Thrun, *2009 Going Concerns: A Ten-Year Review* (Audit Analytics, Sutton, MA 2010) in Carson *et al* (n 121) p. 37.

<sup>159</sup> Ronen (n 4) p. 195.

<sup>160</sup> The number of litigations, such as investigations of the public supervisory authorities and restatement of corporate earnings are considered as other indications of a poorly-performed audit. See *ibid*.

<sup>161</sup> Jeff P. Boone, Inder K. Khurana, and K. K. Raman, 'Do the Big 4 and the second-tier firms provide audits of similar quality?' (2010) 29(4) *Journal of Accounting and Public Policy* 330.

<sup>162</sup> Jere R. Frances and Michael D. Yu, 'Big 4 Office Size and Audit Quality' (2009) 84(5) *The Accounting Review* 1521.

contributes to their competence.<sup>163</sup> Therefore, it could be expected that they would be better able to find misstatements and omissions in financial statements. For example, when rotation occurs, the Big Four can use its reserve of audit partners, which allows them continuity in their expertise from one period to another without any interruption that might cause missing errors in financial statements.<sup>164</sup> The Big Four audit firms are decentralised organisations, and their operations are carried out by nation-based offices. They have branches (national partnership offices) globally, giving the advantage of global network opportunities. Therefore, it is assumed that the Big Four auditors are better at detecting and reporting material errors thanks to their professional knowledge/expertise, network/consulting opportunities, decentralised office structure<sup>165</sup> and technological edge. Thus, in appearance, the Big Four have all the facilities and resources necessary for a high quality audit. Yet, in reality, they are not always successful in detecting and reporting errors, despite this seeming capacity to do so.<sup>166</sup>

### ***Big Four's Going Concern Reporting Accuracy***

Frances and Yu found that the Big Four auditors are more likely to issue going concern audit reports.<sup>167</sup> In relation to smaller audit firms, the Big Four audit firms are more likely to issue going concern opinions because they would not take the risk of losing their reputation in case the company fails with an unmodified (clear) audit opinion and subsequently suffers the litigation cost.<sup>168</sup> In other words, they would not take the risk of reputation loss for not issuing-going concern report because they have more to lose compared with non-Big audit firms. Hence, they are arguably more suited to objectively evaluating their clients' financial situations.

It has been found that the Big Four's going concern reporting quality (providing less reporting errors, such as issuing going concern modified reports to clients who do not subsequently fail, or issuing audit reports without a going concern modification to

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<sup>163</sup> Boone *et al* (n 161) p. 331.

<sup>164</sup> Frances and Yu (n 162) p. 1523.

<sup>165</sup> *Ibid* pp. 1522-4.

<sup>166</sup> See Section 3.3 below.

<sup>167</sup> Frances and Yu (n 162) p. 1543.

<sup>168</sup> Boone *et al* (n 161) p. 332.

bankrupt clients) is higher compared with non-Big Four audit firms.<sup>169</sup> As supporting evidence, Frances and Yu found that the reporting accuracy of the Big Four firms is higher than smaller audit firms. They examined larger and smaller firms' going concern reports and analysed the accuracy of those reports in predicting next-period bankruptcy. They found that of 90 going concern reports issued by the Big Four, 8 clients failed in the next period, while smaller firms issued 83 going concern reports and had only one client failure.<sup>170</sup>

Thus, it can be seen that both larger and smaller audit firms issued a considerable number of going concern opinions where the odds of bankruptcy were very low for both. It should be taken into account that it is the auditors' professional judgment that is used to assess the going concern uncertainty of a firm. If the auditor has not adequate professional expertise to conclude a professional judgment reporting errors are likely to occur. Nevertheless, it is possible that reporting errors might occur where a company's economic status may change as a consequence of market dynamics.<sup>171</sup> Also, it should not be disregarded that the relationship between the auditor and the client might also affect the auditor's willingness to issue going concern report and therefore, the accuracy of that report.

### **3.3. Where were the Auditors?**

In a published document, the European Commission referred to the role of the auditors in the 2008 financial crisis.<sup>172</sup> The European Commission stated in this paper that bank auditors failed to alert their supervisors about the financial situations of certain institutions.<sup>173</sup> The law requires that auditors of credit institutions report to competent authorities in case they recognise certain cases that might have important effects on the financial situation of the institution.<sup>174</sup> Although EU law requires auditors to assess whether there is a suspicion regarding the audited firm's financial

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<sup>169</sup> Marshall A. Geiger and Dasaratha V. Rama, 'Audit Firm Size and Going-Concern Reporting Accuracy' (2006) 20(1) *Accounting Horizons* 1.

<sup>170</sup> The study considered 285 audit clients of the Big Four in the US for the period 2003-2005. See Frances and Yu (n 163) p 1531.

<sup>171</sup> Geiger and Rama (n 169) p. 2.

<sup>172</sup> Commission Staff Working Document, *Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices Accompanying document to the Green Paper Corporate governance in financial institutions and remuneration policies* [COM(2010) 284 final] Brussels, 02.06.2010 SEC(2010) 669.

<sup>173</sup> *Ibid* p. 33.

<sup>174</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 on the taking up and pursuit of the business of credit institutions OJ L 177, para. 27.

situation,<sup>175</sup> auditors did not report to the authorities during or before the crisis. Apparently, banks' auditors failed in their duty to report the component authorities of any situation that may affect the functioning of the financial institutions.

Moreover, many banks collapsed only a few months after receiving a 'clean' audit opinion without any indication regarding the risks in the financial statements and going concern uncertainty. During the global financial crisis of 2008 many large financial institutions collapsed, and were nationalized by their governments, or rescued by other institutions. These institutions included Lehman Brothers, AIG, American Home Mortgage, Citigroup, Merrill Lynch, GE Capital, Fortis, Royal Bank of Scotland, Lloyds TSB, and HBOS,<sup>176</sup> to name but a few. None of these institutions' auditors – except Northern Rock's auditor, PwC<sup>177</sup> - issued a modified audit opinion on going concern uncertainty. In other words, these institutions' auditors did not have any *significant* or *substantial* doubt about the companies' ability to continue as a going concern *for a period of at least 12 months or for a reasonable period of time*. There is an ongoing discussion as to why these institutions were not warned before their collapse by their auditors. However, the current structure of the financial markets – i.e. wherein the availability of alternative financial instruments resulted in more risks factors in the markets – should be considered when criticising auditors for not issuing a modified or adverse opinion on going concern uncertainty.

Auditors use operating losses, working capital inadequacy, and deficits in retained earnings, short corporate operating history, or increased threats from competitors to modify an audit opinion for going concern uncertainty.<sup>178</sup> Profitability, leverage, liquidity, company size, debt defaults, and previous going concern reports are used to assess the firm's ability to continue in the next fiscal year.<sup>179</sup> These factors mostly concern the past period of a firm, for backward-looking evaluation. In contrast, non-

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<sup>175</sup> Ibid, Article 53.

<sup>176</sup> Royal Bank of Scotland, Lloyds TSB and HBOS received a total of £37 billion in government bailouts. Lloyds TSB merged with HBOS while the government took a 40% stake for £17 billion. See <http://news.bbc.co.uk/1/hi/business/7666570.stm> accessed 12/11/2013.

<sup>177</sup> In September 2007, Northern Rock received emergency support right after PwC reported concerns to the FSA. See Sharman's Inquiry (n 142) para. 222.

<sup>178</sup> Cheffers and Thrun (n 158) in Carson *et al* (n 147) p. 37.

<sup>179</sup> Carson *et al* (n 147) pp. 55-7.

financial statements, such as market variables, are used for forward-looking evaluation for the going concern assumption.<sup>180</sup>

Banks are different from other financial institutions in terms of the intensity of the going concern risk.<sup>181</sup> For instance, solvency and liquidity risks are higher for banks compared with other financial institutions.<sup>182</sup> In the credit crisis of 2008, stress testing was critical for banks. Stress testing considers a range of scenarios with stress level that might cause the entity to fail.<sup>183</sup>

Lehman Brothers, Merrill Lynch and other collapsed institutions' auditors issued neither modified nor adverse opinion because the financial statements did not meet the requirements of accounting standards, or else there were no issues of material misstatements or fraud. These institutions collapsed only a few months after receiving clean audit opinions. It is worth highlighting that major financial institutions received clear audit opinions from the Big Four auditors (in the case of Lehman Brothers, Ernst & Young; in the case of JP Morgan Chase and AIG, PwC; in the case of Merrill Lynch, Deloitte & Touché) just before they collapsed.<sup>184</sup> In the Lehman Brothers case, it was found that the investment bank had used the so-called Repo 105 and Repo 108 transactions in order to hide its assets and auditor Ernst & Young approved the audit report by ignoring the mistake and helped the bank to hide \$50.38 billion (£33.7 billion) of debt.<sup>185</sup> Following the collapse of Lehman Brothers in 2008, Ernst & Young were held to private litigation by former Lehman Brothers investors<sup>186</sup> and recently agreed to pay \$99 million (£61.2 million) to the plaintiffs.<sup>187</sup>

Ernst & Young auditors were accused of keeping silent while Lehman executives gave a false picture of the firm's financial statements and its offerings. In their defense, Ernst & Young stated: "*the Lehman's audited financial statements clearly*

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<sup>180</sup> Ibid pp. 59-60.

<sup>181</sup> The corporate governance guidance of the Basel Committee (revised in 2010) necessarily emphasizes the importance of risk management and internal control mechanism. See Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance', October 2010 [www.bis.org](http://www.bis.org)

<sup>182</sup> Sharman Inquiry (n 140) para.25.

<sup>183</sup> Ibid para.12.

<sup>184</sup> Sikka (2009) (n 135) p. 870.

<sup>185</sup> Valukas (n 50), Volume 3.

<sup>186</sup> *In re Lehman Brothers Holdings Inc.*, U.S. Bankruptcy Court, Southern District of New York, No. 08-13555.

<sup>187</sup> Nick Brown, 'Ernst & Young to pay \$99 million to end Lehman investor lawsuit' *Reuters* New York, 18 October 2013.

portrayed Lehman as a highly leveraged entity operating in a risky and volatile industry, and Lehman's bankruptcy was not caused by any accounting issues."<sup>188</sup> As Ernst & Young's defense declared, the industry that Lehman operated was highly risky, and it is beyond doubt that the fact that auditors helped Lehman Brothers to misstate its financial records did not cause the bank to collapse. Nevertheless, it is worthwhile questioning any issues that might hinder auditors to issue modified going concern opinions on financially distressed banks.

It is said that issuing modified going concern opinions is closely related to the auditor's independence and competence, and therefore the audit quality.<sup>189</sup> In this respect, there are some factors (other than the firm's financially distressed situation) that might affect the auditor when assessing the going concern uncertainty. Carson *et al* covered a wide range of factors and their impact on auditors' reports on going concern uncertainty.<sup>190</sup> Accordingly, an auditor would avoid to issue a going concern report if (i) he (or she) is economically depended on a large or important client for audit and non-audit fees,<sup>191</sup> (ii) there is a risk to lose the client after issuing going concern report,<sup>192</sup> and (iii) the audited company is an affiliated company.<sup>193</sup>

Moreover, disclosing going concern uncertainty might impair the entity's economic situation and investors and other stakeholders may overreact to those reports. Ultimately, disclosing such information routinely might jeopardize market confidence.<sup>194</sup> As a result, it is difficult for bank auditors to publicly disclose any going concern issues.

To conclude, there are a number of issues that caused the ineffective function of reporting on going concern. First of all, there is a false perception among stakeholders that a clean, unmodified audit report guarantees the company will not fail in the future. However, a going concern assessment cannot provide such a

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<sup>188</sup> EY's response to New York Attorney General Cuomo complaint [http://www.ey.com/BE/en/Newsroom/News-releases/PR\\_Ernst---Yongs-response-to-Attorney-General-Cuomo-complaint\\_221210](http://www.ey.com/BE/en/Newsroom/News-releases/PR_Ernst---Yongs-response-to-Attorney-General-Cuomo-complaint_221210) accessed 12/11/2013.

<sup>189</sup> Carson *et al* (n 147) p. 70.

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid* pp. 71-2.

<sup>192</sup> Chow and Rice (n 154) p. 334.

<sup>193</sup> Affiliated companies seen in the situations where the auditor becomes employee of the audited company or executive managers' former audit firms is appointed as the auditor. See Clive Lennox, 'Audit quality and executive officers' affiliations with CPA firms' (2005) 39(2) *Journal of Accounting and Economics* 201 p. 204.

<sup>194</sup> Sharman Inquiry (n 140) para.31

guarantee (i.e. the expectations gap<sup>195</sup>). Secondly, there is a fear that disclosing going concern risks might result in investors withdrawing their money in a hurry and may quicken the failure of the entity. Thirdly, due to the increased complexity of the capital markets today, it is getting more difficult for auditors to understand and evaluate the business risk of the companies. Furthermore, it is believed that disclosing such going concern issues and significant doubts about the future of the entities might impair confidence in financial markets. The above arguments can be cited in determining the failure of auditors in issuing going concern reports before and during the financial crisis of 2008.

## **CONCLUSION**

This chapter showed how the objective of auditing has evolved from the 1840s to the present. It is submitted that the relationship between the auditors, the client (the audited firm), and the public (investors) can cause issues, namely the expectations gap and impaired auditor independence.

The role of auditors is primarily backward looking, including the assessment of financial statements as to whether they present a true and fair view on the audited entity's financial situation. With regards to going concern judgements, the auditors' role is to provide an opinion whether there are any 'significant doubts' over the accounts prepared by directors on a going concern basis. It should be taken into account that auditors can practice the latter role on a limited basis within the scope of the external audit. This creates an expectations gap. The expectations gap is wider for the audits of banks because of the complexity of financial institutions. There were indeed individual cases that involved audit failures (e.g. Lehman Brothers and Repo 105 & 108 transactions). Nevertheless, a general conclusion on auditors' failure over going concern judgements would not be justified. The common expectation was that the auditor should have foreseen the financial turmoil that financial regulators did not predict. This expectation is, however, far more beyond the scope of external auditing. As this chapter has submitted, the role of auditors is ill-defined to clarify the principle objective of external auditing and the role of auditors, thus results in an expectations gap.

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<sup>195</sup> See Section 2.1 above.

It should be recognized that issuing accurate going concern judgments is not an easy task considering the instability of financial markets and changing market dynamics. Moreover, during a time of crisis, substantial uncertainties are more frequent. Going concern assessments do not give a hundred per cent guarantee regarding the future of an entity. Therefore, these reports should be evaluated alongside other financial reports on a company as well as future macro-economic conditions that might affect the value of the assets of the company.

This chapter has shown that external auditing has a similar function globally due to the uniform audit standards and the Big Four and their global network. Also, there are shared problems as regards the concept (e.g. the appointment and remuneration of auditors by the audit client) and market structure (e.g. the domination of the Big Four over the audit market). In the aftermath of the global financial crisis, regulators at both national and international levels urged for new regulations and greater scrutiny over the audit profession. The motives and technical justifications of audit regulation will be identified in the next chapter.

## CHAPTER III: THE REGULATION OF AUDITING:

### Why, How, and by Whom?

#### INTRODUCTION

The literature on audit regulation draws upon financial reporting literature. Although the latter is vast, accounting studies usually appear in the literature more so than auditing studies. In addition, most of the financial reporting literature is in the political science or business field, focusing either on the political dimension of regulation,<sup>1</sup> or its organisational concept (e.g. discussions on state or private regulation and rule-based versus principle-based standards).<sup>2</sup>

After the recent global financial crisis audit regulation has received enormous attention from governments, the private sector, and academia. However, debate mainly focuses on the regulatory role of public oversight boards and private international agencies' public interest notion in standard setting process,<sup>3</sup> whereas the complex structure of audit regulation has not been discussed in sufficient detail.

This chapter aims to fill this gap. Both the theory and practice of audit regulation will be covered in this chapter. First, audit regulation is considered from a theoretical perspective. As a contribution to the literature, theory-based motives and technical

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<sup>1</sup> See in general Michael Power, 'The Politics of Financial Auditing' (2005) 64(3) *The Political Quarterly* 272; Prem Sikka, 'The Politics of Restructuring the Standard Setting Bodies: The case of the UK's auditing practices board' (2002) 26(2) *Accounting Forum* 97.

<sup>2</sup> See Ian P. Dewing and Peter O. Russell, 'The role of private actors in global governance and regulation: US, European and international convergence of accounting and auditing standards in a post Enron world' Workshop Paper, *Amsterdam Research Centre for Corporate Governance Regulation*, Vrije Universiteit Amsterdam Inaugural Workshop, 17-18 December 2004, Amsterdam; Julia Black, 'Forms and Paradoxes of Principles-Based Regulation' (2008) 3(4) *Capital Markets Law Journal* 425; Eva Hupkes, 'Regulation, Self-Regulation or Co-Regulation' (2009) 5 *Journal of Business Law* 427.

<sup>3</sup> See Christopher Humphrey, Anne Loft, and Margaret Woods, 'The global audit profession and the international financial architecture: Understanding regulatory relationships at a time of financial crisis' (2009) 34(6-7) *Accounting, Organizations and Society* 810; Anne Loft, Christopher Humphrey, and Stuart Turley, 'In pursuit of global regulation: Changing governance and accountability at the International Federation of Accountants (IFAC)' (2006) 19(3) *Accounting, Auditing and Accountability Journal* 428.

justifications of regulation - inspired by Baldwin and Cave<sup>4</sup> - are applied to audit regulation. Second, these motives and technical justifications are applied to audit regulation. Accordingly, it is submitted that audit regulation finds its place in the overlap of three areas of law: financial markets regulation, competition law, and company law and corporate governance principles, defined as a 'triadic structure of audit regulation'.

The remainder of this chapter is structured as follows: The first section starts with a discussion on audit regulation as regards its motives and technical justifications. It will be questioned whether there is a need for the regulation of external auditing. In this respect, the objective of audit regulation will be questioned and will be justified with substantial reasons. In the second section the long-standing debate of rule-*versus* principle-based regulation will be discussed. The final and third section discusses the role of private and state regulators at national and international level as regards their public interest role. In terms of state regulation, the fragmented form of the structure of auditing regulation in between the financial services, competition, and company law will be presented. In addition, the public interest notion of audit regulation will be questioned as regards the role of key private actors in the auditing field, in particular in standard setting.

## 1. WHY: THE NEED FOR AUDIT REGULATION

This section will present a theoretical discussion on the need for regulation in general, and audit regulation in particular. Motives and technical justifications of regulation will be taken to explain the need of regulation and these theories will be applied to understand the regulation of audit.

For the issuers operating in financial markets there are certain governance rules that need to be applied.<sup>5</sup> However, it can be questioned why we need these governance rules. The need for regulation can be justified by a number of reasons. To begin with, markets are not stable and they need to update their governance mechanisms with the latest developments in financial markets. In addition, markets are not capable of

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<sup>4</sup> Robert Baldwin and Martin Cave, *Understanding Regulation Theory, Strategy, and Practice*, (OUP 1999).

<sup>5</sup> For instance, in the UK issuers and others have to comply with the FCA Disclosure and Transparency Rules.

dealing with irregularities on their own. Laws and regulations are issued in order to fix problems emerging in the market, or they are actioned in response to financial crises to reassure confidence in the market, and sometimes, political intentions involve in regulation.<sup>6</sup> Baldwin and Cave determined two different concepts when analysing the need of regulation: motives for regulation and technical justifications of regulation.<sup>7</sup>

### 1.1. Motives for Regulation

Baldwin and Cave considered the motives for regulation when explaining the rise, development and fall of regulation.<sup>8</sup> In their explanation of regulatory developments, they outline three types of motive for regulation: (i) force of new ideas to change the *status quo*, (ii) force of new conditions to change (economic or technical changes), and (iii) pressures of interests (interest theories).<sup>9</sup> Hood explains these three forms of motive as the “*force of new ideas*” and he believes that they can influence regulatory developments.<sup>10</sup>

According to Baldwin and Cave, regulatory developments can be driven by new ideas via logical force or rhetorical power to change the *status quo*.<sup>11</sup> In some instances, regulatory developments may become inevitable in the face of economic changes and technological improvements. Alternatively, regulatory developments may be forced by different interest groups (i.e. public, private, or institutional) who seek such developments to suit their own benefits.

In most cases, interest theories embrace the first two types of motives of regulation, i.e. (i) and (ii). For instance, public institutions namely the government or governmental institutions, pursue (i) to issue reformist regulations, and/or (ii) to regulate in their interests in responding to financial crises. Likewise, private institutions might pursue regulation with the same intentions and seek to benefit

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<sup>6</sup> David Jackman, ‘Does regulation make it worse?’ (2004) 12(2) *Journal of Financial Regulation and Compliance* 106.

<sup>7</sup> Baldwin and Cave (1999) (n 4). See also Morgan Bronwen and Karen Yeung, *An Introduction to Law and Regulation* (Cambridge University Press 2007).

<sup>8</sup> Baldwin and Cave (1999) (n 4) p. 18.

<sup>9</sup> These three types of motives are seen as external influences on regimes and they can contribute regulatory developments unless there is an internal problem, such as bureaucratic failing occurs. See *ibid* pp. 18-9.

<sup>10</sup> Christopher Hood, *Explaining Economic Policy Reversals* (Open University Press, Buckingham 1994).

<sup>11</sup> Baldwin and Cave (1999) (n 4) p. 18.

private interests. It may be useful to further explain the intentions of these interest groups because there may be a distinction between public, private or institutional arrangements and social processes.

Public interest theory holds that regulatory attempts are developed in accordance to the public interest-related objectives rather than group, sector, or self-interests.<sup>12</sup> It also assumes that expert regulators are disinterested so the public can have trust in them. However, it is acknowledged that it is difficult to reach an agreement on public interest because the concept might be hard to identify.<sup>13</sup> As a drawback, this theory does not take into account that politicians are not always disinterested e.g. there might be individual interest involved in the process that could overtake the public interest. Another issue is that this theory disregards political and economic influences on regulation. Regulatory attempts are likely to be influenced by powerful political parties (or politicians and sectors) that want to use regulation to strengthen their position within their environment.<sup>14</sup>

At its core, private interest theory is based on the economic theory of regulation viewing regulation as emerging from the attempts of individuals or groups who are willing to optimize their self-interests.<sup>15</sup> This theory also finds its grounds when ‘regulatory failure’<sup>16</sup> or ‘regulatory capture’<sup>17</sup> occurs.

According to institutional interest theory, institutional structure and arrangements have a significant role in shaping regulation.<sup>18</sup> It is argued that institutional-interest-designed regulation is a political choice in order to gain the ability to monitor information asymmetry. It is also argued that, via institutional-designed regulation, politicians may be able to shift the blame to institutions when things go wrong.<sup>19</sup>

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<sup>12</sup> Robert Baldwin and Martin Cave, *Understanding Regulation Theory, Strategy, and Practice*, (2<sup>nd</sup> edn, OUP 2012) p.41.

<sup>13</sup> For a further discussion on the public interest concept, see Section 3.2.1 below.

<sup>14</sup> Baldwin and Cave (2012) (n 12) p. 41.

<sup>15</sup> Carlos M. Pelàez and Carlos A. Pelàez, *Financial Regulation after the Global Recession* (Palgrave Macmillan 2009) p. 15.

<sup>16</sup> Regulatory failure is described as the situation where the cost of regulation is greater than its benefits. See Bronwen and Yeung (n 7) p. 43.

<sup>17</sup> Regulatory capture occurs where regulatory institutions disregard the broader welfare of society and promote the interests of those who have political or economic power. See Pelàez and Pelàez (n 15) p. 15.

<sup>18</sup> Baldwin and Cave (2012) (n 12) p. 41.

<sup>19</sup> *Ibid* p. 57.

## 1.2. Technical Justifications for Regulation

The other explanatory concept of regulation is the technical justifications for regulation in the interest of public.<sup>20</sup> In other words, regulation is justified where the uncontrolled market fails to function in accordance with public interest. This concept sits opposite to self-regulation theory. Self-regulation theory states that regulation of markets is not necessary as market forces alone can lead market participants to act with diligence.<sup>21</sup>

Nevertheless, today's financial markets are not able to function without regulatory intervention because of the various participants and many complexities involved in markets. As highlighted by the recent global financial crisis, markets are not always able to respond to rapid changes and can ultimately fail. Thus, regulation can be used to enable a response to market failures, as a rationale.<sup>22</sup>

Baldwin and Cave considered a number of situations where markets fail due to mainly economic inadequacies and they highlighted these situations as technical reasons for regulation.<sup>23</sup> Accordingly, they cited fighting with monopolies, making the market more transparent via effective disclosure mechanisms, and protecting the market from insufficient competition conditions as technical justifications for regulation. Unstable market conditions and asymmetric information are shared problems of market failures. As a result, an expectations gap is likely to occur where the market fails to deliver correct information to issuers. The mutual objective of regulation in these economic conditions is to create a business environment where sources are allocated adequately, services are available to everyone who desires to receive them, access to accurate information is easy and affordable, and consumers are protected by the dominant players in the market via effective competition.<sup>24</sup> Ultimately, the expectations gap would then be narrowed, in accordance with the interests of the public.

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<sup>20</sup> Baldwin and Cave (1999) (n 4) p. 9.

<sup>21</sup> Reiner H. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 *Journal of Law Economics and Organization* 53. See also Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (first published in 1776, Electronic Book Company, London 2001).

<sup>22</sup> This chapter considers financial crises as market failures and looks at the rationale for regulation. The reasons for such crises are beyond the scope of this chapter and this thesis.

<sup>23</sup> For the full list of technical justifications for regulation, see Baldwin and Cave (1999) (n 4) pp. 9-16.

<sup>24</sup> *Ibid.*

So far, the core justifications of regulation have been discussed at a general level. Next, the main principles of regulation (i.e. the motives and technical justifications for regulation) will be applied to justify audit regulation.

### 1.3. Audit Regulation

The need for audit regulation can be derived from a number of rationales, including the economic and political intentions of regulatory authorities. Also, the issues that derive from the audit framework's own natural inconsistencies, such as the expectations gap and auditor independence, are other rationales for regulation.<sup>25</sup> This part will adopt Baldwin and Cave's<sup>26</sup> regulatory concept to identify the need for audit regulation. In this respect, this chapter finds the motives of audit regulation to be changing corporate forms and serving the public interest; technical justifications for audit regulation are noted as information inadequacies, deficient competition, coordination of rules and procedures, dealing with audit failures, and the limitations of self-regulation. These concepts will be explained in turn.

#### 1.3.1. Motives for Audit Regulation

The motives for audit regulation are explained here according to two areas of rationales: the force of new conditions to change, and the public interest theory. The motive of 'changing the *status quo*' is suggested to be covered by the motive of force of new conditions to change.

##### (i) Force of new conditions to change

It is true that corporate structures of today's financial environment have been changing from the classic form of firms to multi-national large corporations. The rise in cross-border investments has urged the need of international standards of auditing. For instance, the International Auditing and Assurance Board (IAASB) - the regulatory body of the IFAC - created the International Standards on Auditing (ISAs). The creation of ISAs aimed to reduce the transaction costs and to provide comparability for cross-border investors.<sup>27</sup>

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<sup>25</sup> For the discussion on auditor independence and expectations gap see Chapter II.

<sup>26</sup> Baldwin and Cave (n 4).

<sup>27</sup> See also Section 3.2.2 below.

**(ii) Serving the public interest**

The auditor has a public interest role that requires ensuring the credibility of financial statements and thus promoting market confidence and trust. However, a conflict of interest is likely to arise due to the relationship with the audited company. Companies ‘hire’ auditors and they have an interest in the audited financial statements and this interest may conflict with the users (particularly investors) and the general public.<sup>28</sup> At this level, audit regulation is used to protect the investors and their interests.

**1.3.2. Technical Justifications of Audit Regulation**

**(i) Limitations of self-regulation**

Self-regulation can be defined as the system where the private organisations and members of the professions set the standards and apply them.<sup>29</sup> In other words, under a self-regulation regime, both regulation and control are in the hands of the members of the profession. There are advantages to self-regulation in terms of flexibility, expertise, low application costs, and cross-border application.<sup>30</sup> In addition, self-regulation might be attractive for market participants because its legal force is relatively limited.

Unfortunately, self-regulation may not be sufficient to operate the audit market efficiently because of imperfections in the market - e.g., the lack of perfect economic competition<sup>31</sup> and information asymmetries<sup>32</sup>. Moreover, the role of self-regulators might be restricted. For instance, self-regulators create the rules but enforcement and

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<sup>28</sup> William R. Kinney, Jr., ‘Twenty-Five Years of Audit Deregulation and Re-Regulation: What does it mean for 2005 and beyond?’ (2005) 24(Supplement) *Auditing: A Journal of Practice and Theory* 89. See also Chapter II, Section 2.2 for the auditor-client relationship.

<sup>29</sup> Hupkes (n 2) p. 429.

<sup>30</sup> *Ibid.*

<sup>31</sup> Perfect competition requires that (i) no participants (firms) have the market power to influence the product price (ii) products must be substitutable (homogeneity), and (iii) low costs of entry to and exit from the market. See Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics*, (7<sup>th</sup> edn, Pearson Prentice Hall 2009).

<sup>32</sup> It is possible that investors are not able to qualify the quality of services they receive and therefore, verify the accuracy of the information because in general (i) the service provider has more knowledge than its recipient; (ii) investors do not have the expertise to read the disclosed information and apply them to their investment decisions; and (iii) investors cannot verify the accuracy of the published information as there might be omissions, or misrepresentations in the statements. See Carsten Gerner-Beuerle, ‘The Market for Securities and Its Regulation Through Gatekeepers’ (2009) 23 *Temple International and Comparative Law Journal* pp. 324, 326, 328.

monitoring can be carried out by a public agency.<sup>33</sup> Also, the degree of binding legal force of self-regulated rules may vary. Self-regulated rules can be adopted voluntarily and no binding force or legal force is involved in the enforcement of self-regulated rules.<sup>34</sup> Hence, self-regulators are often less effective in enforcement of rules compared with government enforcement.

Given these conditions, it might not be the best choice to leave the audit market to be self-regulated since it is highly concentrated<sup>35</sup> and asymmetric information output is likely.<sup>36</sup> Furthermore, self-regulation may not always reflect the best interests of the public and this could harm the public-interest role of auditing. For instance, in a self-regulation set-up where rules are prepared by former practitioners in the industry, it is likely that they may pursue financial interest outcomes in self-regulatory rules<sup>37</sup> or other powerful actors may impact self-regulators to issue favourable rules for themselves.<sup>38</sup>

### (ii) Dealing with audit failures

An audit failure occurs when material misstatements were not detected,<sup>39</sup> when there are information asymmetries between the users of the audit report (shareholders) and the sellers (auditors)<sup>40</sup> or when auditor independence is damaged.

Enron is a good example of an audit failure where the auditor (Arthur Andersen) failed to detect and report material misstatements in financial statements and helped the company to present a false picture of the financial situation of the company to the public.<sup>41</sup> Kaplan *et al* applied Akerlof's theory of the market for lemons<sup>42</sup> to the

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<sup>33</sup> Baldwin and Cave (1999) (n 4) p. 126.

<sup>34</sup> *Ibid.*

<sup>35</sup> For the concentration in the audit market see Chapter II, Section 2.4.

<sup>36</sup> See Chapter I, Section 2.2.

<sup>37</sup> Hupkes (n 2) pp. 429-30.

<sup>38</sup> See also Section 3.2 below.

<sup>39</sup> Audit failure also occurs when the auditor issues a clean audit report when material misstatement existed or the auditor fails to warn the public that the financial statements are not being fairly presented by the management. See Alvin A. Arens, Randal J. Elder, and Mark S. Beasley, *Auditing and Assurance Services* (15<sup>th</sup> edn, Pearson, Boston 2014).

<sup>40</sup> Steven E. Kaplan, Pamela B. Roush, and Linda Thorne, 'Andersen and the Market for Lemons in Audit Reports' (2007) 70(4) *Journal for Business Ethics* 363.

<sup>41</sup> John C. Coffee, Jr., 'Understanding Enron: "It's About the Gatekeepers, Stupid"' (2002) 57 *Business Lawyer* 1403.

<sup>42</sup> Akerlof's theory of the market for lemons is used to explain the information asymmetry in the market. The market for second-hand cars is used as an example in this theory to indicate the problem of quality uncertainty. The buyer of the used car would not know that he (or she) bought a defective

market for the audit reports in Enron case.<sup>43</sup> Their explanation was that Andersen repeatedly issued ‘lemon’ audit reports (i.e. low quality audit reports) due to the structure of the audit report market where it generally takes some time for buyers to realize the quality of service that they received. Financial auditing as a control mechanism is used to reduce such information asymmetry.

It is said that the audit failures that occurred during the global financial crisis revealed the deficiencies in self-regulation.<sup>44</sup> Audit regulation previously, and now, has been used to deal with aftermath of audit failures.<sup>45</sup> Via regulation, it is intended to reduce information inadequacies in the market, and thus the users of the audited financial statements can be provided with accurate information.

### (iii) Narrowing the expectations gap

The other rationale for audit regulation is narrowing the expectations gap. The expectations gap is defined as the situation where the auditors are expected to offer more than they can actually perform.<sup>46</sup>

The expectations gap is widest during the time of audit failures, when the profession fails to react to meet the expectations of society.<sup>47</sup> The question of “*where were the auditors?*” is asked each time these failures occur. Market failures are thus seen as good opportunities to fix inefficiencies and narrow the expectations gap by issuing new regulations.<sup>48</sup> Regulatory remedies aiming at increased audit quality and re-assured the auditor independence can be used to meet with society’s expectations as to the role of auditors and hence, narrow the expectations gap.<sup>49</sup>

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used car (i.e. “lemons”) because the inspection on the car is restricted and access to important information is not fully granted. See George A. Akerlof, ‘The Market for “Lemons”: Quality Uncertainty and the Market Mechanism’ (1970) 84(3) Quarterly Journal of Economics 488.

<sup>43</sup> Kaplan *et al* (n 40) p. 430.

<sup>44</sup> Ibid.

<sup>45</sup> See Chapter IV for the regulatory responses to Enron and the global financial crisis of 2008.

<sup>46</sup> John C. Coffee, Jr., *Gatekeepers: The Professions and Corporate Governance* (OUP, 2006) p.141. See also Chapter II, Section 2.1 for a discussion on the expectations gap.

<sup>47</sup> For the link between the expectation gap and audit regulation, see Ian P. Dewing and Peter O. Russell, ‘UK fund managers, audit regulation and the new Accountancy Foundation: towards a narrowing of the audit expectations gap?’ (2002) 17(9) *Managerial Auditing Journal* 537. See also Christopher Humphrey, ‘Debating audit expectations’ in Michael Sherer and Stuart Turley (eds), *Current Issues in Auditing* (3<sup>rd</sup> edn, first printed in 1997, Paul Chapman Publishing, London 2005).

<sup>48</sup> Kinney (n 28).

<sup>49</sup> Regulatory remedies on auditor independence and audit quality will be dealt with in greater detail in Chapter IV.

### **(v) Dealing with deficient competition**

Monopolies<sup>50</sup> are considered as market failures because they create high prices, reduce output and transfer income from consumers to producers.<sup>51</sup> Regulation of competition in the market is aimed to mitigate anti-competitive behaviours, and fight against monopolies.<sup>52</sup> Although, at present, the Big Four audit firms dominate the audit market, the current structure of the audit market is not a monopoly.<sup>53</sup> Via audit regulation, the concentration in the audit market is intended to be reduced (i.e. the rotation of the key audit partner rule in the EU).<sup>54</sup>

### **(vi) Coordination of rules and procedures**

Coordination is one of the justifications for audit regulation. Audit regulation determines the substance of the audit process and auditing standards in order to coordinate the audit market. Through this coordination, the intention is to set a rationale benchmark for auditing practices (i.e. ISAs) and auditors' behaviours (e.g. code of ethics for auditors) in order to avoid undesirable applications and behaviours. At present, standard-setting for audit practices and auditors' behaviours are carried out by independent institutions at the Member State level, such as the FRC in the UK, and by private organisations at the international level, namely the IFAC.<sup>55</sup>

### **1.3.3. Timeline of Audit Regulation**

The possible theoretical motives and justification for audit regulation, explained in the previous section, will now be applied to the development of audit regulation. For this purpose, Figure 3.1 below illustrates the formation of audit regulation in the US and in Europe between the 1970s and 2010s. Accordingly, the journey of audit

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<sup>50</sup> A monopoly is a market structure wherein one firm controls 100% of the number of clients or fees. See Kevin P. McMeeking, 'Competition in the UK accounting services market' (2007) 22(2) *Managerial Auditing Journal* 197.

<sup>51</sup> Baldwin and Cave (1999) (n 4) p. 10.

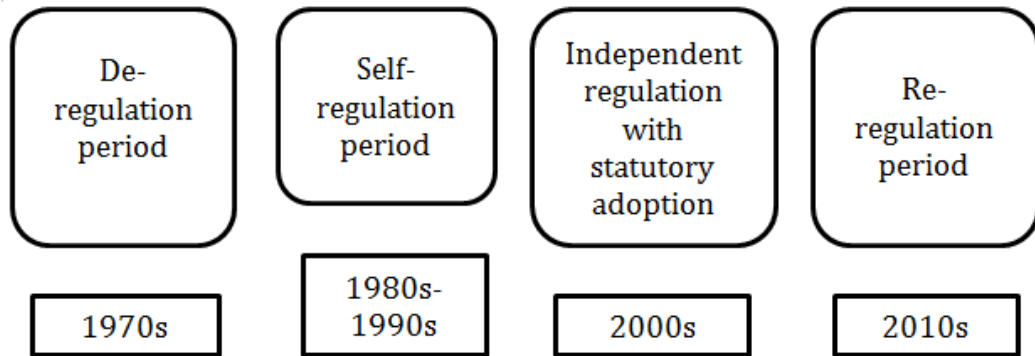
<sup>52</sup> See Consolidated version of the Treaty on the Functioning of the European Union - Part Three: Union Policies and Internal Actions - Title VII: Common Rules on Competition, Taxation and Approximation of Laws - Chapter 1: Rules on competition - Section 1: Rules applying to undertakings, (The Lisbon Treaty), Article 102 (ex Article 82 TEC). Also see Section 3.1.3 below for further explanation regarding competition rules and regulation.

<sup>53</sup> See Section 3.1.3 of this chapter. See also Chapter II, Section 2.4 for the audit market structure.

<sup>54</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87, Article 42. See also Chapter IV, Section 3.3.

<sup>55</sup> For the role of IFAC in the audit standard setting, see Section 3.2.1 below.

regulation starts with the de-regulation trend in the 1970s, followed by a self-regulation period between the 1980s-1990s, then moving to private regulation with statutory adoption in the 2000s, and reaching a re-regulation period in the last decade.



**Figure 3.1:** The Audit Regulation Timeline for the period 1970s-2010s

To elaborate, in the late 1970s, there was a de-regulation trend in the US. Airlines, energy companies, and financial institutions were affected by this trend.<sup>56</sup> From the 1980s-1990s the accounting profession was left to self-regulation in the US until 2004.<sup>57</sup> The self-regulation regime in auditing included mandatory reviews by other auditors (peer review program).<sup>58</sup> In other words, under the self-regulated peer review program, auditors were controlled by other auditors' reviews. During the 1990s, changes in the industry called for uniform standards in accounting and auditing. In 1991, the IAASB regulatory body of the IFAC created the International Standards on Auditing (ISAs). Nevertheless, confidence in the market could not be maintained because of the limits of self-regulation particularly in terms of monitoring and control.<sup>59</sup>

Following the Enron scandal and other corporate scandals around the world, self-regulation was recognised as inefficient. It was observed that financial markets could

<sup>56</sup> Kinney (n 28) p. 94.

<sup>57</sup> A self-regulation regime was introduced in 1988 after the financial crisis in the mid-1980s. In that time, the financial crisis caused a large number of collapses in multiple markets, including in the banking sector. In addition, these collapses involved a number of audit failures. See *ibid* p. 95.

<sup>58</sup> Gilles Hillary and Clive Lennox, 'The credibility of self-regulation: Evidence from the accounting profession's peer review program' (2005) 40(1-3) *Journal of Accounting and Economics* 211.

<sup>59</sup> *Ibid* p. 228

not be left to pure-self regulation.<sup>60</sup> In the early 2000s, state regulation was opted generally as the public expectations increased on political actions. Correspondingly, the SOX<sup>61</sup> was enacted in 2002 issuing stricter rules for the audit profession, including its public oversight.

The Enron scandal was the catalyst for initiatives in audit regulation at EU level. In 2003, the European Commission published a Communication entitled ‘Reinforcing the Statutory Audit in the EU’ to accept ISAs for the EU.<sup>62</sup> Following this Communication, the Statutory Audit Directive 2006/43/EC regulated statutory audit practices in the EU.<sup>63</sup> Through this Directive, the application of ISAs was introduced to all statutory audits in the EU. This means the EU adopted a harmonised regulatory framework for auditing, constituted of the adoption of private-initiated (or independent) standards enforced by law.<sup>64</sup> The new form of self-regulation included both public and private authorities in regulation, in addition to the enforcement power of the law. This process is called ‘autonomous self-regulation’.<sup>65</sup> More recently, the global financial crisis highlighted certain issues in auditing and urged reform. As a response to audit failures in the global financial crisis in the early 2010s, audit regulation was also part of re-regulation attempts in the EU.<sup>66</sup>

Audit regulation has been subject to change through time in accordance with developments in financial markets. There is no straightforward answer as to which form of regulation is more favourable for auditing because each has its own problems and drawbacks at the time of application.<sup>67</sup>

This section submitted that regulation is needed in the audit market; firstly, because adjustments are needed subsequent to financial crisis that involved audit failures;

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<sup>60</sup> A pure form of self-regulation is based on voluntary initiatives by private actors from the industry. See Hupkes (n 2) p. 428.

<sup>61</sup> US Congress (2002) An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. The Sarbanes-Oxley Act, 107th Congress, H.R. 3763 (The SOX).

<sup>62</sup> Communication from the Commission to the Council and the European Parliament ‘Reinforcing the statutory audit in the EU’ Brussels, 21.05.2003 COM (2003) 286 final.

<sup>63</sup> Directive 2006/43/EC (n 54).

<sup>64</sup> The EU audit policy and laws will be examined in more detail in Chapter IV.

<sup>65</sup> The shadow of the law involves in the process of regulating by both private actors and public authorities. See Hupkes (n 2) p. 428.

<sup>66</sup> For critical analysis of the EU audit reform in see Chapter IV, Section 3.

<sup>67</sup> For discussion on the Directive 2006/43/EC and the adoption of ISAs, see Chapter IV, Section 2.2; for a general critique on ISAs, see Section 3.2.

secondly, financial reporting and auditing has to be modernized in accordance to the rising numbers of multinational corporations as a result of globalisation; and lastly, there are limitations to self-regulation. The next section will explore the appropriate degree of regulation by questioning whether rule- or principle-based regulation is preferable in auditing.

## 2. HOW: RULES *versus* PRINCIPLES

Rules can be formed as general principles or prescriptive provisions (rules). In accounting and law literature, the rule- or principle-based debate on standard setting has been running for more than 20 years.<sup>68</sup> The US adopts more rule-based standards, with detailed and complex rules, while the UK takes a principle-based approach to standard setting.<sup>69</sup> Debates on this issue sometimes favour the principle-based and sometimes the rule-based approach to standard setting. However, it is not entirely straightforward to favour one approach over another. The following analysis will explain differences between them. Before that it is useful to identify the levels of regulation in order to distinguish rules from principles.

### 2.1. Levels of Regulation

The level of rules ranges from very simple to highly complex. These levels can be categorised in three ways.<sup>70</sup> The simplest level of regulation constitutes of the first level that is bright-line rules. Level three is comprised of detailed or complex rules. In the middle, principles appear in the form of more general rules.

- 1) *Bright-line rules*: bright-line rules provide clear rules and their application is straightforward.
- 2) *General rules*: principles emphasise the general objective. However, the use of vague terms makes application more obscure.

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<sup>68</sup> David Satava, Cam Caldwell, and Linda Richards 'Ethics and the Auditing Culture: Rethinking the Foundation of Accounting and Auditing' (2006) 64(3) *Journal of Business Ethics* 271. See also David Alexander and Eva Jermakowicz, 'A True and Fair View of the Principles/Rules Debate' (2006) 42(2) *Abacus* 132.

<sup>69</sup> For a comparison between rules-based and principle-based standards, see Section 2.3 below.

<sup>70</sup> Black (2008) (n 2) p. 437.

3) *Detailed/complex rules*: Detailed rules provide more certainty than principles because they list a number of conditions that needed to be considered for its application.

Table 3.1 illustrates examples of these three types of rules from the traffic and audit regulation sectors.

Regulations	Examples	
<b>Traffic Regulation</b>	<b>Bright-line rules</b>	The minimum driving age is 17.
	<b>Principles</b>	Drive carefully.
	<b>Detailed rules</b>	You must use headlights when visibility is seriously reduced, or when you cannot see for more than 100 metres (328 feet). You may also use front or rear fog lights but you must switch them off when visibility improves. <sup>71</sup>
<b>Audit Regulation</b>	<b>Bright-line rules</b>	All statutory auditors and audit firms shall be subject to public oversight. <sup>72</sup>
	<b>Principles</b>	The overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. <sup>73</sup>
	<b>Detailed rules</b>	Member States shall ensure that the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of at least two years. <sup>74</sup>

**Table 3.1:** Levels of regulation and examples

As Table 3.1 shows, there is a positive correlation between the levels of rules and their complexity.<sup>75</sup> In other words, rules become more complex as they become more precise. Detailed rules also tend to be more costly since an increased level of

<sup>71</sup> Road Vehicles Lighting Regulations 1989 RVLRL No. 1796 (amended in 2005), Regulations 25 and 27.

<sup>72</sup> Directive 2006/43/EC (n 54), Article 32(2).

<sup>73</sup> ISA 200, para. 11(a).

<sup>74</sup> Directive 2006/43/EC (n 54), Article 42(2).

<sup>75</sup> Black (2008) (n 2) p. 438.

regulation causes an increase in the cost of regulation.<sup>76</sup> For instance, the list of conditions provided in terms of detailed rules may create more complexity in practice because the practitioner would be dependent on rules in every situation. Although the flexibility of general rules makes their application more favourable, vague terms, such as ‘carefully’ and ‘reasonable assurance’ create ambiguity. General rules may become more detailed over time, however, as a result of incompliance.

The next part will examine the characteristics of rules and principles in detail. After that, how rules and principles are applied in audit regulation will be explained.

## 2.2. Rule-based *versus* Principle-based Regulation

Rule-based regulation adopts more detailed and complex rules for every possible circumstance. In this respect, such rules provide certainty and predictability. However, they are likely to create gaps in application because it is not possible to include every possible circumstance in the rulebook. Thus, a new rule is required when there is no specific rule for a given situation. This may cause a rapid growth in publishing new rules and laws.<sup>77</sup> Such process in establishing new rules on a continuous basis, however, would ultimately cause over-regulation. Moreover, detailed rules may result in ‘creative compliance’.<sup>78</sup> In other words, they may create a system wherein ‘box-ticking’ has become the norm but the objective of the rule is disregarded.<sup>79</sup>

Furthermore, rule-based regulation is likely to be more costly compared with principle-based regulation. The various costs of regulation are described as follows: formulating legal rules (formulating costs), litigation costs (application of these rules in courts), compliance costs (and interpretation of those rules by the public).<sup>80</sup> Because rule-based regulation would indicate rules about each specific situation, it

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<sup>76</sup> Jackman (n 6) p. 110.

<sup>77</sup> Surendra Arjoon, ‘Striking a Balance between Rules and Principles-Based Approaches for Effective Governance: a Risks-Based Approach’ (2006) 68(1) *Journal of Business Ethics* 53.

<sup>78</sup> Creative compliance of rules is seen when a person applies a rule regarding to its formal approach but violating its purpose. See Julia Black, ‘Using Rules Effectively’ in Christopher McCrudden (ed), *Regulation and Deregulation: policy and practice in the utilities and financial services industries* (OUP, Oxford 1999) p. 106.

<sup>79</sup> *Ibid* p. 95.

<sup>80</sup> Louis Kaplow, ‘General Characteristics of Rules’ in John M. Olin (ed), *Encyclopaedia of Law and Economics* (Edward Elgar 2000) 502.

should be expected that these costs, especially formulating costs, would be higher than for principle-based regulation.

Principles outline general regulatory objectives and codes of conduct. Principle-based regulation can be seen as a guide for practitioners to find appropriate moral aspects of their decisions on a specific matter.<sup>81</sup> In other words, while rule-based standards set instructions ‘like a computer program’,<sup>82</sup> principle-based standards intend to provide a code of conduct (e.g. ethical conduct for accountants and auditors<sup>83</sup>).

Despite its simplified definition in the literature, principles-based regulation is actually a complex form of regulation because it can take different regulatory forms. For instance, although principles are mostly considered as having no legal status or no sanction attached to them, they can be legally binding, or disciplinary sanctions can be attached to their breach.<sup>84</sup> As Black states, principles can be incorporated in the rulebook (formal principles-based regulation, e.g. the UK Combined Code on Corporate Governance<sup>85</sup>), or the principles in the rulebook put into practice by regulators (substantive principles-based regulation, e.g. the EU Directive 2006/43/EC).<sup>86</sup> The ‘full principles-based regulation’ is the form where the both situations exist.<sup>87</sup>

For an effective application of principle-based regulation, it is necessary that both the regulators and the regulated engage in a regulatory conversation determining the meaning and application of principles and setting their objectives.<sup>88</sup> Establishing such communication is essential, especially for vague terms used in principles. Because the use of vague terms makes application obscure, practitioners may require guidance on application. If there is a shared understanding of the meaning of such terms between the regulators and the regulated, ambiguity may be reduced.<sup>89</sup> This is

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<sup>81</sup> Arjoon (n 77) p. 67.

<sup>82</sup> The Institute of Chartered Accountants of Scotland, ‘Principles Not Rules: A Question of Judgment’ April 2006 p. 4.

<sup>83</sup> Satava *et al* (n 68) p. 279.

<sup>84</sup> Black (2008) (n 2) p. 428.

<sup>85</sup> *Ibid* p. 435.

<sup>86</sup> *Ibid* p. 429.

<sup>87</sup> *Ibid*.

<sup>88</sup> *Ibid* p. 439.

<sup>89</sup> *Ibid* p. 437.

only possible with “*responsive regulation*”,<sup>90</sup> based on constant dialogue between the regulators and the regulated.

Principles are suggested as more suitable in a constantly-changing marketplace. While principles can adapt to changes and respond in developing new rules, prescriptive rules are difficult to adjust according to changing market circumstances.<sup>91</sup> In addition, principle-based regulation can be regarded as user-friendly for market practitioners, whereas prescriptive and detailed rules can be confusing, particularly for smaller firms because they generally do not have legal expertise.<sup>92</sup>

Criticisms of principle-based regulation focus on content and language. Principles are more akin to recommendations on specific circumstances. Often, these recommendations include vague terms such as ‘fair’, ‘assurance’, or ‘due care’. However, the principle itself does not explain any of these terms. Thus, principles arguably cause uncertainty and are not clear.<sup>93</sup> However, this statement is not entirely accurate, because certainty is a relative assessment. As Black pointed out, the certainty of principles depends on “*who reads it*”.<sup>94</sup> In other words, ‘providing *reasonable* assurance’ might be unclear for lawyers or others, but it has a meaning for accountants. Thus, the use of such terms in principles does automatically not make them unclear or uncertain.

A relatively flexible provision of principle-based regulations can be advantageous both for regulators and regulated but can create problems at the same time. As argued, flexibility allows firms to comply with a minimum level of conduct where investors would be left unprotected, as the enforcement of the general rules is poor.<sup>95</sup>

### 2.3. Rule-based *versus* Principle-based Standards in Auditing

It is evident from the Enron scandal that rule-based accounting standards can be manipulated. Enron’s market value was not based on real values but it was invented

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<sup>90</sup> Michael Moran, ‘Review Article: Understanding the Regulatory State’ (2002) 32(2) British Journal of Political Science 391.

<sup>91</sup> FSA, ‘Principle-based regulation: Focusing on the outcomes that matter’, April 2007 p. 6.

<sup>92</sup> Ibid.

<sup>93</sup> Black (1999) (n 78) p. 99.

<sup>94</sup> Ibid p. 100.

<sup>95</sup> Black (2008) (n 2) p. 428.

using altered accounts.<sup>96</sup> Enron used special-purpose-entities in order to hide its debts and misrepresent their financial situation.<sup>97</sup> Enron's accounting chicanery has shown that prescriptive accounting rules do not preclude accounting misconduct.

Principle-based regulation is seen as an alternative to rule-based regulation since aggressive reporting is less likely under principle-based accounting standards.<sup>98</sup> Also, it is argued that it is impossible to cover all possible misconduct in the financial reports unless there is a discretion power.<sup>99</sup>

Table 3.2 is inspired by Polacek *et al*'s<sup>100</sup> comparison of IFRS and GAAS. In addition to IFRS and GAAS, the US GAAP, UK FRS, UK ISA, and ISA are added to the comparison by the author of this thesis.

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<sup>96</sup> Coffee (2002) (n 41) p. 1404.

<sup>97</sup> Joshua Ronen, 'Corporate Audits and How to Fix Them' (2010) 24(2) *Journal of Economic Perspectives* 189.

<sup>98</sup> Laureen A. Maines *et al*, 'Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting' (2003) 17 (1) *Accounting Horizons* 73.

<sup>99</sup> Ronen (n 97) p. 204.

<sup>100</sup> George A. Polacek, David A. Gianetto, Khaldoun Khashanah, and Danish Verma, 'On principles and rules in complex adaptive systems: A financial system case study' (2012) 15(4) *Systems Engineering* 433.

Characteristics	Rule-based		Principle-based			
	US GAAP	US GAAS SAS <sup>101</sup>	UK FRS	UK ISAs	IFRS	ISA
<b>Issuer</b>	FASB	ASB <sup>102</sup>	ASB	APB <sup>103</sup>	IASB	IAPC <sup>104</sup>
<b>Date</b>	1978	1976	1971	1978	2001	1991
<b>Quantity</b>	Large number of rules		Small number of principles			
	7 concept statements	1-121 <sup>105</sup>	30 standards in total	36 standards in total	1-13	36 standards in total
<b>Content</b>	Specific application guidance		Limited application guidance			
	What is reported and how the accounting is performed	Audit quality and the objectives to be achieved in an audit	Guidance statements and indicators of best practice	Explanation and guidance on auditing	General purpose of financial statements	Helping the auditor to perform audit work in reasonable assurance
<b>Purpose</b>	Prescribe actions of individuals		Guide thinking of individuals			
<b>Growth</b>	+6,100 words per year average	More than 30 new SAS issued <sup>106</sup>	Unchanged	2 new ISAs <sup>107</sup>	Unchanged <sup>108</sup>	Unchanged <sup>109</sup>
<b>Focus</b>	Short-term		Long-term			

**Table 3.2:** Comparison of rule- and principle-based accounting and auditing standards

<sup>101</sup> In the US, GAAS SAS apply to audits of the non-listed entities. PCAOB Auditing Standards are effective for the audits of listed entities.

<sup>102</sup> The Auditing Standards Board is the senior committee of the American Institute of Certified Public Accountants (AICPA).

<sup>103</sup> The FRC took over responsibilities for the setting of accounting and audit standards respectively from the Accounting Standards Board (ASB) in 2004, and the Auditing Practices Board (APB) and in July 2012.

<sup>104</sup> The International Auditing Practices Committee (IAPC) was renamed as the International Auditing and Assurance Standards Board (IAASB) in 2002. The history and development of ISAs is available at <http://www.icaew.com/en/library/subject-gateways/auditing/knowledge-guide-to-international-standards-on-auditing#history> accessed 21/11/2013.

<sup>105</sup> See AICPA's website <http://www.aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx> accessed 21/11/2013.

<sup>106</sup> AICPA make codification of SAS each year and generally issue new standards during the codification process. In 2012, 4 new SASs were issued. See AICPA's website <http://www.aicpa.org/Research/Standards/AuditAttest/Pages/clarifiedSAS.aspx> accessed 21/11/2013.

<sup>107</sup> Under the Clarity Project, all UK ISAs are clarified, 12 UK ISAs are revised, and 2 new ISAs are introduced. Revised ISAs (UK and Ireland) were issued in October 2009 and apply to audits of financial statements for periods ending on or after 15 December 2010.

<sup>108</sup> There were only limited amendments related to global financial crisis. See IFRS website <http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx> accessed 21/11/2013.

<sup>109</sup> The IAASB redrafted 19 ISAs under the Clarity Project that ended in 2008.

In accounting and auditing principle-based standards, e.g. international financial reporting standards (IFRS) and international standards on auditing (ISAs) are accepted globally. The UK's standards on auditing are based on ISAs (i.e. ISAs UK and Ireland). The EU also follows the UK tradition in accounting and auditing regulation. IFRS and ISAs are adopted in the EU by the EU Regulations<sup>110</sup> and Directives<sup>111</sup>.

One of the justifications of the global trend towards principle-based regulation is the UK's well-functioning financial market regulation formed as principles with a "lighter touch" of regulation.<sup>112</sup> The other justification is that rule-based standards were not able to prevent misconducted statements as even prescriptive rules leave gaps that allow for the possibility of such misconduct. It is said there is no major difference between the UK and US accounting standards, and that in fact they were "almost identical"<sup>113</sup>. However, principle-based standards are more concerned with forming a code of behaviour according to its objectives.<sup>114</sup> Resultantly, when they are applied in practice, applicants showed different behaviours, despite their similar structures. It is said that employees of Enron were morally corrupt, but they were doing everything in accordance with the rule-based accounting standards of the US.<sup>115</sup> Nonetheless, their amoral business behaviours caused the dramatic collapse of the institution. Principles at this level are suggested as guidance for accountants and auditors in terms of the development of their ethical behaviours.<sup>116</sup> As was submitted earlier, one of the core incentives of regulation is meeting society's expectations in terms of developing ethical standards.<sup>117</sup> However, stand-alone rules are not sufficient for maintaining professional ethical behaviour of auditors.

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<sup>110</sup> From 2005, listed companies in the EU were required to report in accordance with IFRS. See the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards OJ L 243, 11.9.2002.

<sup>111</sup> ISAs are endorsed by the European Commission under the Directive 2006/43/EC. See Directive 2006/43/EC, n (54).

<sup>112</sup> The regulation policy of the FSA is described as 'light touch' or 'principle-based' regulation. See Joanna Gray, 'Is it time to highlight the limits of risk-based financial regulation?' (2009) 4(1) Capital Markets Law Journal 50.

<sup>113</sup> Ibid.

<sup>114</sup> Mark W. Nelson, 'Behavioural Evidence on the Effects of Principles- and Rules-Based Standards' (2003) 17(1) Accounting Horizons 91.

<sup>115</sup> Satava *et al* (n 68) p. 273.

<sup>116</sup> The Auditing and Assurance Council in the UK, and International Ethics Standards Board for Accountants at international level are bodies responsible for issuing practical and ethical standards for auditors.

<sup>117</sup> See Section 1 of this chapter.

In today's financial markets wherein irregularity and continuous change is the norm, it might be preferable to regulate the market with more general and flexible standards rather than precise rules.<sup>118</sup> Despite its superior aspects, principle-based regulation has its flaws. Regulatory approaches can change direction from lax regulation to tougher regulation, and principles can become more detailed and specific as a result of non-compliance.<sup>119</sup> For instance, the US GAAP was drafted from principles but it has become more detailed and rule-based over time.<sup>120</sup>

### **Conclusion**

On the one hand, principle-based regulation is argued to be superior to rule-based regulation because it helps in the adoption of best practice conduct rather than the mechanical application of rules. On the other hand, it is said that principles are not as effective as rules since their enforcement power is poor. However, it is not possible to universally favour one approach over another; rule- or principle-based approaches may work better in some countries but not suit others. Countries should be able to determine the best approach that suits their market structures.

In addition, rules and principles are not alternatives to each other but should instead be applied as supplementary to the other. In this respect, regulations that constitute solely rules or principles are not the solutions; rather, regulations combined with both with rules and principles would be optimal for audit regulation. In other words, a "tiered approach"<sup>121</sup> to audit regulation can be suggested. Accordingly, principles and rules should be incorporated in standard settings. In some areas, tougher enforcement mechanisms are needed that can be enhanced by rules (e.g. auditor liability<sup>122</sup>). Principles can cover gaps and inconsistencies that prescriptive rules might create.

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<sup>118</sup> Brian Quinn, 'A Model of Financial Regulation' in Christopher McCrudden (ed.) *Regulation and Deregulation: policy and practice in the utilities and financial services industries* (OUP, New York 1999).

<sup>119</sup> Black (2008) (n 2) p. 110.

<sup>120</sup> William W. Bratton, 'Rules, Principles, and the Accounting Crisis in the United States' in John Armour and Joseph A. McCahery (eds) *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publishing, Oxford 2006) 265.

<sup>121</sup> Black (2008) (n 2) pp. 429-30.

<sup>122</sup> See Chapter V.

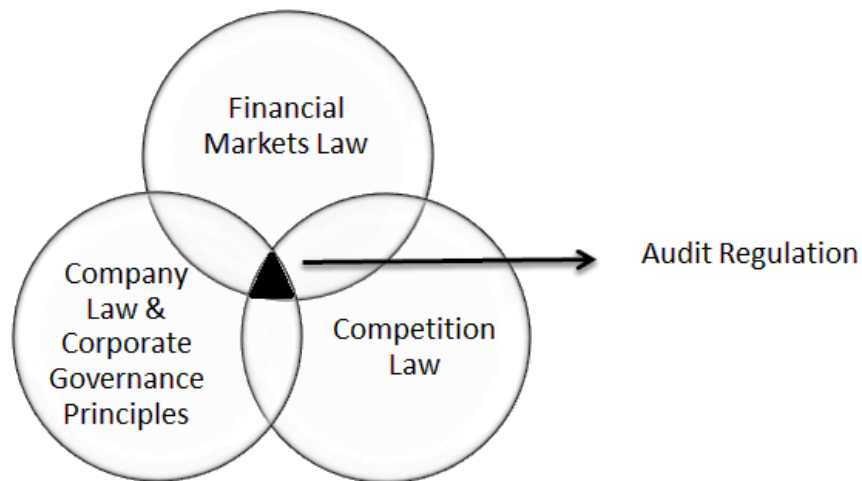
### **3. WHO REGULATES AUDIT?**

Audit regulation has a complex structure. Not only state-regulators but also private independent regulators are involved in its regulation both at the national and international level. First, it will be shown how audit regulation has been integrated with the other areas of law, in particular financial markets law, competition law, and company law. In this respect, these three areas of law and their relation to audit regulation will be identified. State regulation is mostly involved at this level. Second, the role of private actors in audit regulation (as self-regulators) will be discussed. This part supplements the first section of this chapter, which discussed self-regulation and its limits from a more theoretical perspective. In the conclusion, this section critically questions the role of private actors in audit regulation and how the state may influence self-regulators.

#### **3.1. State Regulation**

Audit regulation cannot be independent of other areas of regulation. From the appointment of auditors through to issuing the audit report, there are various parties and issues involved in the audit process. These issues include auditors' relationship with the audited company, the regulation of audit conduct, the protection of investors, and the liability of auditors to name but a few.

External auditing is primarily related to the audited company itself and its shareholders. Therefore, audit regulation in general is a concern of company law and corporate governance principles. In addition, third parties become users of the audited financial reports when a public company issues its securities in the securities markets and they are involved in this. The relationship between investors and auditors is regulated by financial markets laws. The other area of law that overlaps with the audit regulation is competition law. Competition law may involve audit regulation if competition in the market is distorted by (one of) the dominant big audit firms.



**Figure 3.1:** Triadic Structure of Audit Regulation

As Figure 3.2 illustrates, audit regulation is situated where three areas of law overlap: financial market law, company law & corporate governance principles, and competition law. As a result of this location, audit regulation is subject to a form of regulatory pluralism that involves multiple regulatory bodies. A number of governmental and non-governmental organisations regulate and set rules and standards that the audit profession will follow. This structure makes audit regulation complex. The following sub-sections will identify the regulators in these three fields and their role in audit regulation.

### **3.1.1. Financial Markets Law**

#### **(i) The need of financial services regulation in general**

The regulation of financial auditing is a part of financial services regulation. ESMA<sup>123</sup> in Europe, FCA<sup>124</sup> in the UK, and SPK<sup>125</sup> in Turkey are the responsible authorities for the regulation of financial markets. Regulation by these authorities has force of law and considers both participants and consumers in financial markets. The ultimate objective of financial services regulation is to ensure that financial markets operate efficiently with maximum capacity. It is another goal of financial services

<sup>123</sup> The role of ESMA in audit profession supervision will be discussed in limited basis in Chapter IV, Section 3.4.

<sup>124</sup> In April 2013, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) have overtaken the responsibilities of the Financial Services Authority (FSA).

<sup>125</sup> For the roles and responsibilities of the Capital Markets Board of Turkey (SPK), see Chapter VI, Section 2.

regulation that market confidence is maintained, investor protection is secured, and financial crime is reduced. In other words, financial markets regulation is intended to protect the market and its participants from unexpected circumstances and exploitation.

**(ii) How does this apply to auditing?**

Many countries provide self-regulatory arrangements for their stock exchanges.<sup>126</sup> National securities exchanges create and enforce rules for their members based on national securities law. For instance, the London Stock Exchange (LSE) has its own rules and regulations for all members (i.e. Rules of the LSE) alongside with the FSMA 2000<sup>127</sup>. Likewise, Borsa Istanbul in Turkey has its own regulations<sup>128</sup> including governance rules, conduct codes, and processes for disciplinary and enforcement actions for their members alongside Capital Markets Law.<sup>129</sup>

Financial markets law regulates the effective operations of the market and ensures that investors are protected against false and misleading financial information in published accounts and prospectuses. Within this context, regulators impose responsibility on auditors under financial markets regulations. The law requires the disclosure of periodic financial information for listed companies and to issue prospectuses for companies whose securities are offered in the primary market; these documents must also be audited.<sup>130</sup> Under the financial markets regulations,<sup>131</sup> auditors could be held liable for the false and misleading information in the periodic financial accounts and misstatements in or omissions from prospectuses.<sup>132</sup>

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<sup>126</sup> Hupkes (n 2) p. 437

<sup>127</sup> Financial Services and Markets Act (FSMA) 2000.

<sup>128</sup> Regulation on the establishment, operations, and supervision of issuers in financial markets and stock exchanges, 19 July 2013 Official Gazette No. 28712.

<sup>129</sup> Capital Markets Law No. 2499 amended with Law No. 6362, Official Gazette No. 28513 (06.12.2012).

<sup>130</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Article 4 (as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013); Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64, Article 5 (as amended by Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010).

<sup>131</sup> FSMA 2000, s. 90.

<sup>132</sup> The regulation of auditor liability rules under UK financial markets law will be examined further in Chapter V, Section 3.

### 3.1.2. Company Law and Corporate Governance Principles

#### (i) The need for company law in general

The primary function of company law is forming a corporate structure under five corporate attributes: legal personality, limited liability, transferable shares, and delegated management with a board structure.<sup>133</sup> By setting the corporate structure, company law aims to regulate and facilitate the operations of business firms in a more efficient way.

Beside this objective, the main role of company law is to minimize conflicts of interest between participants (e.g. principal and agents; controlling and minority shareholders; directors and creditors<sup>134</sup>) and to serve the interests of all those who are affected by a firm's activities including the shareholders, employees, suppliers, and customers.<sup>135</sup>

#### (ii) How does this apply to auditing?

Conflicts between auditors and the audited company (i.e. the company management) are a form of agency problem.<sup>136</sup> Company law uses regulatory and governance strategies to minimise the conflict between auditors and the audited company.<sup>137</sup>

The regulatory strategies of company law are mandatory (i) *ex ante* rules that govern the agent's behaviours to ensure investor and creditor protection and (ii) *ex post* rules that govern the mechanisms for penalizing offenders.<sup>138</sup>

*Ex ante* and *ex post* rules are governed by the Companies Act 2006 in the UK. For an example of *ex post* rules, the Companies Act 2006 imposes liability on auditors if the auditor fails to meet their duty of care in the completion of their duties.<sup>139</sup> To give an

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<sup>133</sup> Reiner Kraakman *et al*, *The Anatomy of Corporate Law* (2<sup>nd</sup> edn, OUP, Oxford 2009).

<sup>134</sup> John Armour, 'Who Should Make Corporate Law? EC Legislation *versus* Regulatory Competition' (2005) 58 *Current Legal Problems* 369.

<sup>135</sup> Kraakman *et al* (n 133) p. 28.

<sup>136</sup> See Chapter I, Section 1.2.

<sup>137</sup> Kraakman *et al* describe regulatory strategies of company law as prescriptive rules that govern the agents' behaviours, such as minimum capitalisation requirements that have a state enforcement. See Kraakman *et al* (n 133) p. 38.

<sup>138</sup> *Ibid.*

<sup>139</sup> Companies Act 2006, Part 16, s. 498.

example for *ex ante* rules, auditors are required to be independent from the audited company in order to avoid any conflict.<sup>140</sup>

In addition to regulatory strategies, governance strategies are used to facilitate a control mechanism over the agent's behaviour via principles and default rules.<sup>141</sup> Good governance strategies are associated with best practices that mainly lay out board and committee structures.<sup>142</sup> Governance strategies are mainly carried out by corporate governance principles and codes of ethics. For example, the UK Combined Code is applied as default rules. There is no legal obligation for listed companies to adopt the provisions of the corporate governance principles, but listed companies are obliged to report annually whether they comply with code provisions or explain the reasons for noncompliance.<sup>143</sup>

For example, in terms of auditing, the UK Corporate Governance Code recommends that listed firms establish an audit committee formed of independent directors.<sup>144</sup> Additional recommendations can also be attached to corporate governance principles. For example, the objectivity rule of the International Code of Ethics does not tolerate any relationship that might influence the professional judgement of auditors.<sup>145</sup> Governance strategies of company law are important because they can apply reputational sanctions to auditors.<sup>146</sup> For instance, auditors face reputational sanctions if their independence is compromised. Thus, corporate governance principles and codes of ethics for auditors are good strategies to be attached to statutory company law rules as additional governance mechanisms.

### 3.1.3. Competition Law

#### (i) The need for competition law in general

Competition is a market structure that enables a number of firms to operate in a market and ensures that none of these firms have excessive market power that may

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<sup>140</sup> Ibid, s. 936.

<sup>141</sup> Kraakman *et al* (n 133) p. 38.

<sup>142</sup> Ibid p. 67.

<sup>143</sup> FCA Listing Rules, 9.8.6.

<sup>144</sup> FRC, the UK Corporate Governance Code, September 2012, Section C.3.1.

<sup>145</sup> IFAC, International Code of Ethics for Professional Accountants, 2012 Section 100.5.

<sup>146</sup> Kraakman *et al* (n 133) pp. 42-4.

damage the effective function of the market.<sup>147</sup> Competition law, in this respect, aims to prompt effective competition via the prevention of anti-competitive practices, such as predatory pricing, territory division, and any other business practices that may create competitive disadvantage for other participants.<sup>148</sup>

An effective competition policy is considered the most essential factor in terms of the creation of a single market within the EU. The Treaty of Lisbon prohibits “*any abuse*<sup>149</sup> *by one or more undertakings of a dominant position.*”<sup>150</sup> It means that whilst a dominant position in a market does not solely constitute a breach of competition, any abuse of that position (e.g. price fixing) would. According to the Lisbon Treaty Protocol on the internal market and competition, the European Union will take necessary action in order to ensure competition is not distorted.<sup>151</sup> The European Commission has the authority to develop legal rules and procedures in accordance with the EU’s competition policy.

#### **(ii) How does this apply to auditing?**

Currently, the EU audit market structure is characterised as an oligopoly where there are only a few main service providers: the Big Four audit firms.<sup>152</sup> The current market structure may not constitute a risk for competition; however, competition in the market is likely to be distorted if one of the main players withdraws from the market. It is the responsibility of the European Commission and the competition authorities to prompt the competition and take regulatory measures regarding risks to a distortion of competition.

In 1997, the European Commission carried out a number of investigations into the proposed merger between Pricewaterhouse and Coopers & Lybrand. Despite

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<sup>147</sup> McMeeking (n 50) p. 198.

<sup>148</sup> See Cosmo Graham, *EU and UK Competition Law* (2<sup>nd</sup> edn, Pearson, Harlow 2013).

<sup>149</sup> Such abuse may consist of: unfair trade practices, including unfair purchase or selling prices; limiting production or markets; creating competitive disadvantage for other participants. See the Lisbon Treaty (n 52), Article 102.

<sup>150</sup> *Ibid.*

<sup>151</sup> The Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, 13 December 2007, OJEU 2007/ C 306/01, Protocol 156.

<sup>152</sup> For discussion on the domination of the Big Four and the concentration levels in the EU, see Chapter II, Section 2.4.

concerns, the European Commission approved the merger,<sup>153</sup> stating there was no proof the merger would create or strengthen a position of dominance.<sup>154</sup> Moreover, none of the Member States' competition authorities issued any objections to the proposed merger at that time.<sup>155</sup>

Even though the audit market has gradually become more concentrated and this has created some concerns, competition authorities have not issued concerns until recently.<sup>156</sup> Therefore, it is not certain whether the European Commission or competition authorities will take action and issue any regulatory steps to change the market structure.<sup>157</sup>

#### **3.1.4. Conclusion**

It is submitted that audit regulation is situated wherein the three areas of law, namely the financial markets law, company law and competition law overlap. Firstly, financial markets law governs auditor liability rules regarding third parties. The purpose is to eliminate exploitation and fraud and ensure trust is maintained in markets. Secondly, company law governs the mandatory rules and practice guidelines for auditors. Default and mandatory rules of company law specify how a firm will operate in the best way. Default rules of company law, such as corporate governance principles and codes of ethics for auditors can be used as effective governance strategies. Thirdly, competition law seeks to facilitate the maximum level of competitive conditions in the markets. As regards auditing, the main objectives of competition law would be eliminating barriers to entry to the market and reducing the concentration level.<sup>158</sup>

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<sup>153</sup> Mark Hatcher, 'The presentation of a merger case to the European Commission for approval: The case of Price Waterhouse/Coopers & Lybrand' (1999) 3(3) *Journal of Communication Management* 260.

<sup>154</sup> Daren Duxbury, Peter Moizer, and Wan Azmimi Wan-Muhamed, 'Effects of PricewaterhouseCooper Merger on the UK Audit Services Market' (2007) 22(2) *Managerial Auditing Journal* 121.

<sup>155</sup> The US Department of Justice approved of the proposed merger in the USA. See *ibid.*

<sup>156</sup> The UK Competition Commission issued its concern on the high-concentration on the audit market. See Richard Crump, 'Competition Commission aims to break Big Four dominance' *Accountancy Age* 22 February 2013.

<sup>157</sup> Regulatory measures on the concentration in the audit market will be discussed further in Chapter IV, Section 3.3 below.

<sup>158</sup> See also Chapter IV, Section 3.3.

Audit regulation has a complex structure at both national and international levels. In addition to state actors, private actors also play a role in audit regulation. The next part will analyse the role of private actors in audit regulation.

### 3.2. Industry Self-Regulation

Private actors, alongside state actors, play a role in audit regulation. Private regulation, or in other words, industry self-regulation, co-exists with state regulation. In auditing, associations of audit profession set up voluntary codes of conducts, e.g. ASB in the UK and IAASB at international level. The influence of state and private regulators might vary at national, regional and international level in terms of their political power and legislative influence. This is illustrated in Table 3.3 and will be explained in more detail below.

Levels	Private		State	
	Regulation	Power	Regulation	Power
<b>National</b>	<b>Possible</b> (e.g. the ASB in the UK)	<b>Possible</b> (e.g. UK corporate governance principles created by a private sector initiative)	<b>Yes</b> (e.g. UK Companies Act 2006, Chapter 2 appointment of auditors)	<b>Yes</b>
<b>Regional (here: EU)</b>	<b>Not directly but through the endorsement of international private regulation</b> (e.g.; ISAs)	<b>Some</b> (e.g. the Big Four)	<b>Yes</b> (e.g. Directive 2006/43/EC) - though no comprehensive harmonisation in EU	<b>Yes</b>
<b>International</b>	<b>Yes</b> (through ISAs by IAASB)	<b>Yes</b> (e.g. the Big Four)	<b>No</b>	<b>Yes</b> (political influence; World Bank and IMF members of IFAC's advisory committee)

**Table 1.3:** Private and state regulation of auditing at national, regional, and international levels

Table 3.3 summarises the political (or social) influence and regulatory powers of state regulators and private actors involved in auditing regulation. As Table 3.3 illustrates, state actors are more active in national-level regulation. Private actors in turn, are more active at the international level, in particular in terms of standard setting. Industry self-regulation may provide some benefits for participants in the industry who are willing to improve their own conduct. For instance, industry self-regulation might be able to identify weaknesses in a given industry where the state regulators may not have sufficient expertise and information on the subject matter. Nevertheless, unlike state regulators, private regulators might not always pursue public interest.<sup>159</sup> Industry self-regulators may have an incentive to favour one particular group when setting standards (i.e. a self-serving bias).<sup>160</sup> In addition, private regulators are likely to be motivated by gaining financial benefits.<sup>161</sup> Moreover, enforcement of private-initiated standards is weak. At this level, state regulators step up the regulatory process. For instance, the European Commission is engaged with the regulatory process through the endorsement of ISAs.<sup>162</sup> Moreover, the state may be involved in the international regulatory process through its political influence. These issues will be discussed further in the following.

### 3.2.1. IFAC and Its Standard Setting Bodies: the IASB and the IAASB

IFAC is an international private organisation that plays an active role in audit standard setting and governance of ethics and practice of auditors. IFAC is based in New York City and its board members include European countries (UK; France; Germany), Asian countries (India; Japan; China), and other important countries (US; Brazil).<sup>163</sup> The IFAC Council is responsible for the governance of IFAC and it involves representatives from each member country and the IFAC board.<sup>164</sup> The International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Board (IAASB) are the key standard setting bodies that operate

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<sup>159</sup> Baldwin and Cave argue that state regulators often pursue the best interests of the public when creating new regulations. See Baldwin and Cave (1999) (n 4) p. 9.

<sup>160</sup> Marco Becht, Patrick Bolton, and Ailsa Röell, 'Corporate Law and Governance' in A. M. Polinsky and S. Shavell (eds), *Handbooks of Law and Economics* (Volume 2, Elsevier 2007) p. 829.

<sup>161</sup> Michael Clarke, *Regulation: The Social Control of Business Between Law and Politics* (Macmillan, New York 1999) p. 49.

<sup>162</sup> For the discussion on ISAs, see Section 3.2.2 below.

<sup>163</sup> Turkey is also a member of IFAC and the relevant associations are the Expert Accountants' Association of Turkey and the Union of Chambers of Certified Public Accountants of Turkey (TÜRMOB).

<sup>164</sup> Facts about IFAC are available at <http://www.ifac.org/> accessed 27/11/2013.

under IFAC. Standards set by these private organisations are accepted and adopted globally.<sup>165</sup> As of November 2013, IFAC has 179 members and associations in 130 countries and jurisdictions.<sup>166</sup>

The members of these private organisations are mainly from Anglo-Saxon countries. This means that these international private organisations are dominated by the US and UK. IFAC's board is constituted of 22 members mainly from the Anglo-Saxon countries. Moreover, members are current and former practitioners in the accounting or auditing fields.<sup>167</sup> For instance, 16 board members are from auditing profession: as of November 2012, 7 members are former audit partners of the Big Four, 1 member is a partner of the world's fifth biggest accounting firm (BDO) and 2 members used to be partners of Arthur Andersen.<sup>168</sup>

The audit profession, in particular the largest audit firms (i.e. the Big Four), also has a great influence on these standard-setting bodies.<sup>169</sup> Their influence on audit regulation has become more apparent as they become important institutionalized global actors in financial markets.<sup>170</sup> Their powerful lobbies help them get involved in audit regulation or at least leave an impact on the process. For instance, the Big Four firms are widely represented in the auditing standard setter's board, in that the majority of the IAASB's board members are from the Big Four firms.<sup>171</sup> This domination is likely to create conflict between the profession and the regulators. The Big Four firms are commercialised institutions that seek to maximize their profits.<sup>172</sup> However, as said, private regulators of the audit profession have a public interest role. The public interest role of standard-setting bodies will be critically discussed next.

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<sup>165</sup> Although the US is a member of the IFAC, US GAAS is applied in the US. In 2012, the Auditing Standards Board of the US declared plans to harmonise GAAS with ISAs. See IFAC Member Body Compliance Program Basis of ISA Adoption by Jurisdiction, August 2012 p. 26.

<sup>166</sup> See IFAC's website <http://www.ifac.org/about-ifac/membership> accessed 25/11/2013.

<sup>167</sup> Dewing and Russell (n 2).

<sup>168</sup> See IFAC's website <http://www.ifac.org/about-ifac/structure-governance/board> accessed 25/11/2013.

<sup>169</sup> Tom Lee, 'The professionalization of accountancy: A history of protecting the public interest in a self-interested way' (1995) 8(4) *Accounting, Auditing and Accountability Journal* 48.

<sup>170</sup> Loft *et al* (n 3) p. 438.

<sup>171</sup> *Ibid.*

<sup>172</sup> Prem Sikka, 'Enterprise culture and accountancy firms: new masters of the universe' (2008) 21(2) *Accounting, Auditing and Accountability Journal* 268.

***The Public Interest Roles of the IFAC and Its Standards-Setting Bodies***

IFAC has maintained its goal to promote high-quality standards in accounting and auditing and to speak for issues in the public interest.<sup>173</sup> It should be discussed what kind of public interest is intended to be served by the IFAC and its boards, however. The public interest role of the audit profession can be understood as the profession's commitment to fulfil its responsibilities in a way that its actions, decisions and policies serve the best interest of the public in terms of the availability of transparent and reliable financial reports, and efficiency and economic certainty for markets.<sup>174</sup>

Each of the standard-setting bodies of IFAC has an advisory committee, named the Consultative Advisory Groups, and constituted of international organisations and trade associations, including the World Bank, IMF, Basel Committee on Banking Supervision (BCBS) and European Commission.<sup>175</sup> These institutions govern monetary and political policies globally. Their influence on the standard bodies of IFAC is inevitable. This might therefore create conflict between these institutions and IFAC's bodies. There is a potential risk that these organisations might use private actors and standard-setting bodies in pursuit of their political goals. For instance, in the EU, IFAC's international auditing standards (ISAs) do not apply automatically but have to be implemented by the European Commission.<sup>176</sup> Accordingly, the European Commission adopts standards by Commission Regulation, and standards become binding in all Member States. As argued, this endorsement mechanism is likely to create opportunities to influence standard-setting bodies.<sup>177</sup> For instance, Member States may object to some rules if said rules do not reflect the business conduct in their national environment.<sup>178</sup> Thus, the European Commission would have to negotiate with standard-setters or would have to carve out some provision in order to adapt the rules for all Member States. In fact, the EU has strong negotiation power with regards standard-setting bodies. For instance, the EU is highly represented in the boards of these private bodies: 6 out of 22 members

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<sup>173</sup> IFAC, 'Facts about IFAC' April 2011, New York.

<sup>174</sup> See IFAC, 'A Definition of the Public Interest' Policy Position 5, June 2012.

<sup>175</sup> Dewing and Russell (n 2) p. 12.

<sup>176</sup> Directive 2006/43/EC (n 54), Article 26.

<sup>177</sup> Andreas M. Fleckner, 'FASB and IASB: Dependence Despite Independence' (2008) 3 Virginia Law and Business Review 275.

<sup>178</sup> In 2003, France objected to the adoption of the accounting rule for derivatives (IAS 39), stating that this rule would have harmful effects on financial stability deriving from France's cultural differences in accounting. See *ibid* pp. 288-9.

represent the EU on the IFAC board, and 5 out of 10 members represent the EU on the IAASB board.<sup>179</sup> Therefore, the EU is likely to have an influence on IFAC's standard-setting bodies.

In 2005, the Public Interest Oversight Board (PIOB) was created by the International Federation of Accountants (IFAC). The PIOB is committed to the role of monitoring the IFAC and it aims to function in the best interest of the public and ensure they are not exploited by these institutions. The objective of the PIOB is determined as to produce high-quality auditing standards in the public interest.<sup>180</sup> The establishment of the PIOB and the involvement of advisory mechanisms from out of the profession were intended to eliminate any self-serving bias so that IFAC's standard-setting bodies would no longer serve the dominant players in the audit industry. In other words, the influence of the profession on standard-setting was intended to be eliminated via the PIOB's overseeing of the standard-setting process.

However, the current board structure of the PIOB does not seem to satisfy its public interest notion. The members of the PIOB are chosen by a monitoring group whose members are drawn from the same financial market regulatory organisations that also have representatives in the advisory groups of IFAC. These organisations are the Basel Committee on Banking Supervision (BCBS), the World Bank, the Financial Stability Forum, and the International Organizations of Securities Commission. These are the most influential "*likeminded*" organisations representing the financial market regulatory community.<sup>181</sup>

In principle, IFAC and its standard-setting bodies are independent. However, in practice, in addition to political influence, financial influence is also pervasive. IFAC's budget is funded by its member bodies,<sup>182</sup> mainly by the members of the Forum of Firms (FOF)<sup>183</sup>. Also, in 2011, PIOB received a grant of €286,000 from the

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<sup>179</sup> Ibid.

<sup>180</sup> See PIOB's website <http://www.ipiob.org/index.php/how-the-piob-operates> accessed 25/11/2013.

<sup>181</sup> Loft *et al* (n 3) p.435.

<sup>182</sup> The top 42 member bodies of the IFAC raised a \$1.7 million for IFAC's budget. See IFAC, Annual Report, 2011 p. 70.

<sup>183</sup> FOF is an organisation established under IFAC especially for accounting firms that perform transnational audit. Its founder members are BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC. Members of the FOF are obliged to make a financial contribution to the organisation. See Forum of Firms, Constitution, Article 5(b).

European Commission.<sup>184</sup> Private regulators' economic dependence on audit profession is also the case in the UK. Accountancy firms, namely the Big Four, have been active in the audit regulation field since the establishment of the Accounting Standards Board (ASB, formerly APC) in 1976.<sup>185</sup> Sikka argues that ASB is controlled by 'capital' (i.e. the Big Four) when explaining the economic influence of the major audit firms on the UK standard-setting body.<sup>186</sup>

In conclusion, it is questionable as to what extent private standard-setting bodies fulfil their public interest notion since there is a high influence of political and commercialised institutions on auditing standard setting. The next part will continue with a short history of the creation and adoption of international standards on auditing (ISAs).

### 3.2.2. International Standards on Auditing (ISAs)

IFAC has the aim of creating high-quality audit standards and promoting their global adoption.<sup>187</sup> As a private international regulator, the creation of the international standards on auditing (ISA) is a success for IFAC when considering its world-wide application.

The first international guidelines on auditing were issued by the International Auditing Practices Committee (the predecessor of the IAASB) in 1977.<sup>188</sup> Ultimately, in October 1992, ISA was accepted on capital markets as a reference for international auditing standards by the International Organization of Securities Commissions (IOSCO).<sup>189</sup>

From 2004 to 2008, ISAs were subject to a number of modifications, called as the 'Clarity Project', under the supervision of the IAASB.<sup>190</sup> This clarity project was carried out under the oversight of the PIOB and aimed to improve the clarity of the

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<sup>184</sup> IFAC Annual Report, 2011 p. 71.

<sup>185</sup> Sikka (2002) (n 1) p. 98.

<sup>186</sup> Ibid p. 104.

<sup>187</sup> See Section 3.2.1 above.

<sup>188</sup> In 2001, IAPC was reformed by IFAC and became the International Auditing and Assurance Standard Board (IAASB).

<sup>189</sup> Hanno Merkt, 'International Standards on Auditing and Their Adoption in the EU: legal aspects and unsettled questions' in Michael Tison *et al* (eds) *Perspectives in Company Law and Financial Regulation* (Cambridge University Press, 2009) p.246.

<sup>190</sup> For the chronological modification and final clarity project of ISAs, see Daries Schockaert and Nathalie Houyoux, 'International Standards on Auditing within the European Union' *Forum Financier/Revue Bancaire et Financière* 2007/8 515.

standards.<sup>191</sup> Although ISAs were redrafted in the favour of public interest<sup>192</sup>, it was claimed IFAC's public interest approach is encapsulated in oversight or supervision mechanisms (i.e. through the PIOB) rather than representation and participation in standard-setting activities.<sup>193</sup>

The IAASB completed the Clarity Project in March 2009. The final set of clarified standards consisted of 36 ISAs and International Standard on Quality Control (ISQC) 1.<sup>194</sup> Current ISAs are numbered per topic, from series 200 on the responsibility of the auditor until series 700 and 800 on reporting. Each clarified ISA is set by a uniform structure that consists of an objective, a requirements section, and finally the application material.<sup>195</sup> Accordingly, ISAs require that the independent auditor achieves the objectives that are specified under each ISA and exercises their own professional judgement alongside their professional scepticism.<sup>196</sup> Furthermore, the auditor would be expected to identify and assess risks that might derive from fraud or error and obtain adequate evidence in the case of any misstatements. The overall objective of the auditor is defined as concluding an opinion about whether the financial statements are free from misstatement and this opinion should be obtained in accordance with the auditor's findings.<sup>197</sup>

These requirements reflect the principle-based origins of ISAs, as the standards do not cover all issues and circumstances. Instead, they authorize the auditor to perform any necessary procedure in the light of their professional judgement.<sup>198</sup> However, auditors should place particular emphasis on obtaining sufficient evidence about the reliability of financial statements rather than performing procedures. In other words, the main objective of the auditors should be to present an opinion drawn from the audit evidence obtained, with all necessary steps taken for the sake of this objective.

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<sup>191</sup> IAASB Exposure Draft, Improving the Clarity of IAASB Standards, October 2005.

<sup>192</sup> Speech by Aulana L. Peters, 'The Value of Public Oversight of International Standard Setting For Audits' Gabarone, Botswana, 29 April 2011.

<sup>193</sup> Loft *et al* (n 3) p.430.

<sup>194</sup> The complete listing for ISAs and ISQC 1 see the IAASB website at <http://web.ifac.org/clarity-center/the-clarified-standards> accessed 26/11/2013.

<sup>195</sup> IAASB Exposure Draft (n 191)

<sup>196</sup> IFAC, Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, Edition Part I, New York April 2010 p.73.

<sup>197</sup> ISA 200, para. 11.

<sup>198</sup> Merkt (n 189) p.259.

According to IFAC's Compliance Programme,<sup>199</sup> as of August 2012, 126 jurisdictions around the world (including all 27<sup>200</sup> Member States of the EU) adopted ISAs.<sup>201</sup> The countries that did not adopt ISAs are mainly developing African (e.g. Angola, Chad, Congo, Ethiopia, Niger, Somalia, Sudan, and Suriname) and Arabic countries (e.g. Syria, Oman, Sudan, and Algeria). The only European countries to have not adopted ISAs are Macedonia and Liechtenstein.

32 countries, including the UK adopted ISAs without any modifications.<sup>202</sup> In these countries, there are no other national auditing standards, so they adopted ISAs without any modifications or any other additional requirements. In the UK, the Auditing Practices Board (APB)<sup>203</sup> has adopted the clarified ISAs as ISAs (UK and Ireland).<sup>204</sup> The UK issued revised ISAs in October 2009 and required their application to all audits of financial statements for periods ending on or after December 2010.<sup>205</sup> 29 countries, including France Germany, China, and India adopted ISAs with some national modifications. 11 countries, mostly including European countries, such as Bulgaria, Estonia, and Latvia, have required the application of ISAs by national law or regulation.<sup>206</sup>

The UK adopted ISAs without any national modifications, whereas other European countries, such as France and Germany, issued a number of additional requirements. The reason of this may be the Anglo-Saxon domination on IFAC and its auditing standard-setting bodies. It is known that the UK's auditing standard-setter body (ASB) was directly involved in redrafting ISAs in the Clarity Project. ASB's involvement in redrafting procedure was advantageous for the UK in terms of standards' suitability to the UK accounting system and business conduct. Thus, the UK's adoption of ISAs into its national law might have been easier than for other European countries'.

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<sup>199</sup> IFAC Compliance Program (n 165).

<sup>200</sup> Croatia joined the EU in July 2013 thus it was not included in IFAC's Compliance Program of 2012.

<sup>201</sup> At EU level, the implementation of ISAs is carried out by the European Commission through its endorsement mechanism. National lawmakers need to transform ISAs into national legislations and laws under the supervision of the European Commission. See also Chapter IV, Section 2.2.

<sup>202</sup> IFAC Compliance Program (n 165) p. 8.

<sup>203</sup> As of July 2012, the role of setting auditing standards is assigned to the Auditing and Assurance Council.

<sup>204</sup> Companies Act 2006, s. 504.

<sup>205</sup> APB Staff Paper, Summary of the Main Changes in the New ISAs (UK and Ireland), October 2009

<sup>206</sup> IFAC Compliance Program (n 165).

According to IFAC, 54 other countries are either in the process of the translation of ISAs, or have already declared the adoption of ISAs, but are still in the adoption process. For instance, the Greek Accounting and Auditing Oversight Board established an objective to adopt ISAs, yet they are currently in the process of translation.<sup>207</sup> Some jurisdictions indicated that their national standards are based on ISAs, as is the case in Turkey.<sup>208</sup> However, the degree of consistence of these standards with ISAs is not clear.<sup>209</sup> In other words, it is subjective as to what extent Turkey's national standards coincide with ISAs.

Overall, the adoption process of clarified ISAs is underway globally. It can be said that the adoption process of the revised ISAs has concluded with success to some degree. Although there have been some modifications and additional requirements involved, the adoption of the revised ISAs reached 126 jurisdictions worldwide, to serve the goal of the integration of markets and increase comparability.

Despite the problems regarding the adoption problems and selective adoption of ISAs which means some countries agreed to adopt only specific provisions,<sup>210</sup> there are overall some specific positive outcomes of these uniform auditing standards. To begin with, it is accepted that harmonised auditing standards across the EU ensures comparability and reduces the complexity of auditing as it makes application easier.<sup>211</sup> Also, complex cross border transactions are, in general, subject to the audits of large corporate clients and their affiliations. With harmonised auditing standards, mistakes previously derived from the complexity of cross-border auditing can be avoided.<sup>212</sup> Finally, it can be accepted uniform standards may encourage investors to go cross-border and hence, may stimulate the global economy.

### **3.3. Conclusion**

This section had the aim of answering the question of who regulates auditing. It has been shown that, in addition to state regulation, the profession is given a role in setting its own standards. State regulators are involved in audit regulation through

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<sup>207</sup> Ibid p. 14.

<sup>208</sup> For the adoption of ISAs by Turkey, see Chapter VI, Section 2.3.

<sup>209</sup> IFAC Compliance Program (n 165) p.19.

<sup>210</sup> For further discussion on the adoption of ISA in the EU, see Chapter IV, Section 2.2.

<sup>211</sup> Merkt (n 189) pp.261-2.

<sup>212</sup> Merkt advocates that this even would reduce the risk of civil and criminal liability for auditors. See *ibid*.

financial services law, competition law, and company law. The state is not directly involved in auditing standard-setting. The auditing standard-setting role is delegated to the profession itself. However, this is not a traditional form of self-regulation.

It has been shown that current audit regulations do not represent a traditional form of self-regulation. In appearance, audit regulation looks like professionally enforced self-regulation wherein the state allowed the profession to set its own standards. However, it is often a government body (e.g. FRC in the UK) that supervises the accounting profession. Moreover, private independent regulators (i.e. IFAC) have close links with inter-governmental actors that are active in financial markets era, such as the IMF, World Bank, and European Commission. These influential and powerful regulatory organisations undertake the role to ‘advise’ and ‘monitor’ the IFAC standard setting bodies. Thus, it is difficult to expect these standard-setting bodies to be independent of the political influence of states. It is likely that conflict between the regulatory approaches of different participants would appear because of the political pressures and lobbying activities of powerful actors<sup>213</sup> - be it dominant accountancy firms (e.g. the Big Four) or inter-governmental organisations (e.g. the IMF; the World Bank).

To conclude, industry self-regulation of auditing operates in the shadow of the state at two levels: First, states control the audit profession indirectly via national private supervisory authorities given statutory powers, such as FRC in the UK. Second, the public-interest role of IFAC and its standard-setting bodies is restricted via the political influence of advisory and monitoring groups. Moreover, IFAC’s public-interest notion is likely to be hindered due to its economic reliance on accountancy firms.

## **CONCLUSION**

This chapter has made a number of contributions to the literature. The first section theoretically explored the need for audit regulation and the motives and justifications for regulation. In this respect, it is submitted that audit regulation is needed, dealing with the expectations gap, the aftermath of audit failures, information asymmetries,

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<sup>213</sup> Moran (n 90) p. 400.

and the risk of competition distortion in the market. The second section sought to show the appropriate degree of audit regulation and contributed to the debate on rules *versus* principles. It is not suggested that one approach is *per se* preferable. Rules have the advantage of clarity. Yet, principles in audit regulation are often more effective in terms of maintaining a set of ethical standards and helping the audit profession in the development of their professional behaviour. The triadic structure of audit regulation was presented in the third section. It was shown that both private and state regulators have a role to play in audit regulation. In this respect, it was illustrated that state and private regulators influence audit regulation at national, regional (i.e. EU) and international level. Although the main role of the state appears in law-making, the state is also indirectly involved in the standard-setting process, through political and commercial benefit seeking. The contributions of this chapter help to explain the audit regulation better.

This chapter concludes as follows. The triad-structure of auditing makes auditing different from the traditional form of industry self-regulation. In principle, private regulators set standards for the profession; however, their powers are limited by the state through financial markets regulation (i.e. oversight by financial services authorities regarding the conduct of the audit profession and compliance with standards). State and private actors might have different motives and intentions regarding regulation. In addition, the dominant accountancy firms have a great influence on the private standard-setting bodies of IFAC. The political desires of the state regulators and the economic interests of ‘commercialised firms’<sup>214</sup> in standard-setting might hinder the primary role of IFAC, which is to serve the public interest.

IFAC and its standard-setting bodies have become important organisations in terms of private regulation of auditing as ISAs have been adopted globally. The EU has contributed to the global adoption of international auditing standards by recognising ISAs as the basis for audits across the EU.<sup>215</sup> The next chapter will explore EU audit policy under its long-standing single market objective and discuss laws on auditing, particularly the Audit Directive 2006/43/EC. The EU audit reform as a response to the global financial crisis will also be critically discussed in the next chapter.

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<sup>214</sup> See Sikka (2008) (n 172). See also Chapter II, Section 2.3.

<sup>215</sup> Directive 2006/43/EC (n 54), Article 26.

# **CHAPTER IV: A CRITICAL ANALYSIS OF EU AUDIT POLICY AND LAWS IN TERMS OF CONVERGENCE**

## **INTRODUCTION**

The previous chapter presented the forms of regulation and discussed how national, regional (i.e. the EU), and international actors are involved in the law making of auditing.<sup>1</sup> This chapter will focus on EU laws on auditing and identify its policy factors. Issues like the expectations gap, auditor independence, and concentration in the audit market have been already discussed.<sup>2</sup> This chapter will supplement previous chapters by providing a legal perspective and will critically discuss regulatory remedies for these issues.

The aim of this chapter is to question the regulatory responses of the EU to audit failures both in Enron and in the global financial crisis and how the regulatory approach of the European Commission will evolve for future law reforms. The analysis of this chapter contributes to existing literature by examining preliminary audit issues while discussing possible solutions within the context of the reform proposals in the EU.

This chapter starts by identifying the policy objectives of the EU in terms of audit regulation. The first section will submit that EU law on auditing has been determined by two concepts: the harmonisation of accounting and auditing rules under the single market objective, and dealing with audit failures after corporate scandals and financial crises. In this respect, the second section will provide a critical analysis of existing Audit Directive 2006/43/EC<sup>3</sup> and the reform proposals of the European Commission.<sup>4</sup> There are specific audit issues that have been subject to a number of

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<sup>1</sup> See Chapter III.

<sup>2</sup> See Chapter II.

<sup>3</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87.

<sup>4</sup> For EU proposals for a Directive amending the Directive 2006/43/EC and the Regulation proposal for statutory audits of the PIEs, see Section 2.3.

debates since Enron, such as the expectations gap, auditor independence, and the domination of large audit firms in the market. After the global financial crisis, these issues received attention from the EU regulators once again.<sup>5</sup> The third and final section of this chapter will closely examine regulatory proposals for these prevailing audit issues.

This chapter concludes with the following: the existing Directive 2006/43/EC has partly helped the long-standing single market objective of the EU. The current law proposals of the Commission aim to increase the level of harmonisation by forming a single market for auditing in the EU. However, there is still room for debate until the regulators have reached a conclusion.

## **1. THE DETERMINANTS OF EU AUDIT POLICY AND LAWS**

This chapter determines two aspects of EU audit policy and laws: internal and external perspectives. Internal perspective views that EU audit policy and laws are determined by the EU's long-standing single market objective. According to the external perspective, the effects of audit failures are the main determinants of EU audit policy and laws. This chapter suggests that the law on auditing in the EU has mainly been structured to date according to these two factors, which will be explained respectively.

### **1.1. Internal Perspective: the single market objective**

The audit policy of the EU has followed the form of integration of markets under the single market<sup>6</sup> aim, including the harmonisation of accounting and auditing rules. The harmonisation of accounting standards and increased transparency requirements are considered integral parts of the single market objective by the Commission.<sup>7</sup> In 1999, the European Commission published a Communication launching the Financial Services Action Plan (FSAP) that consists of a number of measures applied

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<sup>5</sup> European Commission Green Paper Audit Policy: Lessons from the Crisis Brussels, 13.10.2010 COM(2010) 561 final (Audit Green Paper).

<sup>6</sup> A single market ensures the removal of barriers in financial markets wherein the same service would be available throughout the EU and the legal environment is consistent. See The EU Financial Services Action Plan: A Guide Prepared by HM Treasury, FSA and the Bank of England, 31 July 2003.

<sup>7</sup> International Finance Corporation, The EU approach to Corporate Governance, Washington D.C. International Finance Corporation/Global Corporate Governance Forum, p. 3.

by 2005 serving the objective of achieving a single market across the EU.<sup>8</sup> As outcomes, a number of directives and regulations were enacted under FSAP measures, including the Fair Value Accounting Directive<sup>9</sup> and the Transparency Directive<sup>10</sup>. Following the Fair Value Accounting Directive, international accounting standards apply to all listed companies across the EU for each financial year starting on or after 1 January 2005.<sup>11</sup> The Transparency Directive provided enhanced minimum disclosure standards for European public companies, such as the requirement for audited annual financial statements.<sup>12</sup> Accordingly, listed companies must prepare their consolidated accounts in accordance with IFRS and have their accounts audited in accordance with the EU Statutory Audit Directive 2006/43/EC.<sup>13</sup>

FSAP had an important role in ensuring the integration of markets across the EU via harmonisation.<sup>14</sup> According to FSAP measures, the EU followed a strategy based on the adoption of uniform standards for an effective harmonisation.<sup>15</sup> Auditing harmonisation is carried out by post-FSAP directives under the Action Plan on Modernising Company Law<sup>16</sup> and the Statutory Audit Directive 2006/43/EC.<sup>17</sup>

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<sup>8</sup> Communication from the Commission of 11 May 1999 Implementing the framework for financial markets: Action Plan [COM(1999) 232 final - Not published in the Official Journal].

<sup>9</sup> Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions OJ L 283/28. Accounting directive has been revised in 2013. See Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC OJ L 182/19.

<sup>10</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013).

<sup>11</sup> Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. The application of standards is carried out by the Commission's endorsement mechanism.

<sup>12</sup> Directive 2004/109/EC (as amended) (n 10), Article 4.

<sup>13</sup> Ibid.

<sup>14</sup> FSAP measures were adopted with a 98% success rate by 2005. See European Commission, FSAP Evaluation Part I: Process and Implementation p. 3.

<sup>15</sup> Ian Dewing and Peter O. Russell, 'Financial Integration in the EU: the First Phase of EU Endorsement of International Accounting Standards' (2008) 46(2) *Journal of Common Market Studies* 243.

<sup>16</sup> Communication from the Commission to the Council and the European Parliament Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, Brussels, 21.05.2003 COM (2003) 284 final.

<sup>17</sup> See Section 2.1 below.

## 1.2. External Perspective: effects of corporate scandals and financial crises

Subsequent to the Enron scandal, SOX came into force in 2002 in the US.<sup>18</sup> The enactment of SOX had a direct effect on EU law in accounting and auditing.<sup>19</sup> This is because SOX brought restrictive regulations, such as the prohibition of non-audit services<sup>20</sup> and public oversight over profession<sup>21</sup> for not only the audits of US listed companies but also non-US companies and its auditors with a US market listing.<sup>22</sup> It means that SOX provisions also apply to foreign public accounting firms preparing an audit report for US companies and to foreign companies reporting under US securities law and their auditors.

Although SOX had some new provisions aimed at mitigating the effects of the Enron scandal, it was not without critics. As argued, SOX was an outcome of a “*partisan battle*” and therefore, its corporate governance provisions did not coincide with the reasons for Enron’s failure.<sup>23</sup> Romano emphasised that SOX provisions launched under political pressure while the current literature was unnoticed.<sup>24</sup> Moreover, it is claimed that negotiations that normally take place in such a regulation making process did not take place for SOX. Accounting committees were not involved in the negotiations because of the damaged reputation of the accounting profession.<sup>25</sup>

Despite the critics, the far-reaching effects of SOX and the Parmalat case in Europe forced the EU to revise laws in auditing even closer to the US’ SOX regime.<sup>26</sup> As a response to audit failures and SOX, the EU issued reforms under the Action Plan of 2003. It was aimed at creating a common European model for auditing and corporate governance. In this respect, two important Communications were issued: Reinforcing Statutory Audit in the EU<sup>27</sup> and Modernising Company Law and Enhancing

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<sup>18</sup> US Congress (2002) An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. The Sarbanes-Oxley Act (SOX), 107<sup>th</sup> Congress, H.R. 3763.

<sup>19</sup> Dewing and Russell (2008) (n 15).

<sup>20</sup> SOX (n 18), s. 201.

<sup>21</sup> Ibid, ss. 103-105.

<sup>22</sup> Ibid, s. 106.

<sup>23</sup> Roberta Romano, ‘The Sarbanes-Oxley Act and the Making of Quack Corporate Governance’ (2005) 114 The Yale Law Journal 1521.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid p.1528.

<sup>26</sup> For the EU responses to the audit failures, see Section 2.2 below.

<sup>27</sup> Communication from the Commission to the Council and the European Parliament Reinforcing the statutory audit in the EU Brussels, 21.05.2003 COM (2003) 286 final.

Corporate Governance.<sup>28</sup> In addition, the Statutory Audit Directive of 2006 (amending the 8<sup>th</sup> Company Law Directive) was considered an important legislative response enacted five years after the Enron scandal.<sup>29</sup>

As seen, the EU configured its laws on auditing in accordance with the effects of major corporate scandals. The global financial crisis of 2008 also urged the EU to reform its law on auditing.<sup>30</sup> The next section will examine EU audit policy and laws in light of internal and external perspectives, harmonising auditing under the single market objective and dealing with the aftermath of failures through reforming the law.

## **2. EU AUDIT POLICY AND LAWS IN THE LIGHT OF THE INTERNAL AND EXTERNAL PERSPECTIVES**

### **2.1. Harmonising Auditing**

There is a strong link between the harmonisation of accounting and auditing standards.<sup>31</sup> Hence, EU harmonisation in accounting and auditing should be considered jointly, as they are indispensable to the creation of a common market.<sup>32</sup> This section will provide an overview of accounting harmonisation, with a more detailed treatment of auditing harmonisation.

EU laws on accounting and auditing are based on company law directives. Accounting Directives of the EU are constituted of the Fourth<sup>33</sup> and Seventh<sup>34</sup> Company Law Directives. The Fourth Directive of 1978 for the first time required companies to have their annual accounts audited by one or more persons authorised by national law.<sup>35</sup> The Seventh Directive later extended the audit requirement to consolidated accounts. The Accounting Directives apply to all limited liability

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<sup>28</sup> See Communication from the Commission COM(2003) 284 final (n 16).

<sup>29</sup> Directive 2006/43/EC (n 3).

<sup>30</sup> For the regulatory responses to the global financial crisis of the EU, see Section 2.3 below.

<sup>31</sup> Peter Wong, 'Challenges and Success in Implementing International Standards: Achieving International Convergence to IFRSs and ISAs', September 2004.

<sup>32</sup> *Ibid.*

<sup>33</sup> Fourth Council Directive 78/660/EEC of 25 July 1978 based on the Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies OJ No L 222/11.

<sup>34</sup> Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54(3)(g) of the Treaty on consolidated accounts OJ No L 193/1.

<sup>35</sup> Directive 78/660/EEC (n 33), Article 51.1(a).

companies whether listed or not. These directives did not provide extensive coverage of all regulatory issues, but rather issued basic standards in accounting. As a consequence, the level of harmonisation in accounting was limited.

In 2002, the EU issued a Regulation<sup>36</sup> requiring all listed companies' financial statements to be prepared in accordance with International Accounting Standards (IAS)<sup>37</sup> by 2005. Before the adoption of uniform accounting rules, each EU Member State had its own accounting standards. The adoption of uniform standards was a significant step in terms of achieving the single market objective.<sup>38</sup>

In terms of auditing harmonisation in the EU, in 1984, the European Commission issued the Eighth Company Law Directive that addressed statutory audit for the first time, though only very briefly.<sup>39</sup> A more extensive process of harmonisation started with the Green Paper entitled 'The Role, Position, and the Liability of the Statutory Auditor in the EU' in 1996.<sup>40</sup> The Green Paper of 1996 questioned the need for a common European framework on the independence of the statutory auditor and the role of auditors in corporate governance. It was followed by the Commission's Communication entitled 'Statutory Audit in the EU: the way forward'.<sup>41</sup> It aspired to increase audit quality by improved cooperation between the accounting profession and Member States. This was followed by the Commission's Recommendation on quality assurance systems for statutory auditors in the EU.<sup>42</sup>

In 2002, following the Enron scandal – and the collapse of the one of the Big Five (as they were then) audit firms, Arthur Andersen - the Commission issued a Recommendation on statutory auditors' independence in the EU discussing various issues, including the provision of non-audit services, the rotation of key audit

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<sup>36</sup> See Regulation (EC) No 1606/2002 (n 11).

<sup>37</sup> The IASs were renamed by the IASB as International Financial Reporting Standards (IFRSs) in 2001.

<sup>38</sup> Dewing and Russell (2008) (n 15).

<sup>39</sup> Eight Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents OJ No L 126/10.

<sup>40</sup> European Commission Green Paper of 24 July 1996 The role, the position and the liability of the statutory auditor within the European Union COM(96) 338 OJ C 321/1.

<sup>41</sup> Communication from the Commission of May 1998 on the statutory audit in the European Union: the way forward, OJ 98/C143/03.

<sup>42</sup> Commission Recommendation of 15 November 2000 on quality assurance for statutory audit in the EU: minimum requirements 2001/256/EC OJ L 91/91.

partners, and the disclosure of audit and non-audit fees.<sup>43</sup> This Recommendation can be considered the very first phase in the regulatory responses of the Commission to the Enron scandal. In 2003, the Commission issued a Communication: 'Reinforcing the statutory audit in the European Union.'<sup>44</sup> Subsequently, the Company Law Action Plan and the Statutory Audit Action Plan were launched, providing a reform package to tackle the increased number of cross-border operations within European countries in the internal market, and the effects of corporate failures.<sup>45</sup>

The Company Law Action Plan and Statutory Audit Action Plan had the aim of tackling the effects of corporate and audit failures through a harmonised accounting and auditing framework in the EU.<sup>46</sup> In other words, the EU intended to restore investor confidence in capital markets through endorsing globally accepted and strengthened accounting and auditing standards on the grounds of contribution of integrated audit markets in the EU. It was aimed at maintaining confidence across the EU by strengthening shareholders' rights and protection of stakeholder groups.<sup>47</sup>

Consequently, the EU issued Statutory Audit Directive 2006/43/EC. The Directive 2006/43/EC broadened the scope of statutory audits in the EU and replaced the Eighth Directive of 1984, which dealt only with the qualification of statutory auditors. Moreover, as the most remarkable development in terms of harmonisation in auditing standards, it has brought the enforcement of the application of ISAs for all statutory audits to be conducted in the EU.<sup>48</sup> The next part will critically evaluate the Directive 2006/43/EC and its enforcement of the application of ISAs in the EU.

## **2.2. Statutory Audit Directive 2006/43/EC**

The EU Directive 2006/43/EC was part of the post-FSAP directives in terms of providing rules to ensure integration in financial markets across Europe. After the Enron scandal in the US and the other failures of the European companies, such as

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<sup>43</sup> Commission Recommendation of 16 May 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles 2002/590/EC OJ L 191/22.

<sup>44</sup> See Communication from the Commission COM(2003) 286 final (n 27).

<sup>45</sup> Thomas Clarke and Jean-Francois Chanlat, *European Corporate Governance Readings and Perspectives* (Routledge New York, 2009) p.31.

<sup>46</sup> Anita Anand and Niamh Moloney, 'Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives' (2004) 2 European Business Organization Law Review 223.

<sup>47</sup> Klaus J. Hopt, 'European Company Law and Corporate Governance: Where Does the Action Plan of the European Commission Lead?' European Corporate Governance Institute Law Working Paper No.52/2005, Brussels October 2005 p. 3.

<sup>48</sup> Directive 2006/43/EC (n 3), Article 26.

Parmalat (Italy), Ahold (Netherlands) and Nordisk Fjer (Denmark), the EU felt compelled to revise the Eighth Directive 84/253/EEC. All of these failures, including Enron, shared some important common features, such as corrupt accounting records, weak corporate governance structures, and auditors' failures in detecting fraud and, moreover, helping to hiding that fraud.<sup>49</sup>

As a response to these audit failures, the European Commission issued a new directive that replaced the Eighth Company Law Directive of 1984: Directive 2006/43/EC.<sup>50</sup> It was aimed at strengthening the statutory audit quality and enhancing auditor independence. Accordingly, the Directive 2006/43/EC included a comprehensive set of rules in terms of public oversight, supervision, and quality assurance systems, and allowed for regulatory cooperation between Member States and third countries whereas Directive 84/253/EEC has failed to provide it.<sup>51</sup> The influence of SOX can be seen on the provisions of Directive 2006/43/EC, especially the measures on registration, oversight and third country cooperation.<sup>52</sup> Directive 2006/43/EC was recognised as one of the most remarkable reforms regarding auditing harmonisation at that time.<sup>53</sup>

With regards binding force, EU directives have force of law in Member States. EU directives are considered legislative procedures in order to achieve a particular result. EU directives oblige each Member State to achieve the stated results, but leave national authorities to choose their methods in doing so. Moreover, the Commission has the right to complain to the European Court of Justice in case of any failure of implementation or wrong implementation of the directives by Member States.<sup>54</sup> Therefore, Member States had to transpose Directive 2006/43/EC into their own national law.

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<sup>49</sup> John C. Coffee, Jr., 'Understanding Enron: It's About the Gatekeepers, Stupid' (2002) 57 *The Business Lawyer* 1403; Guido Ferrarini and Paolo Giudici, 'Financial Scandals and the Role of Private Enforcement: the Parmalat Case' *European Corporate Governance Institute Law Working Paper No. 40/2005*, May 2005; Michael C. Knaap and Carol A. Knaap 'Europe's Enron: Royal Ahold, N.V.' (2007) 22(4) *Issues in Accounting Education* 641.

<sup>50</sup> Directive 2006/43/EC (n 3).

<sup>51</sup> *Ibid*, Recital 34.

<sup>52</sup> Dagmar Eberle and Dorothee Lauter, 'Private interests and the EU-US dispute on audit regulation: The role of the European accounting profession' (2011) 18(4) *Review of International Political Economy* 436.

<sup>53</sup> Ian P. Dewing and Peter O. Russell, 'Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Development Before and After Enron' (2004) 42(2) *Journal of Common Market Studies* 289.

<sup>54</sup> Treaty on the Functioning of the European Union (TFEU), Article 258 (ex Article 226 TEC).

### ***Transposition scores of the Member States***

According to the scoreboard on the transposition, most Member States missed the transposition deadline of 29.06.2008.<sup>55</sup> Member States' progressive adoption of the Directive 2006/43/EC was comparatively slow. For example, some Member States, including the Czech Republic and Ireland, had more than 31 non-transposed articles. These non-transposed articles were mostly on the establishment of a public oversight body. Only 12 out of 27 Member States fully completed the transposition by 2008.

According to the scoreboard published on February 2010, Member States had made further progress on the transposition, especially by making their public oversight systems operational.<sup>56</sup> The number of Member States who fully completed transposition was 25 by February 2010.<sup>57</sup> As of 1 September 2010, all Member States had completed the transposition of Statutory Audit Directive 2006. Yet, some Member States, including Cyprus, Lithuania, and Poland have not yet fully implemented the requirement to establish a public oversight body.<sup>58</sup>

### ***Objective of the Statutory Audit Directive 2006/43/EC***

In addition to the aim of harmonising statutory audits in the EU, the purpose of the Directive 2006/43/EC is to restore and strengthen investor confidence in the financial markets. In order to achieve this, the Directive dealt mainly with the following topics: auditor independence,<sup>59</sup> professional ethics,<sup>60</sup> ISA application,<sup>61</sup> external quality assurance requirements,<sup>62</sup> public oversight of the audit profession,<sup>63</sup> and improved cooperation between supervisory authorities in the EU.<sup>64</sup> More importantly, Directive 2006/43/EC deals with statutory audits of public-interest

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<sup>55</sup> Scoreboard on the transposition of the Directive on Statutory Audit Directive (2006/43/EC), Brussels 31 July 2008.

<sup>56</sup> Scoreboard on the transposition of the Directive on Statutory Audit Directive (2006/43/EC), Brussels 1 February 2010.

<sup>57</sup> The other Member States who remained slow on the transposition were Spain and Ireland. These countries' adoption process was uncompleted because of the non-transposed articles.

<sup>58</sup> See the Scoreboard on the transposition of the Directive 2006/43/EC (n 56).

<sup>59</sup> Directive 2006/43/EC (n 3), Article 22.

<sup>60</sup> Ibid, Article 21.

<sup>61</sup> Ibid, Article 26.

<sup>62</sup> Ibid, Article 29.

<sup>63</sup> Ibid, Article 32.

<sup>64</sup> Ibid, Article 33.

entities (PIEs)<sup>65</sup> in a separate section.<sup>66</sup> The reason for this is explained in that PIEs are economically more important and, therefore, laws for statutory audits of these entities should be stricter.<sup>67</sup> According to Directive 2006/43/EC, the statutory auditors or audit firm of PIEs shall publish a transparency report on their website covering the following: legal structure and ownership, a list of PIEs that they have carried out the statutory audit, and financial information regarding partners' remuneration.<sup>68</sup> It is also required that each PIE has an audit committee comprised of non-executive members of the administrative body.<sup>69</sup> Regarding the independence of statutory auditors or the audit firm of a PIE, it is required that key audit partner(s) rotate every seven years and that the statutory auditor or audit firm is obliged to confirm to the audit committee that their independence from the audited entity is secure.<sup>70</sup>

### ***The adoption of ISAs in the EU***

Directive 2006/43/EC requires all statutory audits to be conducted on the basis of ISAs.<sup>71</sup> Yet, it allows some flexibility for Member States to adopt and modify (carve-out) ISAs.<sup>72</sup> Accordingly, Member States may impose procedures and requirements in addition to ISAs if certain procedures and requirements have not been covered by adopted ISA.<sup>73</sup> If adopted standards contain audit procedures that could create a specific legal conflict with national law, Member States may carve-out the conflicting part of ISAs as long as the conflict exists.<sup>74</sup> Member States are allowed to impose procedures and requirements in addition to ISAs or carve-out some parts from the adopted ISA but only (i) if these procedures and requirements comply with a high level of credibility and quality of the true and fair view of the annual and consolidated accounts and with the European public good, and (ii) these procedures

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<sup>65</sup> PIEs includes listed entities, credit institutions, insurance undertakings and other entities which are of significant public interest because of their business, their size, their number of employees or their corporate status is such that they have a wide range of stakeholders. See *ibid*, Article 2(13).

<sup>66</sup> *Ibid*, Chapter V.

<sup>67</sup> *Ibid*, Recital 23.

<sup>68</sup> *Ibid*, Article 40.

<sup>69</sup> *Ibid*, Article 41.

<sup>70</sup> *Ibid*, Article 42.

<sup>71</sup> *Ibid*, Recital 13.

<sup>72</sup> *Ibid*.

<sup>73</sup> *Ibid*.

<sup>74</sup> *Ibid*.

and requirements are communicated to the European Commission and Member States before their adoption.<sup>75</sup>

ISAs are transformed into national laws of Member States through the endorsement mechanism of the European Commission.<sup>76</sup> In this respect, Directive 2006/43/EC grants implementing powers to the European Commission.<sup>77</sup> The Commission is responsible for ensuring that i) ISAs have been developed with proper due process, public oversight and transparency, and are generally accepted internationally, ii) they contribute to a high level of credibility and quality of the true and fair view of the annual and consolidated accounts, iii) they are conducive to the European public good.<sup>78</sup> So far, the Commission has not taken any steps regarding the implementation of ISAs under its implementation powers. Therefore, most Member States apply national auditing standards ‘based on’ ISAs. It means that national standards and ISAs are not identical, but do share fundamental principles. According to one study, 11 out of 30 countries imposed one or more significant additional requirements to ISAs, such as additional exception reporting requirements.<sup>79</sup>

The problems regarding the adoption of ISAs in the EU are derived from the regulatory structure of the standards and their adoption method. The regulatory structure of ISAs is problematic because they are principle-based<sup>80</sup> and are not drafted as legislation, but will become part of a legal system through adoption.<sup>81</sup> In other words, switching from voluntary standards to mandatory regulation is not consistent with ISAs’ content and style because ISAs do not cover a wide range of issues as regulations. Member States first have to translate standards into their national language and then integrate them into national law. Furthermore, it should be taken into account that changes in international standards would require reform of related legislation. Therefore, national law has to be revised every time international

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<sup>75</sup> Ibid, Article 26(3).

<sup>76</sup> Ibid, Article 26(2).

<sup>77</sup> Ibid.

<sup>78</sup> Ibid

<sup>79</sup> See Wong (n 31) p.8. See also Chapter III, Section 3.2.2 for the selective adoption of ISAs.

<sup>80</sup> ISA are categorized as principle-based standards. See Chapter III, Section 2.2.

<sup>81</sup> Hanno Merkt, ‘International Standards on Auditing and Their Adoption in the EU: legal aspects and unsettled questions’ in Michael Tison *et al* (eds) *Perspectives in Company Law and Financial Regulation* (Cambridge University Press, 2009) p. 257.

standards are revised. As a consequence, it is suggested that transforming ISAs to national legislation may impose upon countries a significant compliance cost.<sup>82</sup>

The adoption of ISAs in the EU is also problematic due to bureaucratic burdens in the endorsement mechanism of the European Commission. In addition, Member States who vary legislatively and culturally may find it difficult to adopt a certain type of standards. For instance, the UK adopted ISAs without any modifications, whereas France and Germany adopted ISAs with some national modifications.<sup>83</sup> Because the UK auditing standards board (APB) was involved in redrafting ISAs, this may have helped the UK adopt ISAs without modifications. However, other countries, especially continental European countries, may find it difficult to adopt ISAs into their national law due to differences in business and accounting systems. When taking into consideration these issues, the Directive's flexibility in terms of allowing Member States to include add-ons and carve-outs has its merits. However, although the adoption of ISAs has resulted in some level of comparability, additional national requirements into ISAs are likely to increase existing differences and might impair the harmonisation of audit standards in the EU.

#### ***A critical evaluation of the Statutory Audit Directive 2006/43/EC***

Like the US SOX, EU Directive 2006/43/EC is also a regulatory response to audit failures and corporate scandals that occurred both in the US and in Europe. Similar to SOX, Directive 2006/43/EC aimed to strengthen control mechanisms over statutory audits through public oversight supervision,<sup>84</sup> and to increase auditor independence by prohibiting any direct or indirect financial relationship between the auditor and the audited company.<sup>85</sup>

In order to increase auditor independence, the Directive introduced a maximum 7-year audit engagement for key audit partners.<sup>86</sup> In addition, the provision of non-audit services to the audit client was restricted to some degree.<sup>87</sup> However, the Directive does not provide a clear rule regarding the provision of non-audit services

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<sup>82</sup> Ibid.

<sup>83</sup> See IFAC Member Body Compliance Program Basis of ISA Adoption by Jurisdiction, August 2012. See also Chapter III, Section 3.2.2.

<sup>84</sup> Directive 2006/43/EC (n 3), Article 32(2).

<sup>85</sup> Ibid, Article 22(2).

<sup>86</sup> Ibid, Article 42(2).

<sup>87</sup> Ibid, Article 22(2).

but leaves this to the discretion of Member States. Thus, Article 22 of the Directive has been interpreted differently by Member States.<sup>88</sup> The public oversight and independence requirements may enhance audit quality and increase control over the audit process. However, these requirements come with costs. For instance, the establishment of a public oversight body and the continuing education of statutory auditors would be costly to Member States.

Directive 2006/43/EC was an outcome of the EU's post-FSAP regulations.<sup>89</sup> It intended to provide full harmonisation of corporate audits in Europe and serve the EU's single market objective. Nevertheless, the level of convergence in terms of statutory audits across the EU has been limited because Directive 2006/43/EC affords Member States discretion with regards some specific issues (i.e. auditor independence requirements; the adoption of ISAs).<sup>90</sup> In addition, Directive 2006/43/EC grants Member States discretionary powers in terms of training, education, and approval of statutory auditors, since the competent authorities of the Member States will be responsible on these issues.<sup>91</sup> As a result, the level of harmonisation reached by the adoption of Directive 2006/43/EC is questionable.

To conclude, although Directive 2006/43/EC was a late response to audit failures that started with Enron, it was essential in setting the grounds for the adoption of international auditing standards, quality assurance systems, and oversight mechanisms over statutory auditors and audit firms in the EU. However, the impact of Directive 2006/43/EC on the national laws of Member States has stayed limited in terms of establishing uniform laws and practices for statutory audits.

The global financial crisis occurred at the time Directive 2006/43/EC was in the implementation process. The debate on the role of external auditing (and auditors) has been sparked by audit failures during the crisis.<sup>92</sup> Directive 2006/43/EC was ineffective in responding to the issues raised by the crisis. Hence, it was judged

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<sup>88</sup> For a critic, see Section 3.2 below.

<sup>89</sup> See section 2.1 above.

<sup>90</sup> ESCP Europe, 'Study on the effects of the implementation of the *acquis* on statutory audits of annual and consolidated accounts including the consequences on the audit market' Final Report by Joëlle Le Vourc'h and Pascal Morand Paris, 9 November 2011 (Study by ESCP Europe). See also Section 3 for a detailed discussion.

<sup>91</sup> The establishment of a European passport for statutory auditors and audit firms carrying out statutory audits of PIEs is in the discussion. See Section 3.

<sup>92</sup> For the role of auditors in the financial crisis, see Chapter II, Section 3.

necessary to re-regulate external auditing to reassure market confidence. The EU's regulatory responses to the global financial crisis will be addressed next.

### 2.3. Regulatory Responses to the Global Financial Crisis in terms of Auditing

The global effects of the 2008 financial crisis showed that there was a need for a common international policy to deal with the international regulation of financial markets and this should be done by way of supranational co-ordination. In this regard, there were a number of meetings held by the group of twenty (G-20), in addition to the finance ministers and Central Bank Governors of EU member countries.<sup>93</sup> In these meetings, the aim was to deal effectively with the financial crisis by strengthening international co-operation. Accordingly, policy co-ordination among G-20 members has been improved while the scope of financial regulation and supervision has been strengthened.<sup>94</sup> At the G-20 summit of 2009, the European Commission highlighted the need for global financial regulatory system with *“improved transparency and accountability alongside with enhanced regulation and supervision”*.<sup>95</sup>

At the EU level, the European Commission issued a number of communications immediately as a response to the crisis.<sup>96</sup> Strengthening investor confidence, improving risk management in financial firms, and increasing protection against market misconduct through improved supervisory mechanism were the focus of these responses.<sup>97</sup>

It is argued that the failure of auditors during the global financial crisis has damaged the reliability of financial statements and statutory auditors.<sup>98</sup> In the same manner, the Commission stated that bank auditors failed to alert supervisors as to the situation

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<sup>93</sup> These meetings were held in Washington, London and Pittsburgh in 2009 and in Toronto and Seoul in 2010.

<sup>94</sup> G-20 website available at [http://www.g20.org/about\\_what\\_is\\_g20.aspx#top](http://www.g20.org/about_what_is_g20.aspx#top) accessed 19/06/2013

<sup>95</sup> G20 Summit on April 2, 2009.

<sup>96</sup> Communication from the Commission, From financial crisis to recovery: A European framework for action, Brussels, 29.10.2008 COM(2008) 706 final; Communication from the Commission to the European Council A European Economic Recovery Plan Brussels, 26.11.2008 COM(2008) 800 final; Communication for the Spring European Council Driving European recovery Volume1 Brussels, 04.03.2009 COM(2009) 114 final.

<sup>97</sup> See Communication COM(2009) 114 final (n 96) p.5.

<sup>98</sup> See Prem Sikka, 'Financial Crisis and the Silence of Auditors' (2009) 34 Accounting, Organizations and Society 868. See also Chapter II, Section 4.2.

of the banks before they collapsed.<sup>99</sup> Correspondingly, in October 2010, the Commission issued a Green Paper entitled ‘Audit Policy: Lessons from the Crisis’ that emphasised the role of the auditors in financial markets and their relation to the financial crisis.<sup>100</sup> Following the Audit Green Paper, in November 2011, the European Commission issued two law proposals: a Directive to enhance the single market for statutory audits<sup>101</sup> (amending existing Directive 2006/43/EC) and a Regulation to increase the quality of audits of financial statements of PIEs.<sup>102</sup> These reform proposals highlight the need for a single market for auditing in the EU that encompasses the EU’s long-standing single market objective in general.

### ***Reforming the Audit: Overview of the Proposal for a Directive amending directive 2006/43/EC and Proposal for a Regulation of the Audit of PIEs***

The Audit Green Paper was issued by the European Commission, in order to assess the aftermath of the global financial crisis and to reassure market stabilisation.<sup>103</sup> The Commission’s Green Paper received a significant number of responses (almost 700) from a wide range of stakeholders after consultation between 13 October to 8 December 2010.<sup>104</sup> Having such wide-range of responses may suggest it was the right time for the EU to issue the Audit Green Paper since, overall, responses were in favour of a change the *status quo* in the EU audit market.<sup>105</sup>

The main concerns issued in the Audit Green Paper can be summarised as follows: the expectations gap related to the role of the auditor, the governance and

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<sup>99</sup> Commission Staff Working Document, Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices Accompanying document to the Green Paper Corporate governance in financial institutions and remuneration policies [COM(2010) 284 final] Brussels, 02.06.2010 SEC(2010) 669, para. 6.1.1.

<sup>100</sup> Audit Green Paper (n 5).

<sup>101</sup> European Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts Brussels, 30.11.2011 COM(2011) 778 final (Draft Directive).

<sup>102</sup> European Commission Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities Brussels, 30.11.2011 COM(2011) 779 final (Draft Regulation).

<sup>103</sup> Green Papers are formally described as documents issued by the European Commission in order to prompt discussion on a specific topic and then they may be lead to legislative developments. See European Commission website [http://europa.eu/legislation\\_summaries/glossary/green\\_paper\\_en.htm](http://europa.eu/legislation_summaries/glossary/green_paper_en.htm) accessed 04/12/2013.

<sup>104</sup> Summary of Responses Green Paper Audit Policy: Lessons from the Crisis, Brussels, 4 February 2011 (Responses to Audit Green Paper).

<sup>105</sup> There were also strong objections from the audit profession, especially the Big Four, to the radical changes proposed by the Audit Green Paper, such as the mandatory rotation of audit firms. Yet, a significant number of stakeholders support the establishment of a European passport for auditors including the EU-wide supervision of audit oversight. See *ibid*.

independence of auditors, market concentration and lack of choice, a lack of effective national and EU-wide supervision over auditors, and the need for a simplified audit standards for the SMEs.<sup>106</sup> With respect of these findings, the Commission issued a Working Document Impact Assessment to analyse problems in the audit market and the potential impact of the intended measures.<sup>107</sup> It was highlighted in the Commission's Impact Assessment that the combination of these problems impaired trust in the quality of the audit opinion.<sup>108</sup> It also revealed that neither audit practices nor auditor oversight were sufficiently harmonised in the EU, even after the adoption of Directive 2006/43/EC. Member States have discretionary powers, limited to ISAs framework, concerning the qualifications and supervisory arrangements for statutory auditors. The EU audit market is diverse where differences exist in legislative and regulatory frameworks (i.e. the thresholds for statutory audit exemption, auditors' liability and audit standard setting vary significantly) and the qualification of auditors (i.e. education and professional training of auditors).<sup>109</sup> This fragmented national regulation in the Member States entails significant compliance costs.<sup>110</sup> Furthermore, the current legal framework does not address concentration in the audit market. In light of all of these problems, a regulatory change was judged necessary in order to address all of these issues under a single market for audit services to also be in line with the Europe 2020 Strategy.<sup>111</sup>

As a result, in November 2011, the European Commission issued the proposal for a statutory audit Directive in Europe.<sup>112</sup> PIEs often involve cross-border activities across the EU. Audit practices and regulation in Member States, however, are not homogenous, but have different auditing standards and different approval/registration

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<sup>106</sup> The EU has recently proposed the adoption of auditing standards to the size of the audited entity. This proposal would allow Member States to provide simplified auditing standards for SMEs. See Draft Directive (n 101), Articles 43(a), 43(b).

<sup>107</sup> The Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities [COM (2011) 778 COM (2011) 779 SEC (2011) 1385] SEC(2011) 1384 (Commission's Impact Assessment).

<sup>108</sup> Ibid p. 9.

<sup>109</sup> Study by ESCP Europe (n 90).

<sup>110</sup> The costs are derived from the requirements for auditors to be approved in all Member States in which they want to carry out statutory audits. Member States may require passing an aptitude test for approval. See Directive 2006/43/EC (n 3), Article 14.

<sup>111</sup> Communication from the Commission Europe 2020 A Strategy for smart, sustainable and inclusive growth Brussels 03.03.2010 COM(2010) 2020 final.

<sup>112</sup> Draft Directive (n 101).

rules for auditors and audit firms. This situation creates a high administrative burden on the audit of PIEs. Therefore, regarding the audit of PIEs, a separate legal requirement was suggested.<sup>113</sup> In this respect, on the same date as the directive proposal in November 2011, the European Commission issued a proposal for the Regulation of statutory audits of PIEs.<sup>114</sup> Although the general requirements for a statutory audit of PIEs (i.e. the requirements for the registration/approval of auditors) dealt with existing Directive 2006/43/EC,<sup>115</sup> the specific additional requirements regarding the conduct of statutory audits of PIEs were set by this Regulation. To be sure, the enactment of a separate detailed Regulation of the audit of PIEs will increase the regulatory burden. However, since regulations become binding as soon as they are passed,<sup>116</sup> regarding this Regulation, the audit of PIEs will be carried out with the same rules applicable in all Member States at the same time. While the proposal for Regulation concerns in particular the audit of PIEs, the scope of the statutory audit directive remains a general one. Hence, the revised Directive and forthcoming Regulation must be read together.

The financial stability of banks and other PIEs (e.g. listed companies) is particularly important for public confidence in the markets. The role of auditing is to enable trust in markets by verifying the accuracy of the financial statements. Hence, for the sake of market confidence and stability, the audits of PIEs have a special importance. For this reason, as the global financial crisis highlighted, the main issues in the audit market of the PIEs have to be addressed. The prevailing issues in the audit market are as follows: the expectations gap regarding the role of statutory auditors, conflict of interest driven by the relationship between the auditor and audited entity (namely auditor independence), the high concentration and limited choice in the audit market, and the lack of EU-wide effective supervision over auditors. These issues will be critically discussed respectively, in line with the European Commission's law proposals.

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<sup>113</sup> Commission's Impact Assessment (n 107) p. 9

<sup>114</sup> Draft Regulation (n 102).

<sup>115</sup> Directive 2006/43/EC (n 3), Articles 39-44. Articles 39 to 44 and 22 (2) will be deleted to be integrated to the Regulation on specific requirements for the statutory audits of PIEs.

<sup>116</sup> Regulations are different from directives. Member States do not have to implement the rules of regulations as they do for directives. Regulations become binding for all Member States as they are passed.

### **3. CRITICAL DISCUSSION OF THE PREVAILING PROBLEMS IN THE EU AUDIT MARKET**

The prevailing problems in the audit market, such as the expectations gap, auditor independence, and high concentration, have long been a subject of debate since Enron and have received significant attention since the global financial crisis of 2008. These issues were explained in the previous chapters.<sup>117</sup> This section primarily concerns itself with possible regulatory remedies for those issues. In addition to those three, the need for EU-wide supervision over the audit profession will be added to the discussion. Legal analysis of those issues will include the recent law proposals of the Commission.<sup>118</sup> The aim of this section is to discuss the Commission's law proposals and to provide some suggestions as to the best regulatory suggestions for these issues.

#### **3.1. Filling the Expectations Gap**

The collapse of major financial institutions caused a global financial crisis, and also resulted in a crisis in auditing. The role of auditors in the crisis has been one of the big debates since the crisis first occurred in 2008.<sup>119</sup>

It is felt that external auditing adds credibility to financial statements by providing an objective assurance that financial statements are fairly represented.<sup>120</sup> Furthermore, external auditing is an important tool in ensuring trust in financial markets.<sup>121</sup> Nevertheless, it is argued that external auditors (namely the largest audit firms) failed to ensure the trust in financial markets since they failed to assure the market through clean audit opinions.<sup>122</sup> For example, major financial institutions filed for bankruptcy after they received clean audit opinions by their auditors. It is argued that the financial crisis showed that the safety of markets was not assured by clean audit

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<sup>117</sup> See Chapter II, Section 2.

<sup>118</sup> See Draft Directive (n 101) and Draft Regulation (n 102).

<sup>119</sup> For the role of auditors in the global financial crisis, see Chapter II, Section 3.

<sup>120</sup> See OECD Principles of Corporate Governance 1999 (revised in 2004), Chapter V. See also Chapter I.

<sup>121</sup> See Chapter I, Section 2.3.

<sup>122</sup> See Sikka (n 98). See also Chapter II, Section 3.3.

reports, and therefore the credibility afforded to the financial statements of external auditors is questionable.<sup>123</sup>

Nevertheless, concluding in such strong terms raises doubts. It is true that a number of audit failures (mostly related to the going concern opinion) occurred during the financial crisis.<sup>124</sup> However, this does not suggest that external auditing does not add credibility to financial statements. Such cases tend to occur more in the time of crisis due to uncertainties in the market.<sup>125</sup> These cases can be considered as audit failures - but this fact does not suggest that the credibility of financial statements can no longer be assured by external auditors.

It is true that the quality of audits is questioned by investors in financial markets because auditors failed to detect and report the misstatements in financial statements and give warning to the market about financially distressed institutions. However, it should also be taken into account that the financial markets did not fail because of failed audits *per se*. Similarly, neither trust nor confidence was lost only because of misreported financial statements or not issuing going concern opinions. There is a wrong assumption amongst users of audited financial statements that a clean audit opinion means that an audited firm will not fail in the near future.<sup>126</sup> It is possible that major financial institutions that collapsed during the crisis could have failed even if there were no misstatements and fraud in the financial statements. These perceptive (or dogmatic) problems derive mainly from the expectations gap: a lack of awareness amongst the users of the audited financial statements regarding the scope of external audits.<sup>127</sup>

There are two possible solutions to narrow the audit expectations gap.<sup>128</sup> The first is to improve audit reports to provide more information to the public. The second is to improve communication between auditors (or audit committees) and company managers. These two remedies will be discussed respectively.

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<sup>123</sup> Sikka (n 98) p. 871.

<sup>124</sup> See Chapter II, Section 3.3.

<sup>125</sup> See *ibid*.

<sup>126</sup> For auditors' going concern judgment, see Chapter II, Section 3.1.

<sup>127</sup> For the ill-defined role of auditors and expectations gap, see also Chapter II, Section 2.1.

<sup>128</sup> Commission's Impact Assessment (n 107) p. 10.

### ***Improved audit reports***

Previously, shareholders were considered to be the main target group of audit reports. In other words, an audit report was supposed to fulfil shareholders' needs only.<sup>129</sup> Since capital markets have become more interdependent, audit reports have been subject to wider interest groups, in addition to shareholders.<sup>130</sup> Hence, it is necessary that audit reports should be enhanced and the complexity of these reports should be reduced for the effective use of these reports by a wider range of stakeholders.

It has long been the subject of a number of discussions as to what sort of information auditors should be providing to stakeholders.<sup>131</sup> It is highlighted that users cannot find what they are looking for in auditor reports since the most common audit opinion is a “*template*”,<sup>132</sup> providing a standard content. Similarly, it is quoted in the House of Lords Report that “...*audit reports... are very, very standardised in their context (...)*”.<sup>133</sup>

A recent study showed that auditors' reports should include more specific information about the audit process itself (i.e. how materiality test is determined, an outline of the risk factors underlined within the audit, and time spent on audit by auditors) and matters related to the audited financial statements (i.e. any areas of weakness found in the audit and any disagreement with management regarding material misstatements).<sup>134</sup> The same study also revealed that auditors' reports need to contain additional information that normally was not included. For example, users of audit reports would like to see additional information about the audit materiality and any relationship that might impair auditor independence, e.g. the consecutive years of the auditors' engagement with the audited company.<sup>135</sup> Similarly, another study found that more specific information was needed in the auditors' report about

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<sup>129</sup> Mohammed B. Hemraj, 'How to restore confidence in auditing and prevent corporate scandals' (2005) 26(8) *Company Lawyer* 235.

<sup>130</sup> For the expanded role of auditors, see Chapter II, Section 1.2.

<sup>131</sup> For a brief history of the last 100 years of the expectations gap, see Christopher Humphrey, Peter Moizer, and Stuart Turley, 'The Audit Expectations Gap-Plus Ca Change, Plus C'est La Meme Chose?' (1992) 3 *Critical Perspective on Accounting* 136.

<sup>132</sup> Commission's Impact Assessment (n 107) p. 13.

<sup>133</sup> House of Lords, Auditors: Market Concentration and Their Role House of Lords Select Committee on Economic Affairs, Volume: I Report, 30 March 2011 (House of Lords Report) p. 39.

<sup>134</sup> Chartered Financial Analyst (CFA) Institute, Independent Auditor's Report Survey Results, March 2010 p. 11.

<sup>135</sup> *Ibid* p. 20.

how auditors reached their opinion on whether a company has fairly presented its financial statements in accordance with the related reporting standards.<sup>136</sup> To conclude, it was found necessary to include more information in the audit reports for stakeholders and for the public in general.

In line with the suggestions of the above studies, the European Commission aims to reduce the audit expectations gap by improving audit reports. It has proposed to expand audit reports to provide more information to stakeholders and to the public.<sup>137</sup> The Regulation proposal of the Commission suggests a number of provisions on what needs to be included in the audit report, in particular the following: the audit reports shall indicate that the statutory audit was conducted in accordance with ISA, identify key areas of risk of material misstatement in the financial statements, provide a statement on the situation of the entity especially on assessment of the entity's ability to continue as a going concern, explain to what extent the statutory audit was designed to detect irregularities (i.e. the fraud), declare the prohibited non-audit provisions were not provided, and that the statutory auditor(s) or the audit firm(s) remained completely independent.<sup>138</sup>

Expanding audit reports that include more information may indeed be helpful to the users of the audit reports in understanding the work of the auditor and the business of the audited entity. Hence, the expectations gap is likely to be reduced by the expanded content of public audit reports. Nevertheless, the long list of additional information to be included in audit reports (almost 30 provisions with seven clauses as indicated in the Draft Regulation) may give rise to unintended costs for auditors and audit firms.

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<sup>136</sup> CFA Institute, *Usefulness of the Independent Auditor's Report Survey to the CFA Institute Financial Reporting Survey Pool*, March 2011 p. 2. See also the Study by MARC, 'The Value of Audit' Research project commissioned by the Standards Working Group/Global Public Policy Committee, 1 March 2010. This study specified an expectations gap between the auditors and the audit committees where they found that the audit committees expect auditors to evaluate the reliability of the internal control system whereas ISAs do not place such duty on auditors.

<sup>137</sup> Draft Regulation (n 102), Article 22.

<sup>138</sup> *Ibid*, Article 22(f), (k), (l), (n), and (q).

### ***Improved communication***

In the EU, existing regulations on financial market instruments<sup>139</sup> and banking<sup>140</sup> already require auditors of financial institutions to report to the relevant authorities.<sup>141</sup> The Commission has proposed that not only the auditors of financial institutions, but also other auditors of PIEs, should be obliged to report to the supervisory authorities in case of any material breach of laws, any decision that might affect the ability of the company to continue as a going concern, or any other situation that lead to refusal to certify the financial statements.<sup>142</sup> Such dialogue could be useful for the regulatory authorities to identify risks in advance and enable them to take appropriate action before serious risks spread to the markets.<sup>143</sup>

In addition to the audit report as an output of the audit, the Commission has proposed that the auditors of PIEs should provide a separate report to the audit committee,<sup>144</sup> stating that this report should be longer and should include more details.<sup>145</sup> Accordingly, the information in this report should include explicit and detailed results of the conducted audit, such as explanations as to the auditor's judgement on the going concern opinion and the appropriateness of the consultancy services.<sup>146</sup> Producing such a report to the audit committee is likely to enable a communication between the statutory auditors and the audit committee. However, it can also be considered that the current audit committee frameworks are not the best structure for such an effective communication.<sup>147</sup>

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<sup>139</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145/1, Article 55.

<sup>140</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 on the taking up and pursuit of the business of credit institutions OJ L 177, Article 53.

<sup>141</sup> However, in 2006, before the bailouts of Northern Rock and HBoS, there were no meeting, between the FSA and the external auditors; PwC (Northern Rock) and KPMG (HBoS). In 2007, there was only one, and in 2008, there were 2 meetings between the external auditors and the FSA. See House of Lords Report (n 133) p. 45.

<sup>142</sup> Draft Regulation (n 102), Article 25.

<sup>143</sup> A study revealed that chief financial officers, audit committee members, and financial analysts find useful the communication with the auditor during and after the audit. See Study by MARC (n 136) p. 12.

<sup>144</sup> This report can be submitted to another body that has equivalent functions in the absence of an audit committee. See Draft Regulation (n 102), Article 23.

<sup>145</sup> Ibid.

<sup>146</sup> Ibid, Article 23(f), (g).

<sup>147</sup> For suggestions to improve the audit committees, see Section 3.2 below.

### 3.2. Reinforcing Auditor Independence

In order to ensure trust in financial markets, audited financial statements should be reliable. Auditor independence is one of the key elements reflecting the reliability of financial statements. An auditor's ability to reflect his (or her) professional judgement freely on the audit report is also necessary for audit quality. However, some auditors might be involved in certain situations where independence is impaired due to a conflict of interest. The provision of certain types of consultancy services, auditors' dependency upon company management over audit fees, and the long auditor engagement periods (threat of familiarity) could impair auditor independence.<sup>148</sup> There are some possible remedies that can be suggested in order to avoid this, and ultimately reinforce auditor independence, such as strengthened audit committees, the prohibition of provision of specific non-audit services, and reducing the threat of familiarity. These regulatory remedy proposals will be discussed respectively.

#### *Strengthened audit committees*

Performing an audit with professional scepticism can be challenging for auditors who are dependent upon company management for audit and non-audit fees.<sup>149</sup> In such cases, the audit client may have influence on the auditor's professional judgement by threatening their dismissal.

A number of remedies are suggested in order to eliminate the influence of the company management on auditor independence. For example, it is suggested that the appointment of auditors should be carried out by a third party, such as a regulator or a supervisory body, rather than the company itself.<sup>150</sup> Alternatively, it is suggested that a fixed period should be applied in auditor appointment.<sup>151</sup> This alternative system requires that auditors should be appointed for a fixed period of time, namely 4 years, and the termination of the engagement is not possible unless in exceptional conditions (e.g. change of control in the audited company after merger or

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<sup>148</sup> Prem Sikka, Steven Filling, and Pik Liew, 'Audit crunch: reforming auditing' (2009) 24(2) Managerial Auditing Journal 135. See also Chapter II, Section, 2.2.

<sup>149</sup> Sikka *et al* (n 148) p. 136.

<sup>150</sup> This model has been tested in German cooperatives and saving banks. See Audit Green Paper (n 5) p.11.

<sup>151</sup> Max Planck Institute, 'Auditor Independence at the Crossroads Regulation and Incentives' Max Planck Private Law Research Paper No. 12/1 (2012).

acquisition). This might reduce the conflict of interest as the auditor would know that the audit engagement is fixed for a certain period (so he/she is secured from dismissal), and also that indefinite reappointment is not possible (so he/she does not have to please the company management for reappointment).<sup>152</sup>

None of these suggestions is favoured by the European Commission. Instead, in their proposed Regulation, the European Commission aimed to eliminate the influence of company management on the auditor by strengthening the role of audit committees.<sup>153</sup> The role of independent audit committees (comprised of non-executive members) in terms of their supervisory function over external auditors was first addressed in a Recommendation by the European Commission.<sup>154</sup> The existing Directive 2006/43/EC requires the formation of an audit committee constituted of non-executive members but it does not impose any role on audit committees with respect of the appointment of auditors only stating this as an alternative system.<sup>155</sup>

In the Regulation proposal, the Commission has suggested that the appointment of auditors should be based on audit committees' recommendations followed by a justification on the recommendation.<sup>156</sup> The Commission's suggestion to increase the role of audit committees seems to be more reasonable than third party auditor appointments. The proposals for auditor appointment or engagement by a third party may lead to inappropriate auditor selection, since companies may have different choices in auditor selection.<sup>157</sup> Audit committees, in turn, would be far more effective,<sup>158</sup> since they are more likely to understand the audited entity's business model than a third party, and can therefore make a better auditor choice.

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<sup>152</sup> Ibid p. 5.

<sup>153</sup> Draft Regulation (n 102).

<sup>154</sup> Commission Recommendation of 15 February 2005 on the role of non-executives or supervisory directors of listed companies and on the committees of the (supervisory) board 2005/162/EC OJ L 52/51.

<sup>155</sup> It is required that the appointment of statutory auditors should be carried out by the shareholders. See Directive 2006/43/EC (n 3), Article 37(1).

<sup>156</sup> Draft Regulation (n 102), Article 32.

<sup>157</sup> A large global company may prefer a Big Four audit firm while a small company may prefer to appoint a local audit firm. A third party may not be able to appoint auditors in line with firms' preferences. See Max Planck Research Paper (n 151) p. 6.

<sup>158</sup> Klaus-Peter Naumann, 'Audit policy for the single market – lessons from the crisis' in EC Conference on Financial Reporting and Auditing: A Time for Change? Day 2, Brussels 9-10 February 2011.

Nevertheless, audit committees do not always serve their intended objectives, and in most cases are found to be ineffective.<sup>159</sup> The main role of audit committees is to ensure that external auditors receive no pressure from the company management, namely the threat of dismissal.<sup>160</sup> However, in practice, audit committees operate as a proxy mechanism of the company management. In other words, these committees are not truly independent from the management. Controlling shareholders are likely to dominate the audit committee,<sup>161</sup> as it has been found that the influence of the shareholders in the selection of auditors is minor or absent.<sup>162</sup>

The practical independence of audit committees can be obtained via the appointment of non-executive directors who are not involved in company operations and who do not have a direct business relationship with the audited company.<sup>163</sup> The existing Directive 2006/43/EC allows Member States to decide whether audit committee members are to be non-executive members.<sup>164</sup> As a result, the independence of audit committees is interpreted differently by Member States. For example, in the UK, it is required that at least three, or in the case of smaller companies, two members of the audit committee should be independent non-executives,<sup>165</sup> while the German Corporate Governance Code 2013 only states that the chairman of the audit committee should be independent, and not be a former member of the management board.<sup>166</sup>

Moreover, non-executive audit committee members only work part-time; hence, they often lack of information regarding the business operations of the company. As a

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<sup>159</sup> Stuart Turley and Mahbub Zaman, 'The Corporate Governance Effects of Audit Committees' (2004) 8(3) *Journal of Management and Governance* 305.

<sup>160</sup> Christopher Humphrey, Peter Moizer, and Stuart Turley, 'Independence and Competence? A Critical Questioning of Auditing' in Cheryl R. Lehman (ed), *Independent Accounts (Advances in Public Interest Accounting, Volume 12)* (Emerald Group Publishing Ltd 2006) 149.

<sup>161</sup> John C. Coffee, Jr., 'A Theory of Corporate Scandals: Why the USA and Europe Differ' (2005) 21(2) *Oxford Review of Economic Policy* 198.

<sup>162</sup> Study by London Economics, 'The Economic Impact of Auditors' Liability Regimes' Final Report to EC-DG Internal Market and Services (MARKT/2005/24/F), September 2006, p. 73.

<sup>163</sup> The EU determined the role of audit committees (consisted sufficient number of independent non-executive directors) as to oversee the independence, objectivity and effectiveness of external auditors. See Commission Recommendation 2005/162/EC (n 154), chapter II, para.4.

<sup>164</sup> At least one member shall be independent. See Directive 2006/43/EC (n 3), Article 41. In the proposed Regulation, the Commission has proposed that audit committees should be composed of non-executive members of the administrative body and at least one member should have experience and knowledge in auditing. See Draft Regulation (n 102), Article 31.

<sup>165</sup> FRC, Guidance on Audit Committees, September 2012 para. 2.3.

<sup>166</sup> See German Corporate Governance Code (as amended on May 13, 2013), paras. 5.2, 5.3.2. available at [http://www.corporate-governance-code.de/eng/download/kodex\\_2013/D\\_CorGov\\_final\\_May\\_2013.pdf](http://www.corporate-governance-code.de/eng/download/kodex_2013/D_CorGov_final_May_2013.pdf) accessed 06/02/2014.

result, they often rely on management for that information. Non-executive audit committee members can serve better if they are given a full-time role on the audit committees similar to the Japanese *Kansayaku* Boards.<sup>167</sup> Full-time non-executives on audit committees can gather related information regarding the business practices of the company and can therefore minimize its dependency on management and be more effective on auditor appointment.

### ***Prohibition of provision of specific non-audit services***

The provision of non-audit services, such as bookkeeping and tax consultancy, are likely to compromise auditor independence because there is a risk in this situation that auditors become more dependent on non-audit fees.<sup>168</sup>

Directive 2006/43/EC states that the auditor shall not carry out a statutory audit if there is any direct or indirect financial, business, employment or any other relationship between the auditor (or audit firm) and the audited company.<sup>169</sup> Directive 2006/43/EC granted Member States discretionary powers to take necessary steps to ensure the appropriate safeguard on the auditors' independence. As a result, Member States take different approaches in terms of the provision of non-audit services. For instance, the French Code of Ethics banned the provision of non-audit services,<sup>170</sup> while the UK's approach is less restrictive since there is no such ban with respect to the provision of non-audit services to the audit client.<sup>171</sup> Therefore, it is common in the UK that audit firms, including the Big Four, offer consultancy services to their audit clients,<sup>172</sup> and listed companies disclose fees paid to auditors for those services.<sup>173</sup> There is no homogeneity regarding the provision of non-audit services to the audit client in the EU, since Article 22 of Directive 2006/43/EC has been interpreted differently by Member States.

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<sup>167</sup> Asian Corporate Governance Association, 'The Roles and Functions of *Kansayaku* Boards Compared to Audit Committees' Hong Kong, October 2013.

<sup>168</sup> Abraham J. Briloff, 'Accountancy and society a covenant desecrated' (1990) 1(1) *Critical Perspectives on Accounting* 5. See also Chapter II, Section 2.3.

<sup>169</sup> Directive 2006/43/EC (n 3), Article 22(2).

<sup>170</sup> See French Code of Ethics, Articles 10, 23, and 24. See also Study by ESCP Europe (n 90) p.154.

<sup>171</sup> Auditing Practices Board (APB) Ethical Standards state that audit firms should consider any possible threat to independence when accepting a proposed engagement with non-audit services. See APB Ethical Standard 5 (Revised) para. 14.

<sup>172</sup> For instance in 2006, PwC received £700,000 fees not related to audit from Northern Rock. See House of Lords Report (n 133) p. 24.

<sup>173</sup> The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 No. 489.

On the one hand, provision of non-audit services can improve auditors' skills and knowledge, and this may enhance their audit quality in general.<sup>174</sup> On the other hand, certain types of non-audit services not related to the audit work can impair auditor independence. It could be suggested that auditors should not be forbidden to provide all consultancy services to the audit clients. However, it might be necessary to divide non-audit services into categories with respect to their degree of threat to auditor independence.

The first category is the type of non-audit services that have a direct impact on the accounts, which should be banned, as they will have a direct impact on auditor independence.<sup>175</sup> These services are consultancy services that are not related to audit. The Commission has proposed to specify this kind of service, which would impair auditor independence and prohibit the provision for the auditors of PIEs.<sup>176</sup>

The Commission, on the other hand, shed a green light on the provision of the second type of non-audit services with subject to prior approval either by component authorities<sup>177</sup> or by audit committees.<sup>178</sup> Non-audit services as outlined in Article 10(3) of the Draft Regulation can be necessary for auditors to perform the audit work more effectively and should therefore not be banned completely from provision, but could be provided with a prior approval.

The third category includes services that are termed audit-related financial services, encompassing services required by legislation or contract to be undertaken by auditors.<sup>179</sup> The Commission's proposal does not bring a prohibition clause on these non-audit services to the non-audit client (except for large audit firms).<sup>180</sup> The

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<sup>174</sup> Clive S. Lennox, 'Non-audit fees, disclosure and audit quality' (1999) 8(2) *The European Accounting Review* 239.

<sup>175</sup> Max Planck Research Paper (n 151).

<sup>176</sup> Services completely banned from provision are expert services unrelated to audit, bookkeeping, designing and implementing internal control and risk management systems, and investment banking services. See Draft Regulation (n 102), Article 10(3)(a).

<sup>177</sup> Services including designing financial technology systems and providing due diligence services on potential mergers and acquisitions may be provided subject to prior approval by the component authorities. See *ibid*, Article 10(3) b(iii) and b(iv).

<sup>178</sup> Services including human resource services and provision of comfort letters for investors for issuing of an undertaking's security. See *ibid*, Article 10(3) b(i) and b(ii).

<sup>179</sup> Audit related services include services such as reporting required by law or regulation to be provided by the auditor, reviews of interim financial information, and reporting on regulatory returns. See APB Ethical Standard 5 (Revised) para. 54.

<sup>180</sup> The Commission has proposed that audit and non-audit activities of large audit firms should be separated. See Draft Regulation (n 102), Article 10(5). See also next section: Section 3.3.

provision of non-audit services is necessarily problematic when non-audit fees are higher than audit fees. This situation can increase auditor dependency on non-audit fees and hence, mitigate independence (e.g. Enron).<sup>181</sup> The Commission addressed this threat and has proposed that the total amount of fees generated from consultancy services that fall into the third category should be limited. Accordingly, related financial audit services referred to in Article 10(2) of the Draft Regulation may be provided only if they do not exceed 10% of the total audit fees.<sup>182</sup> Furthermore, when a substantial part of an audit firms' revenues originate from a single audited entity, this should be published in the annual accounts of the auditing company.

The Commission's proposal on the prohibition of provision of non-audit services has its merits because auditor dependency on non-audit fees is likely to impair auditor independence. However, the Commission's proposal for large audit firms to limit the provision of related non-audit services to the audit client is rather restrictive. These services are closely related to audit work and therefore are less likely to have a negative impact on independence. It is clear that the business of the large audit firms is likely to be affected by this restriction.

### ***Reducing the threat of familiarity***

Another problem for auditor independence is the risk of getting overfamiliar with the audited company due to long audit tenures. Currently, Directive 2006/43/EC requires the key audit partner to be rotated every seven years.<sup>183</sup> However, the existing law does not state any rotation rules for audit firms. In fact, Directive 2006/43/EC falls short in addressing the so-called 'familiarity threat'<sup>184</sup> that is likely to be created because of long and close auditor engagements with the same audit firm. Thus, it is common across EU listed companies to have the same audit firm for many years. For example, according to a survey, it is common in the EU (except in Italy)<sup>185</sup> to have

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<sup>181</sup> See Chapter II, Section 2.3.

<sup>182</sup> Draft Regulation (n 102), Article 9(2).

<sup>183</sup> Directive 2006/43/EC (n 3), Article 42.

<sup>184</sup> The familiarity threat may occur because of a long or close relationship between the auditor and the audited company wherein the professional accountant may become too sympathetic to the interests of others. See IFAC, Code of Ethics for Professional Accountants, 2012 Edition para.100.12. See also Chapter II, Section 2.2.

<sup>185</sup> In Italy, there is a regulatory requirement for mandatory rotation for audit firms every 9 years. See Commission's Impact Assessment (n 107) p.170.

the same audit firm for more than 7 years.<sup>186</sup> Having the same audit partner for many years is also evident in the UK financial markets where the average tenure rate for FTSE 100 companies is 48 years on average.<sup>187</sup>

The trend to have the same audit firm for many years is hazardous for auditor independence in a number of ways. First, this situation might impose pressure on auditors not to lose the client, say in the UK market, for another 48 years on average. Because of this pressure, it would be difficult for auditors to carry out statutory audits with a questioning mind (i.e. professional scepticism), which involves critical evaluation and questioning existing information in the financial statements provided by the management. Therefore, they would be reluctant to detect and report errors in the financial statements.<sup>188</sup>

Because of these reasons, key audit partner rotation by itself is not enough to reinforce auditor independence. In order to reduce the threat of familiarity, two types of auditor rotation might be suggested: internal and external rotation. While internal rotation allows a different audit partner from the same audit firm to engage in the audit for the next period (tendering), external rotation requires a change of audit firm (rotation).

The European Commission has proposed a mandatory rotation policy for audit firms. In this respect, audit firms would no longer be appointed for many years, but the maximum duration will be 6 years (or 9 years in case of joint audits), including the renewed engagement.<sup>189</sup> In addition, it is suggested that there should be a four years gap (cooling period) if the same audit firm were to be appointed after the maximum period of six years.<sup>190</sup> The Legal Affairs Committee of the European Parliament, however, takes the view that 6 years would be too costly and has proposed of a maximum period of 14 years.<sup>191</sup> Internal rotation is also proposed by the

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<sup>186</sup> Study by London Economics (n 162) p.73.

<sup>187</sup> House of Lords Report (n 133) p.13.

<sup>188</sup> Also, auditors who have long-tenure tend to be reluctant to make adjustments regarding errors in the prior audit periods because this would mean admitting past mistakes. See Max H. Bazerman, George Loewenstein, and Don A. Moore, 'Why good accountants do bad audits' (2002) 80(11) Harvard Business Review 96.

<sup>189</sup> In case of continuous engagement of 6 years, the maximum duration of the engagement is 9 years. See Draft Regulation (n 102), Article 33.

<sup>190</sup> See *ibid*, Article 33(2).

<sup>191</sup> Committee on Legal Affairs, Reforming EU audit services to win back investors' confidence *Press release* 25.04.2013.

Commission. However, its proposal does not specify any standard of such mechanism but only states that the rotation should take place on the basis of individuals rather than of a complete team.<sup>192</sup>

These proposed policy options for the mandatory rotation of audit firms is expected to create a healthy competition environment. This policy will also increase the choice of auditors in the market, as mandatory rotation is likely to break up the barriers to mid-tier firms.<sup>193</sup> Nevertheless, mandatory audit rotation is not unproblematic. As Arrunada and Paz-Ares argue, mandatory audit firm rotation results in significant costs<sup>194</sup> and reduces audit quality.<sup>195</sup> Mandatory audit firm rotation increases the so-called “*start-up cost*” because a substantial amount of specific assets is destroyed and has to be rebuilt every time a rotation takes place.<sup>196</sup> For example, auditors have to have knowledge of the audited company’s accounting system and internal control; the audited client must in turn make resources available for the audit.<sup>197</sup> The auditor as well as the audited client must rebuild these audit routines every time a rotation takes place, which is costly for both sides of the engagement.<sup>198</sup>

According to Arrunada and Paz-Ares, mandatory rotation also reduces audit quality because it undermines auditors’ ability (“*technical competence*”) and willingness to detect irregularities in the financial statements.<sup>199</sup> Likewise, it is argued that financial reporting quality is lower when the audit-client relationship is short (one to three years) compared with long-term auditor tenures (nine to ten years).<sup>200</sup> However, it was later found that fraudulent practices tend to occur in the first three years of the audit-client relationship.<sup>201</sup> Therefore, these findings do not suggest that the reason

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<sup>192</sup> Draft Regulation (n 102), Article 32.

<sup>193</sup> Commission’s Impact Assessment (n 107) p. 57.

<sup>194</sup> It is estimated by PwC that switching costs for the audited company could be up to £1 million, while Office of Fair Trading (OFT) found the average of FTSE 100 audit fees was £5.2 million. See OFT, Statutory audit market investigation reference to the Competition Commission of the supply of statutory audit services to large companies in the UK, October 2011 para.516.

<sup>195</sup> Benito Arrunada and Candido Paz-Ares, ‘Mandatory Rotation of Company Auditors: A Critical Examination’ (1997) 17(1) *International Review of Law and Economics* 31.

<sup>196</sup> *Ibid* p. 34.

<sup>197</sup> *Ibid*.

<sup>198</sup> Also, it should be taken into account that many of these assets may not be rebuilt immediately, such as the trust that builds between two parties over the past successful audits. See *ibid* p. 45.

<sup>199</sup> *Ibid* p. 44.

<sup>200</sup> Van E. Johnson, Inder K. Khurana, and Reynolds J. Kenneth, ‘Audit-Firm Tenure and the Quality of Financial Reports’ (2002) 19(4) *Contemporary Accounting Research* 637.

<sup>201</sup> Joseph V. Carcello and Albert L. Nagy, ‘Audit Firm Tenure and Fraudulent Financial Reporting’ (2004) 23(2) *Auditing: A Journal of Practice and Theory* 55.

behind undetected irregularities in the financial statements is necessarily a short auditor tenure.

It can be concluded that there is no proof of a negative correlation between auditor continuity and the degree of auditor failure, as Arrunada and Paz-Ares claimed. However, there is also no empirical evidence that suggests that audit firm rotation will enhance competition in the market, but it is likely to increase audit costs. Thus, until now, regulators have focused on the rotation of key audit partners instead of audit firm rotation.<sup>202</sup> The mandatory rotation of audit firms may not be the best remedy for increasing competition, but it can be considered an effective tool in terms of preventing auditors from becoming overfamiliar with the audited company. Alternatively, voluntary rotation might be suggested. However, if the auditor resigns voluntarily, investors might consider this resignation a warning sign for the company and this would therefore not be a perfect alternative to mandatory rotation.

In addition to the above measures (i.e. strengthening audit committees, banning provision of non-audit services, and mandatory rotation of audit firms), transparency is another tool for reinforcing auditor independence. It is important that all fees, including audit fees and non-audit fees, should be disclosed separately in annual accounts. Whether the audited company or audit firm should disclose this information is questionable. Some suggest this information should be included in the audited company's annual accounts.<sup>203</sup> However, the Commission has proposed that the audit firm should disclose this information in the audit firm's annual account to be publicly available on their website.<sup>204</sup>

Furthermore, if audited company accounts generate a substantial part of the audit firm's revenues, this should be published as well. In this regard, the Commission has proposed that audit firms should disclose in a transparency report (apart from the audit report<sup>205</sup> and additional audit report<sup>206</sup>) the lists of entities from which the substantial part of the audit firm's revenues (i.e. more than 5 per cent of its annual revenue) originate.<sup>207</sup>

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<sup>202</sup> See Directive 2006/43/EC (n 3), Article 42.

<sup>203</sup> Max Planck Research Paper (n 151) p. 17.

<sup>204</sup> Draft Regulation (n 102), Article 26.

<sup>205</sup> *Ibid*, Article 22.

<sup>206</sup> *Ibid*, Article 23.

<sup>207</sup> *Ibid*, Article 27.

### 3.3. Reducing Concentration in the Audit Market

It has been found that the market of audits of large and listed companies is dominated by a few audit firms, namely the Big Four audit firms: Deloitte, PwC, EY (formerly Ernst & Young<sup>208</sup>) and KPMG.<sup>209</sup> Although concentration may differ in terms of global revenues and the number of audit engagements,<sup>210</sup> domination is apparent in the audit market. It is worth noting that the concentration level is the highest for listed companies.<sup>211</sup> For this reason, the high level of concentration in terms of statutory audits of PIEs is under scrutiny by regulatory authorities.

At the EU level, anti-competitive agreements and abusive practices by a dominant undertaking are prohibited.<sup>212</sup> However, so far, there has been no intervention by the EU competition authorities in the audit market. In its report dated 2003, the Office of Fair Trading (OFT), the UK's national competition authority, found no evidence to suggest that firms had acted to prevent, restrict, or distort competition contrary to the Competition Act 1998.<sup>213</sup> As a result, since then, there has been no competition intervention from the OFT. More recently, in February 2013, the UK Competition Commission issued the findings of its investigations on the UK audit market following reference made by the OFT.<sup>214</sup> After investigation, the UK Competition Commission concluded that the reputational barriers for mid-tier audit firms and high switching cost of company managers are likely to have an “*adverse effect on competition*” and hence restrict competition in the audit market.<sup>215</sup>

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<sup>208</sup> Ernst & Young simplified its name and has become EY in July 2013.

<sup>209</sup> Oxera Report, ‘Ownership of audit firms and their consequences for audit market concentration’ prepared for European Commission DG Internal Market and Structure, October 2007 Available here [http://ec.europa.eu/internal\\_market/auditing/docs/market/oxera\\_report\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/market/oxera_report_en.pdf) accessed 19/07/2013; See also Study by London Economics (n 162); the Study by ESCP Europe (n 90).

<sup>210</sup> It was found that the concentration would be higher when considering turnovers instead of mandates. See the Study by ESCP Europe (n 90). See also Chapter II, Section 2.4.

<sup>211</sup> The EU average market share of the Big Four was 90% in 2009. See the Study by ESCP Europe (n 90) p. 100. See also Chapter II, Section 2.4.

<sup>212</sup> TFEU, Article 101 and 102 (ex Articles 81 and 82 of the EC Treaty).

<sup>213</sup> OFT, Coordinating Group on Audit and Accounting Issue: Final Report 2003.

<sup>214</sup> See OFT Report 2011 (n 194). In this report, the OFT issued its concerns about the high concentration, barriers to entry, and low annual switching rates in the audit market.

<sup>215</sup> Competition Commission found that 67% of FTSE 100 companies and 52% of FTSE 250 companies have had the same auditor for more than 10 years. See Competition Commission Statutory Audit Services Market Investigation Summary of provisional findings, 22 February 2013.

In its final report, the Competition Commission has proposed a 10-year mandatory rotation of FTSE 350 companies.<sup>216</sup> By contrast, the UK Competition Commission does not address the scenario of a demise of one of the Big Four and the risk that the market would be exposed to in the aftermath of such collapse. Although a mandatory rotation rule might increase the choice of auditors for listed companies, it does not promise any prominent change in the audit market structure with regards competition.

High concentration may have a reverse effect on the effective function of the market.<sup>217</sup> Moreover, there would be serious consequences of a withdrawal of one of the Big Four from the market.<sup>218</sup> There have been previous withdrawals from the market;<sup>219</sup> however, a withdrawal from the market now would have greater effects as the market is highly dependent of the services on these firms. It is said that the audit market would be disrupted in the case of a scenario where one of the Big Four collapsed. For instance, it is predicted that nearly 40 per cent of the UK's FTSE 100 companies would have no auditor, and more than 50 per cent of France's CAC 40 would be left without their joint audits.<sup>220</sup>

Furthermore, the loss of confidence in the audit profession and, subsequently in the reliability of the markets is likely to result in inevitable risks if one of the Big Four collapses (e.g. as a result of fraud). This is explained via the famous 'too big to fail' phenomenon. It is possible that a Big Four firm could collapse because of criminal activities (e.g. tax sheltering), country bans<sup>221</sup> or civil litigation costs<sup>222</sup> in excess of their capital and insurance coverage.<sup>223</sup> The possible effects of this turbulence would likely undermine market confidence significantly. Therefore, it is acknowledged that

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<sup>216</sup> Competition Commission, *Statutory audit services for large companies market investigation Summary of report*, 15 October 2013.

<sup>217</sup> It was found that market concentration might result in high prices. See Oxera Report (n 209). See also Chapter II, Section 2.4 for the results of high concentration.

<sup>218</sup> House of Lords Report (n 133) p. 12.

<sup>219</sup> See Chapter II, Section 5.

<sup>220</sup> Edward E. Nusbaum (CEO Grant Thornton International Limited), 'Too Big to Fail -- How big is the Problem?' in EC Conference on Financial Reporting and Auditing: A Time for a Change? Brussels 9-10 February 2011.

<sup>221</sup> Currently, Deloitte faces the risk of losing its license to audit in Spain as the authorities investigate the audit firm's role in the collapse of Bankia in 2012. See Big4.com <http://www.big4.com/deloitte/could-deloitte-lose-its-audit-licence-in-spain-less-likely-than-more/> accessed 17/07/2013.

<sup>222</sup> As a result of private litigation, Ernst & Young recently agreed to pay \$99 million (£61.2 million) to the plaintiffs for the collapse of Lehman Brothers. See Chapter II, Section 3.3.

<sup>223</sup> See Nusbaum (n 220).

domination in the market should be eliminated for the sake of stability in the markets.<sup>224</sup>

In its proposal for a Regulation, the EU has specified a role for national authorities with respect of the risk of market concentration. Accordingly, national auditing authorities should monitor the risks arising from high concentration, such as the demise of audit firms with a significant market share, the disruption of audit services, and overall effect on the stability of the market.<sup>225</sup> In addition, the Commission has proposed a number of policy measures in order to break up the dominance of the Big Four and reduce the effect of market concentration. The Commission has proposed to ban large audit firms and their networks (whose total audit revenues exceed €1,500 million) from auditing PIEs in case they offer consulting services in the EU.<sup>226</sup> Therefore, the Commission aims to divide the large audit firms into two professions: audit firms that only provide audit work (pure audit firms) and audit firms that also provide consultancy services. The radical approach of the Commission might be justified on the grounds of the high proportion of advisory services in total revenues of the Big Four and their possible effects on independence.<sup>227</sup> It is clear that the Commission's proposal would have a great impact on the revenues of the Big Four if the proposals were accepted to become a rule. However, this approach might not be in the best interests of auditors and their professional development. Unsurprisingly, the audit profession does not support the Commission's proposal. They argue that a strict ban on the provision of advisory services would restrict auditors' ability to perform better quality audits.<sup>228</sup> Likewise, most of the Legal Affairs Committee members of the European Parliament agreed that the general prohibition of advisory services would be "*counterproductive*" for audit quality.<sup>229</sup> However, the Committee agrees with the 'blacklisting'<sup>230</sup> of advisory services directly affecting a company's financial statements.

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<sup>224</sup> Responses to Audit Green Paper (n 104) p. 16.

<sup>225</sup> Draft Regulation (n 102), Article 42.

<sup>226</sup> Ibid, Article 10(5).

<sup>227</sup> The share of advisory services in total revenue of the Big Four has been the fastest-growing service line compared with other services, such as audit and tax services. The combined advisory revenue of the four firms has reached a 33% share of total revenue in 2012, having been 22% in 2004. See The Big Four Firms Performance Analysis, 2012 by Big4.com p. 18. See also Chapter II, Section 2.3.

<sup>228</sup> ICAEW, 'Reform of Statutory Audit Assessing the Legislative Proposal' 14 March 2012.

<sup>229</sup> European Parliament Press Release, April 2013 (n 191).

<sup>230</sup> Blacklisting means the prohibition of services that are not related to audit work, i.e. the first category of non-audit services. See also Section 3.2 above.

In order to open the market to new audit firms, a number of remedies are proposed. Strict ownership regulations for audit firms may create additional difficulties for small and medium-sized audit firms entering a specific market segment that is dominated by the Big Four (e.g. the listed market segment<sup>231</sup>). The Commission, therefore, has decided to liberalise the ownership rules of audit firms. In this respect, the law will no longer require statutory auditors or audit firms to hold a minimum of capital or voting rights.<sup>232</sup> It is expected that the less strict ownership rules of audit firms will help small- and medium-sized audit firms to grow and encourage new firms to enter the market. In addition, removing market barriers for smaller audit firms, the EU has proposed to ban contractual clauses requiring the appointment of one of the Big Four.<sup>233</sup> The prohibition of Big Four-only contractual clauses has been supported by the European Parliament.<sup>234</sup>

In case of a scenario of the failure of one of the Big Four, in order to prevent contagious effects to other audit firms, the Commission has proposed that at least the six largest audit firms in each Member State establish contingency plans addressing a possible event threatening the continuity of operations of the concerned firm, including liability and reputation risks.<sup>235</sup>

Another remedy to open the market for new audit firms and break up the dominance of the Big Four is the joint audit system. It was found that countries with a joint audit system requirement (e.g. France and in Denmark, until 2005) have lower concentration levels.<sup>236</sup> In joint audit systems, listed companies are required to appoint two different audit firms who perform the audit work together and jointly sign the audit report. This practice may help smaller audit firms enter into a specific market segment that is largely dominated by the Big Four.

However, the joint audit requirement for listed companies in Denmark was terminated because the costs were higher than the benefits.<sup>237</sup> In addition to the

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<sup>231</sup> See Chapter II, Section 2.4.

<sup>232</sup> However, the requirement regarding the majority of the members of the management board of audit firms remained the same. See Draft Directive (n 101), Article 3.

<sup>233</sup> Ibid, Article 37(3); Draft Regulation (n 102), Article 32(7).

<sup>234</sup> European Parliament Press Release, April 2013 (n 191).

<sup>235</sup> Draft Regulation (n 102), Article 43.

<sup>236</sup> Charles Piot, 'Auditor concentration in a joint-auditing environment: French market 1997-2003' (2007) 22(2) *Managerial Auditing Journal* 161.

<sup>237</sup> Oxera Report (n 209) p. 177.

additional costs, joint audit systems may not be practical in terms of efficiency. There is a risk that more than one auditor (or audit firm) involved in auditing is likely to increase the audit process and may therefore result in a failure to issue audit reports on time. Because of the costs and possible disadvantages of the joint audit system, the Commission has chosen to leave it to companies to decide whether to have a joint audit.<sup>238</sup>

### ***Conclusion on high concentration***

High competition in a market may promote service providers to produce higher quality services. Currently, competition is restricted in the audit market insofar as the dominance of the Big Four audit firms is present. In order to reduce the effects of restricted competition in the market, two main remedy policies could be suggested. The first is to open the market to new audit firms by reducing barriers for entry. In this respect, liberalising ownership rules and voluntary joint audit system could be introduced.<sup>239</sup> Second, policies could be focused on eliminating the existing domination of the particular firms. The prohibition of any restriction of the choice of auditors (i.e. contractual clauses requiring that the audit is performed by a Big Four only) and mandatory rotation of audit firms could be suggested in this respect.

The above remedies alone might not be sufficient to control the risk of high concentration in the market, however. It is the general public perception that the Big Four always provide better quality audits.<sup>240</sup> The bias of the Big Four's professionalism derives from their global network, technological advantage, and sectorial expertise. Individually or in combination, these elements empower the Big Four with a 'reputational advantage'.<sup>241</sup> However, it is not certain how long the reputation of the Big Four will last. It is for this reason that the Commission's invitation for the national audit authorities to monitor the risk arising from high concentration is so important. It can also be suggested that regulatory remedies to

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<sup>238</sup> Draft Regulation (n 102), Article 22(3).

<sup>239</sup> Reducing the risk of civil litigation via liability might also help reduce the risk of firms' failure because of civil litigation and therefore, eliminates the risk of more concentration. See Study by London Economics (n 162) p. 164. For auditor liability, see also Chapter V.

<sup>240</sup> There is no proof whether the Big Four audit firms have low quality audits compared with smaller audit firms. For a discussion on this, see Chapter II, Section 5.2.

<sup>241</sup> See Chapter II, Section 2.4.

enhance market competition should go further than introducing mandatory rotation, as the UK Competition Commission cited in its report.<sup>242</sup>

### **3.4. Establishing a European passport and EU-wide Supervision**

Currently, auditors and audit firms need to be approved and pass an aptitude test to be able to provide statutory audit services in an EU Member State in which they want to carry out statutory audit services.<sup>243</sup> Auditing and independence standards, as well as public oversight and quality assurance practices, vary between Member States in terms of their structures, mandates and administrative capacities.<sup>244</sup> As a result, auditors and audit firms face significant compliance costs if they want to conduct audit services in more than one Member State.<sup>245</sup> In order to remove unnecessary compliance costs, the European Commission aims to create a single market for statutory audit services under the European Quality Certificate framework. This framework provides an environment where auditors would be recognised across Europe once licensed in one Member State. In other words, the European passport system would establish mutual recognition of statutory auditors by all Member States. The European Quality Certificate will not be a condition for auditors and audit firms but will have a voluntary character.<sup>246</sup>

Although a significant number of stakeholders support the idea, the public authorities of Member States are not in favour of a European passport for auditors.<sup>247</sup> It is true that the enactment of Directive 2006/43/EC and the adoption of ISAs have helped to achieve a degree of common audit practices and rules across the EU.<sup>248</sup> However, there are still differences between Member States on several issues (e.g. different standard-setting rules on auditor independence and selective adoption of ISAs).<sup>249</sup> In addition to those issues, there are differences in the company and tax laws of the Member States. One can legitimately ask how to verify auditors' competence in

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<sup>242</sup> See UK Competition Commission Report, (n 215).

<sup>243</sup> Directive 2006/43/EC (n 3), Article 14.

<sup>244</sup> See Commission's Impact Assessment (n 107) p. 23. See also Study by ESCP Europe (n 90) p. 5.

<sup>245</sup> According to Directive 2006/43/EC, a Member State may approve a third-country auditor as statutory auditor if that person complies with requirements to be a statutory auditor in that Member State. Accordingly, the person should have a good repute (Article 4), met the educational qualifications (Article 6), succeed in the examination of professional competence (Article 7) and pass a test of theoretical knowledge (Article 8) to be followed by adequate practical training (Article 10).

<sup>246</sup> Draft Regulation (n 102), Article 50(1)(j).

<sup>247</sup> Commission's Impact Assessment (n 107) p. 46.

<sup>248</sup> See Section 2.2 above.

<sup>249</sup> See *ibid.*

respect of national law knowledge (i.e. legislative rules on company tax law) given that Member States' national laws are diverse.<sup>250</sup>

The Europeanisation policy of the Commission has been criticised in terms of its added value to the audit market. It is said that the creation of a European passport for auditors would be more advantageous for the Big Four than for smaller sized audit firms.<sup>251</sup> This is because the larger audit firms can cross borders, but smaller-sized audit firms in general tend to be active at local and regional levels only.<sup>252</sup> Therefore, not the whole audit market, but rather only a part of the market - namely the largest audit firms - would be able to take advantage of this framework. In addition, a European certification for audit firms may create another barrier for smaller audit firms and might therefore have an adverse effect on concentration.<sup>253</sup>

However, the creation of a single passport for auditors could be advantageous for a Union-wide supervision. At present, supervision over auditors and audit firms is carried out by national supervisory authorities.<sup>254</sup> Establishing public oversight of the audit profession at a national level was first recommended by the Commission in 2001.<sup>255</sup> The later Commission Recommendation of 2008 suggested that the members of such a body should be comprised of non-practitioners, but left it to Member States to form such bodies.<sup>256</sup> According to Directive 2006/43/EC, public oversight bodies would be responsible for the approval and registration of statutory auditors and audit firms, the adoption of standards on professional ethics, the continuing education of auditors, and conducting investigations and disciplinary actions regarding statutory auditors (and audit firms) when necessary.<sup>257</sup> In addition, public oversight covers the audit firms' quality assurance system that takes place at least every six years.<sup>258</sup> The scope of the audit quality assurance system includes an assessment of compliance with international auditing standards and independence

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<sup>250</sup> Commission's Impact Assessment (n 107) p. 46. The Commission has proposed to not allow carve-out provisions from ISAs anymore and only allow imposing additional national audit requirements if ISAs have not covered them already. See Draft Directive (n 101), Article 26.

<sup>251</sup> Klaus-Heine Lehne, 'European Passport for Auditors', in EC Conference on Financial Reporting and Auditing: A Time for Change? Brussels 9-10 February 2011.

<sup>252</sup> *Ibid.*

<sup>253</sup> See Study by ESCP Europe (n 90) p. 202.

<sup>254</sup> Directive 2006/43/EC (n 3), Article 32.

<sup>255</sup> See Commission Recommendation 2001/256/EC (n 42).

<sup>256</sup> Commission Recommendation of 6 May 2008 on external quality assurance for statutory auditors and audit firms auditing public interest entities 2008/362/EC OJ L 120/20.

<sup>257</sup> Directive 2006/43/EC (n 3), Article 32.

<sup>258</sup> *Ibid.*, Article 29.

requirements, audit fees charged, and reviews on audit firm's internal quality control. A public oversight mechanism for statutory auditors and audit firms was established in every Member State as of 2010.<sup>259</sup> In the UK, the monitoring operations of the UK's Public Oversight Board on major audit firms are carried out through the Audit Inspection Unit (AIU),<sup>260</sup> renamed as the Audit Quality Review.

At present, there is no supervisory convergence at the EU level.<sup>261</sup> For instance, there is no common practice on the part of national supervisory authorities regarding inspections and supervisions. In fact, it is common that national supervisory authorities are reluctant to issue sanctions following their inspections.<sup>262</sup> In most Member States, practising auditors are involved in the quality assurance reviews of public oversight authorities, which undermines the independence and efficiency of such bodies.<sup>263</sup> It is often the audit profession that has influence on these authorities because of the weak oversight structures deriving from budgetary constraints.<sup>264</sup> In addition, the current supervisory framework under the national supervisory authorities is not sufficient to cover the integrated structures of audit firms that usually go beyond national border. For example, audits of an audit firm's network in various Member States are not supervised by the national component authorities, but are supervised by the national supervisory authority with which the audit firm is registered.<sup>265</sup>

These examples result in ineffective supervision over auditors at EU level and indicate the need for a more integrated supervision mechanism in the EU.<sup>266</sup> In order to contribute the co-ordination of public oversight authorities across the EU, a European Group of Auditors Oversight Boards (EGAOB) has been established. Comprised of representatives from the authorities responsible for public oversight of Member States, the role of this body is to ensure co-operation between public

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<sup>259</sup> Scoreboard on the transposition of the Statutory Audit Directive 2006/43/EC, 1 September 2010

<sup>260</sup> See FRC, Professional Oversight Board Draft Publication Theme, December 2007.

<sup>261</sup> Commission's Impact Assessment (n 107) p. 153.

<sup>262</sup> Inspection reports for 2000 and 2010 for France, Italy and UK national supervisory authorities made recommendations to audit firms regarding audit quality but did not provide any information on sanctions. See *ibid* p. 150.

<sup>263</sup> *Ibid* p. 22.

<sup>264</sup> Commission's Impact Assessment found that the Netherlands, France and Bulgaria have considerably effective public oversight system where inspections were carried out without any influence from the profession. See *ibid* p. 23.

<sup>265</sup> *Ibid*.

<sup>266</sup> Audit Green Paper (n 5).

oversight authorities within the EU and audit oversight systems in different Member States are comparable.<sup>267</sup> However, the EGAOB is not a legal entity because its structure is informal.<sup>268</sup> Mainly, the EGAOB is a group formed by experts advising the Commission. Because of the structural limitations, it is said that the EGAOB has fallen short of securing the convergence of supervisory rules within the EU in terms of investigations and penalties.<sup>269</sup>

Replacing the EGAOB, the Commission has proposed that EU-wide supervision over auditors should be ensured within the framework of the European Markets and Securities Authority (ESMA).<sup>270</sup> Under this framework, the mandate, powers and independence requirements for those public authorities will be established at the EU level but supervision will be carried out nationally.<sup>271</sup> Yet, a component authority of a Member State may request an investigation by a component authority of another Member State in the latter's territory.

The EGAOB has no powers to take formal decisions on inspections and oversights over auditors and audit networks; it was not practical to form such an EU-wide supervision mechanism under the EGAOB.<sup>272</sup> However, establishing a newly created body for this role would be much more costly.<sup>273</sup> In the light of these issues, the EU-wide supervision system has been proposed to be created under the existing body of ESMA. Established in January 2011, the role of ESMA is to achieve integrity between Member States in securities regulation.<sup>274</sup>

One may question the proficiency of ESMA in EU-wide auditing supervision because it is not specialised in the field of auditing. Yet, ESMA already collaborates with the European Banking Authority and European Insurance and Occupational Pensions Authority in the field of auditing regarding PIEs. Also, ESMA would be required to establish an internal committee devoted to audit policy comprising

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<sup>267</sup> Commission Decision of 14 December 2005 setting up a group of experts to advise the Commission and to facilitate cooperation between public oversight systems for statutory auditors and audit firms, OJ L 329/38.

<sup>268</sup> Commission's Impact Assessment (n 107) p. 153.

<sup>269</sup> *Ibid* p. 23.

<sup>270</sup> Draft Regulation (n 102), Article 46.

<sup>271</sup> *Ibid*, Articles 35-8.

<sup>272</sup> Commission's Impact Assessment (n 107) p. 153.

<sup>273</sup> *Ibid*, p. 155.

<sup>274</sup> See ESMA website <http://www.esma.europa.eu/page/esma-short> accessed 25/07/2013.

members of the component authorities.<sup>275</sup> Thus, it may benefit from this experience. The main work of ESMA is mostly related to PIEs. This might be the possible limitation of ESMA supervision in terms of the supervision of the whole audit market.<sup>276</sup> Yet, when considering the fact that it is PIEs that are mostly involved in cross-border business, EU-wide supervision is most needed at PIE level. Therefore, this would actually be advantageous for EU-wide supervision under ESMA.

## **CONCLUSION**

This chapter has sought to contribute to the literature through a critical analysis of existing and proposed laws of the EU in auditing. This chapter also showed how EU audit policy and laws have been shaped from Enron to date. It is submitted that the first factor that shaped the EU audit policy and laws is the long-standing single market objective. Directive 2006/43/EC is an important regulatory tool with a binding force in terms of harmonisation of the laws on auditing in the EU. This Directive is important in terms of setting up the core principles and requirements for EU statutory audit practices. However, as this chapter has submitted, Directive 2006/43/EC did not establish a sufficient level of standardisation in auditing rules and practices within the EU. Divergence results add to additional regulatory costs, especially for auditors and audit firms that operate cross borders. In addition, this chapter has submitted that, at present, there is no effective supervision at EU level since only national supervisory authorities oversee the auditors and audit firms within their territory.

These issues are seen as obstacles to the integration of markets and development of cross-border businesses. Therefore, the Commission aims to increase the level of harmonisation in statutory auditing in the EU and has issued proposal for a new Directive amending existing Directive 2006/43/EC<sup>277</sup> and a Regulation for audits of PIEs.<sup>278</sup> Currently, the statutory audit requirements for PIEs and other firms are governed by Directive 2006/43/EC. It is believed that the global financial crisis highlighted the importance of listed entities and financial institutions (i.e. PIEs in

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<sup>275</sup> Draft Regulation (n 102), Article 46.

<sup>276</sup> Commission's Impact Assessment (n 107) p. 53.

<sup>277</sup> See Draft Directive (n 101).

<sup>278</sup> See Draft Regulation (n 102).

general) in the economy. Therefore, the Commission has proposed to govern the statutory audit requirements of the PIEs with a separate Regulation. A directly applicable Regulation would provide a higher level of harmonisation and legal certainty. This new approach may suggest that maximum harmonisation is sought in auditing, instead of minimum harmonisation.

The most fundamental proposals of the EU are the requirements of ISAs without allowing carve outs,<sup>279</sup> the establishment of a European passport for auditors, and EU-wide supervision over statutory auditors in the EU.<sup>280</sup> These proposals reflect the Commission's aim to create a single market for auditing in the EU. In doing so, it expects to reduce additional costs for statutory auditors that go beyond national borders. These reforms would in this respect increase the level of harmonisation of the laws on auditing in the EU.

This chapter has submitted that the effects of the crisis that was associated with auditing failures has been the second factor that shape the EU audit policy and laws. While post-Enron debates have focused on the problem of non-audit services, and oversight over audit profession, the post-financial crisis debates have focused on audit quality and the high-concentration issue. It was not until recently that the regulators addressed the restricted competition in the audit market.<sup>281</sup> At the EU level, the Commission issued some radical proposals to change the *status quo* in the market aiming to break-up the dominance of the large audit firms. Some proposals, such as banning the Big Four-only contractual clauses have received support. However, it will take some time until an agreement is reached on relatively radical proposals, such as dividing the audit profession into pure audit firms and consultancy firms, and the mandatory rotation of audit firms. Restrictions on the provision of advisory services for the large audit firms would affect the large audit firms' businesses in consultancy services. Yet, it is uncertain how this would affect the audit quality. It is also uncertain whether mandatory rotation would increase audit quality, whereas it is almost certain to increase the audit costs. It is an important question as to whether the Commission will keep its radical proposals to change the

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<sup>279</sup> Draft Directive (n 101), Article 26.

<sup>280</sup> Draft Regulation (n 102), Articles 46, 50.

<sup>281</sup> See OFT Report 2011 (n 194).

situation in the market or will compromise those radical proposals with moderated suggestions.<sup>282</sup>

It is true that financial scandals and crises give lawmakers opportunities to regulate the market. While crisis time regulations were seen as lifesavers during the crisis time, there is a risk that they have become an over-reaction to corporate scandals<sup>283</sup> and not be effective, but represent only symbolic actions.<sup>284</sup> As for the Commission's proposals, it is important that they provide a practical response to the issues, rather than following a regulatory routine.<sup>285</sup> Time will tell as to when we might see the effects of these proposals in the EU audit market.

Auditor liability has not been a topic of the 2011 proposals of the EU. Because audit quality largely depends on auditors' judgement and care, which require professional scepticism, it may be suggested that legal reform should focus on how to increase the professional trustworthiness of auditors through training and education.<sup>286</sup> Alternatively, effective liability rules for auditor negligence can be used as a tool for motivation for auditors to provide better quality audits. However, large litigation risks faced by the Big Four may result in more concentration. The next chapter will directly address auditor liability, its regulation and consequences on the market.

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<sup>282</sup> On 17 December 2013, the European Council and the Parliament have reached a preliminary agreement on the proposals. On 21 January 2014, the Legal Affairs Committee (the JURI) approved the draft agreement between the Parliament and Council. On 27 May 2014, the European Commission issued the Directive 2014/56/EU amending 2006/43/EC and Regulation No. 537/2014 in the Official Journal.

<sup>283</sup> See also Chapter III, Section 2.2.

<sup>284</sup> Roman Tomasic and Folarin Akinbami, 'Towards a new corporate governance after the global financial crisis' (2011) 22(8) *International Company and Commercial Law Review* 237 pp. 272-3.

<sup>285</sup> Hatice Kubra Kandemir, 'The EU Law on Auditing and the Role of Auditors in the Global Financial Crisis of 2008' (2013) 10 *International Journal of Disclosure and Governance* 213.

<sup>286</sup> Matthew Gill, *Accountants' Truth Knowledge and Ethics in the Financial World* (OUP, 2009).

## CHAPTER V: AUDITOR LIABILITY

### INTRODUCTION

EU law requires publicly held companies whose securities are admitted to a regulated market to disclose periodic financial information<sup>1</sup> and prospectuses when securities are offered to the public or admitted to trading.<sup>2</sup> Disclosing this kind of information about the financial situation and performance of companies is crucial for the efficient operation of markets, and such information is important for shareholders, investors, and other third parties who have an interest in capital markets. External auditors then check on the company management by ensuring the management's financial accounts and other disclosure statements for public offerings present accurate information about that companies' financial situation.<sup>3</sup> Auditors undertake the responsibility of those accounts' accuracy.<sup>4</sup>

As well as the accuracy and credibility of audited accounts and prospectuses, the early detection of fraud in those statements is important in maintaining confidence in financial markets. Auditors provide an independent opinion about companies' economic positions based on their financial accounts. In case of an audit failure, such as undetected or unreported material misstatements in the accounts, auditors can be subject to civil liability. Auditor liability regimes, including the conditions for a civil liability, are in general governed by the national law of EU Member States. EU law does not provide any regulation on auditor liability; nor do ISAs impose any liability on auditors, but only specify the auditors' role in detecting and reporting on the company's financial statements.

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<sup>1</sup> Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] L390/38, Article 4 (as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013).

<sup>2</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64, Article 5 (as amended by Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010).

<sup>3</sup> It is required that financial statements be audited. See Directive 2004/109/EC (as amended) (n 1), Article 4(4).

<sup>4</sup> See Section 3.2.2 below.

The previous chapters provided examples of audit failures.<sup>5</sup> This chapter will examine the elements for a civil action against auditors with respect of the accuracy of financial accounts and public offerings. In doing so, this chapter critically discusses EU and UK law, as well as international standards: ISAs. Through the analysis of these three aspects, the objective of this chapter is to determine to whom auditors are in fact liable, and whether the law in this context is effective in holding auditors liable for misleading accounts and public offers.

This chapter is laid out as follows: The first part presents how professional standards, namely ISAs, confer responsibilities for detecting fraud in financial statements upon auditors.<sup>6</sup> It is shown that ISAs do not ascribe liability to auditors for negligent acts. The second section discusses the EU approach on auditor liability, and concludes that there is no common approach on auditor liability at the EU level. Since there is no uniformed application of auditor liability at the EU level, the last part examines UK law on auditor liability where liability rules are governed by both common law and statute.

## **1. RESPONSIBILITIES OF THE AUDITOR FOR DETECTING MATERIAL MISSTATEMENT DUE TO FRAUD UNDER ISAs**

The duties of auditors are determined by the laws of Member States.<sup>7</sup> In addition, international standards detail the duty of care to be exercised by auditors when performing audit work.

ISAs 240, 300, 315, and 330 provide guidelines relating to auditing assurance and fraud detection. ISA 240 places the primary responsibility for the prevention and detection of fraud upon the management. Accordingly, an auditor's responsibility is to establish reasonable assurances that a company's financial statements are free from misleading information. The term 'reasonable' is rather vague. However, it can be understood that the auditor cannot obtain absolute assurances regarding the detection of material misstatements. According to ISA 240, auditors are required to give reasonable assurances only, as there are inherent limitations in internal control.

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<sup>5</sup> See Chapter II, Section 3.3.

<sup>6</sup> ISA 240.

<sup>7</sup> See Section 3.1 below for UK laws on auditors' duties.

Auditors are also required to show ‘professional scepticism’ when obtaining reasonable assurance throughout the audit. Scepticism is a mindset requiring continual questioning that mandates the auditor to critically evaluate existing information and to look for evidence of the validity of the given information.<sup>8</sup> In this respect, a skeptical audit should involve critical and continuous evaluation of information given by the management, actively looking for risks of material misstatements, and designate an audit test to identify those misstatements.<sup>9</sup> In order to fulfill the role of professional skepticism, an auditor should develop a good understanding of the audited entity’s business and its environment.<sup>10</sup> Establishing an audit plan involves the creation of an overall audit strategy prior to the auditor’s identification and assessment of the risks of material misstatement<sup>11</sup>, and the design of further audit procedure if necessary (e.g. in response to assessed risk).<sup>12</sup>

The guidance provided by ISAs only requires auditors to take a minimum concern for financial fraud but does not place the auditor in the role of a first responder for fraud.<sup>13</sup> In other words, according to ISA, auditors will not become first responders to financial fraud if they maintained “*an attitude of professional skepticism throughout the audit*”<sup>14</sup>. First responders for financial fraud are the management and the persons responsible for governance of the entity. Therefore, ISAs do not impose a liability on auditors directly. However, auditors still can be held liable for undetected fraud in accounts under statutory law and common law rules.

## 2. AUDITOR LIABILITY IN EU LAW

Although EU law does not itself directly impose any uniform rules on auditor liability, auditor liability might arise due to misstatements in and omissions from the periodic disclosures and prospectuses issued in regulated markets, as harmonised by

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<sup>8</sup> FRC, Auditing Practices Board, ‘Professional Scepticism Establishing a Common Understanding and Reaffirming Its Central Role in Delivering Audit Quality’, March 2012.

<sup>9</sup> Ibid, pp. 12-3.

<sup>10</sup> ISA 315.

<sup>11</sup> ISA 300.

<sup>12</sup> ISA 330.

<sup>13</sup> G. Stevenson Smith, ‘Can an auditor ever be a first responder to financial frauds?’ (2012) 19(3) Journal of Financial Crime 291.

<sup>14</sup> See ISA 240. See also the case, *Llyod Cheyman & Co Ltd v Littlejohn & Co* [1987] BCLC 303, where not applying professional practice was regarded as evidence of breach of duty. See also Paul L. Davies and Sarah Worthington, *Gower & Davies’ Principles of Modern Company Law*, (9<sup>th</sup> edn, Sweet and Maxwell, London 2012) p. 937.

EU law. The Transparency Directive 2004/109/EC (as amended) requires companies whose securities are traded on regulated markets (e.g. the London Stock Exchange) to provide periodic disclosure documents (e.g. annual and half-yearly financial reports).<sup>15</sup> In addition, according to the Prospectus Directive 2003/71/EC (as amended), a prospectus must be available to the public when securities are offered to the public or admitted to trading.<sup>16</sup> Member States implement these directives by setting the rules for listing standards, disclosure of information in a prospectus and periodic information under a component authority.<sup>17</sup>

A prospectus is a disclosure document and it must contain all the information required by investors to make an informed assessment of assets and liabilities, financial position, profit and losses, and the prospects of the issuer and of any guarantor and the rights attaching to the securities.<sup>18</sup> As the Prospectus Directive requires, Member States shall apply “*their laws, regulations and administrative provisions on civil liability*” to those responsible for the information contained in the prospectus.<sup>19</sup> Similarly, Transparency Directive 2004/109/EC (as amended) requires Member States’ laws, regulations, and administrative provisions on liability apply to the issuers and other persons responsible under the Directive.<sup>20</sup>

Although EU law left auditor liability rules to be regulated by Member States, in 2008, the European Commission issued Recommendation 2008/473/EC allowing liability limitations.<sup>21</sup> In the Recommendation, the European Commission suggested three possible liability limiting methods, arguing that this would reduce barriers to entering the audit market and reduce liability risk in capital markets.<sup>22</sup> The suggested liability caps were as follows: (i) an EU-wide cap that sets a maximum amount of

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<sup>15</sup> Directive 2004/109/EC (as amended) (n 1), Articles 4-6.

<sup>16</sup> Directive 2003/71/EC (as amended) (n 2), Article 5.

<sup>17</sup> FCA’s Prospectuses Rules, Listing Rules and Disclosure and Transparency Rules exist for the purpose of implementing the Prospectus Directive and Transparency Directive respectively. See further Section 3.2.2 below.

<sup>18</sup> See Directive 2003/71/EC (as amended) (n 2), Article 5(1). See also the Commission Regulation No 862/2012 that sets out the requirements as regards to information included into a prospectus. See Commission Delegated Regulation (EU) No 862/2012 (amending Regulation (EC) No 809/2004) under authority given by the Directive 2010/73/EU.

<sup>19</sup> Directive 2003/71/EC (as amended) (n 2), Article 6.

<sup>20</sup> Directive 2004/109/EC (as amended) (n 1), Article 7.

<sup>21</sup> Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms 2008/473/EC OJ L 162/39.

<sup>22</sup> Commission Staff Working Document Accompanying Document to The Commission Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms Brussels, SEC(2008) 1975.

compensation, (ii) a cap on auditors' liability depending on the company size (measured by its market capitalisation), and (iii) proportionate liability where the auditor is liable only for the share of the loss that is attributed to his (or her) actions (or inaction).<sup>23</sup> In other words, under proportionate liability, an auditor could be liable only for the proportion of loss that corresponds to their degree of responsibility in negligence.

The proposed liability limiting methods aimed to restrict the liability exposure of the audit profession. The main grounds for this approach of the Commission might be the possible disappearance risk of the Big Four in case of any major lawsuits takes place.<sup>24</sup> Small and mid-tier audit firms face obstacles to entering the audits of large listed firms that are dominated by the Big Four.<sup>25</sup> As these firms face difficulties accessing the market and competing with the Big Four, liability risks constitute another difficulty. The existence of an auditor liability cap may help smaller audit firms breaking up the market and entering into a specific market segment that is currently dominated by the Big Four (i.e. the main index and regulated market).<sup>26</sup> Also, an auditor liability cap might help reduce the risk of firms' failure because of civil litigation. Moreover, it might encourage the growth of smaller audit firms because investors may be eager to invest in the audit firms if liability risks were reduced. Therefore, an auditor liability cap could be helpful in reducing the audit market concentration and eliminating the risk of further concentration.

Directive 2006/43/EC left auditor liability issue to be regulated by the national laws of the Member States.<sup>27</sup> As a result, there is no common approach in EU Member States with respect of auditor liability regimes and thus, there are differences in the scope of auditor liability, statutory liability limitations, and practices of standing to sue.<sup>28</sup> These differences may suggest that there is no harmonisation on auditor

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<sup>23</sup> Commission Recommendation 2008/473/EC (n 21).

<sup>24</sup> See also Section 3.3 below.

<sup>25</sup> For the high concentration in the audit market, see Chapter II, Section 2.4.

<sup>26</sup> Study by London Economics on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F) Final Report to EC-DG Internal Market and Services, Germany September 2006 p. 164.

<sup>27</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87, Article 31.

<sup>28</sup> A Study on Systems of Civil Liability of Statutory Auditors in the Context of a Single Market for Auditing Services in the European Union, carried out on behalf of the European Commission, 15 January 2001 p. 101.

liability in the EU, although EU Recommendation 2008/473/EC aimed to establish a common approach to liability caps.

Apart from the permission given for liability limitation agreements, the EU has left the regulation of auditor liability to Member States. Although auditor liability has been much debated since the global financial crisis, recent EU reforms did not cover this issue.<sup>29</sup> This may suggest that the EU is not in favour of EU-level regulation on auditor liability. However, the lack of EU-level regulation on auditor liability should not reduce the significance of this issue. It is most likely that an ideal liability regime would be the one that suits a particular country's legislative and market structure most. The differences between Member States can account for the reason the EU chose to propose liability limitations in the form of a Recommendation rather than a binding regulation.

In light of the above considerations, further examination of auditor liability for tortious acts and negligent misstatements is necessary in order to understand the role of auditors and their legal responsibility. To provide an example, the next section will closely look at UK law and question to whom and under what conditions auditors can be held liable in UK law. The pillars of the liability regime in the UK were set in the late 19<sup>th</sup> century.<sup>30</sup> Its rules have broad application, which has resulted in extensive discussion on the issue. Thus, looking into the UK liability regime is useful for setting the scene for the subsequent discussion of auditing law in Turkey (including questions of auditor liability) in Chapter VI.

### **3. AUDITOR LIABILITY FOR NEGLIGENCE AND FRAUD IN UK LAW**

As previous chapters discussed, auditors have two roles: detectives (public watchdogs) and certifiers (gatekeepers).<sup>31</sup> In addition to the detective-auditor role, companies ask auditors to approve the information that will be disclosed to third parties, namely shareholders, investors or in general to the public. Because of this dual role, there is no single liability regime for auditors. Instead, auditors may be

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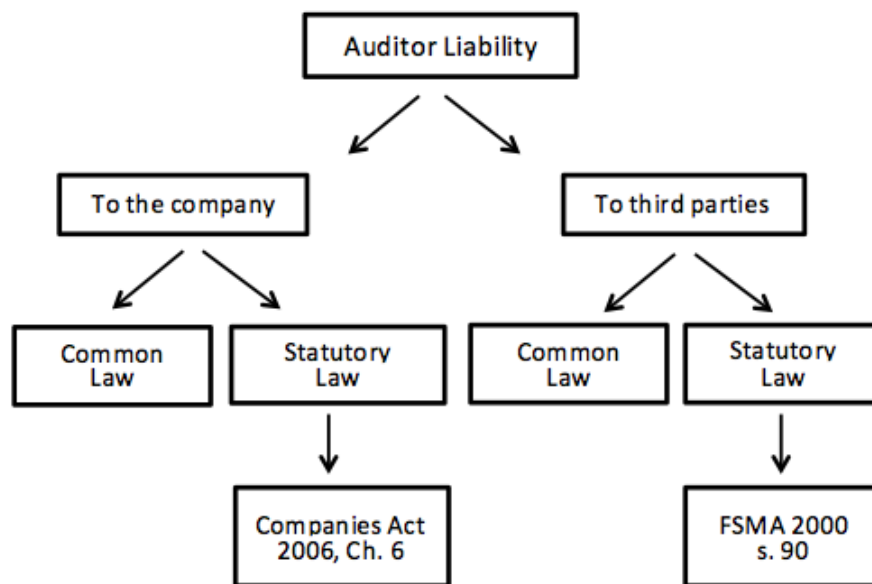
<sup>29</sup> For a critique of the EU reforms, see Chapter IV, Section 3.

<sup>30</sup> See Section 3.1 below.

<sup>31</sup> For the dual role of auditors, see Chapter II, Section 1.2.

potentially subject to three or four liability rules (i.e. ‘multi-layered’ liability of auditors<sup>32</sup>).

In addition to civil liability, auditors might be subject to criminal liability for breach of their duties. Although discussions in this section will mainly consider civil liability rules, it may be useful to briefly explain what the criminal liability conditions are. As the Companies Act 2006 obliges, an auditor must carry out investigations that enable him (or her) to form an opinion as to whether the company’s accounts are in agreement with the accounting records, otherwise the auditor shall state the fact in this report.<sup>33</sup> According to the Companies Act 2006, an auditor who knowingly or recklessly makes a statement in the audit report that is misleading, false, or deceptive is subject to criminal liability.<sup>34</sup> An auditor can also be subject to criminal liability for intentional or reckless misstatements.<sup>35</sup> In other words, the claimant company must prove that the auditor has intentionally stated the inaccurate information.



**Figure 5.1:** Auditor Liability in UK Law

<sup>32</sup> Giudici explains auditor liability under four titles: (i) auditor liability to the company, (ii) auditor liability to third parties, (iii) auditor liability in primary markets, and (iv) auditor liability in secondary markets. See Paolo Giudici, ‘Auditors’ Multi-Layered Liability Regime’ (2012) 13(4) European Business Organization Law Review 501.

<sup>33</sup> Companies Act 2006, s. 498.

<sup>34</sup> *Ibid*, s. 507.

<sup>35</sup> Davies and Worthington (n 14) p. 846.

As Figure 5.1 shows, auditors are liable to both the audited company and third parties (i.e. the investors). These will be examined separately.

### 3.1. Auditor Liability to the Company

Auditors are hired and paid by a company to provide an audit report based on the financial statements of that company. This contractual relationship imposes on auditors a duty of care to the audit client (i.e. the audited company). Both under statutory law and common law, auditors owe a duty of care to the company that they audit, i.e. see Figure 5.1 above.

Although Chapter 6 of the Companies Act 2006 relates to auditor liability, the Act does not specify the conditions of a liability regime. Instead, the elements of civil liability action are specified by common law rules.<sup>36</sup> Under case law, a claim against an auditor could be based either on the tort of negligence or contract.

Cases from the 19<sup>th</sup> century described the standard of care to be exercised by auditors when performing the audit work. In *Re London and General Bank*, Lindley LJ stated that:<sup>37</sup>

*“An auditor... is not an issuer; he does not guarantee that the books do correctly show the true position of the company’s affair; he does not even guarantee that his balance sheet is accurate according to the books of the company...”* but auditors must exercise *“reasonable care and skill”* and *“...he must not certify what he does not believe to be true”*.

In another 19<sup>th</sup> century case, in *Re Kingston Mill Company*,<sup>38</sup> the accounts of the company had been certified wrongly by company managers for years. The liquidator of the company claimed against the auditors for the overstated value of stock-in-trade. For the value of the stock, auditors had relied on the certificate of a director and manager. The court discharged auditors of liability for believing the certifications of the company director and held that they were not in breach of their duty of care and skill because they were entitled to rely on the director. Lopes LJ

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<sup>36</sup> Janne Chung, Jonathan Farrar, Poonam Puri, and Linda Thorne, ‘Auditor Liability to third parties after Sarbanes-Oxley: An international comparison of regulatory and legal reforms’ (2010) 19(1) *Journal of International Accounting, Auditing, and Taxation* 66 p. 70.

<sup>37</sup> Lindley LJ in *Re London and General Bank (No. 2)* [1895] 2 Ch. 673, Court of Appeal.

<sup>38</sup> *Re Kingston Cotton Mill Co. (No. 2)* [1896] 2 Ch. 279, Court of Appeal.

described the duty of auditors in stating that “*An auditor is not bound to be detective. He is a watchdog, but not a bloodhound*”.<sup>39</sup>

This case established that auditors may rely on the certifications of the company director in the absence of suspicious circumstances. However, it is a professional requirement for auditors to have a questioning mind in terms of ‘professional scepticism’.<sup>40</sup> Therefore, auditors must be critical of the accounts and reports provided by the company management in order to perform the audit work properly.

Based on the contractual relationship between the auditor and the company, the statutory auditor’s duty is to ensure the annual accounts of the company present a true and fair view. In addition, the statutory auditor is responsible for the certification of the accounts, and for consideration of fraudulent misstatements in financial accounts. In principle, if an auditor fails to discover misstatements in a company’s account due to negligence, the auditor could be held liable and be asked to recover the whole of the loss. In addition, the statutory auditor must alert the audited company and disclose information about important events, such as the increase or decrease of capital, mergers, insolvency, and any other factors that might affect the company’s going concern ability.<sup>41</sup> The company and the auditor have a client relationship and the audit client could make a claim against the auditor based on the contract between them.<sup>42</sup>

Nevertheless, a different result was reached in *Stone & Rolls v Moore*.<sup>43</sup> Stone & Rolls (S&R) was a one-man company under complete control and ownership of Mr. Stojevic that was involved in a large-scale fraud. The company went into liquidation as a result of the claims brought against it by banks. The appointed liquidators sued the auditor (Moore Stephens) on behalf of the company, claiming that the auditors should have discovered the fraud. The auditor raised the defence of *ex turpi causa non oritur actio*: that a party engaged in an illegal act cannot bring a claim.<sup>44</sup> If this defence was to succeed, then the court would have to treat the fraud of the “directing

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<sup>39</sup> Ibid.

<sup>40</sup> See ISA 315. See also Section 1 above.

<sup>41</sup> For auditors’ duty to issue going concern opinions, see Chapter II, Section 3.1.

<sup>42</sup> Davies and Worthington (n 14) p. 837.

<sup>43</sup> *Stone & Rolls Ltd (In Liquidation) v Moore Stephens (A Firm)* [2009] 2 B.C.L.C. 563; [2009] UKHL 39; [2009] 1 AC 1391, House of Lords.

<sup>44</sup> Lee Roach, ‘Auditor liability: the case for limitation: Part 1’ (2010) 31(5) *Company Lawyer* 135, p. 140.

*mind and will*” of the company (i.e. Mr. Stojevic) as the fraud of the company. The House of Lords was prepared to do so.

By a three to two majority<sup>45</sup>, the House of Lords held that Stojevic’s deliberate fraud – which would be attributed to the company itself - prevented the auditors from being liable, even though the auditors had failed in their contractual duty (i.e. to use reasonable care and skill in investigating the accounts and documents).<sup>46</sup> Lord Philips held that S&R’s claim could not succeed for two reasons. First, S&R was seeking to put itself forward as the victim of fraud when it was, in fact, the perpetrator of the fraud.<sup>47</sup> Second, S&R should not be able to seek compensation for the consequences of its own fraud where the defendants (i.e. S&R’s auditors: Moore Stephens) were also the victims of S&R’s fraud.<sup>48</sup>

The other issue here is the fact that S&R was an insolvent company. This meant that the beneficiaries of a successful claim against the auditors would not be the shareholders, but the creditors. It might seem appropriate to use the *ex turpi causa* defence to prevent a one-man company, controlled by a fraudulent shareholder, from suing for the benefit of that shareholder. But should it not be different if the benefit of the action would go to the creditors, who took no part in the fraud? In addition to the creditors, other stakeholders may be affected by the fraudster’s mismanagement, and as argued, excluding the interests of other stakeholders may be unjust.<sup>49</sup> Yet, the House of Lords insisted on applying the *ex turpi causa* defence, notwithstanding that interests of creditors thereby lost out.<sup>50</sup> This can be justified by reasoning that an auditor’s duty to the company is owed for the benefit of the interests of the shareholders but not the interest of its creditors.<sup>51</sup> Because S&R was a one-man

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<sup>45</sup> The majority judges were Lords Philips, Walker and Brown; the dissenting judges were Lords Scott and Lord Mance.

<sup>46</sup> *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43).

<sup>47</sup> Lord Philips of Worth Matravers para. 61 in *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43).

<sup>48</sup> *Ibid.*

<sup>49</sup> Ernest states that other than creditors there are also other stakeholders who would be affected by the fraudster’s mismanagement and the auditors’ failure to detect such fraud. See Lim Ernest, ‘A critique of corporate attribution: “directing mind and will” and corporate objectives’ (2013) 3 *Journal of Business Law* 333 pp. 350-1.

<sup>50</sup> *Ibid.*

<sup>51</sup> See Lord Philips of Worth Matravers para.19 in *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43). See also Len Sealy and Sarah Worthington, *Sealy’s Cases and Materials in Company Law* (9<sup>th</sup> edn, OUP 2010) p. 442. See also *Al Saudi Banque v Clarke Pixley* [1990] Ch 313, a claim that a duty of care was owed by auditors to a bank lending to a company was rejected.

company and the sole shareholder was the perpetrator of the fraud, the *ex turpi causa* defence was applicable: S&R could not make a claim by relying on its own illegal acts.

Lord Brown and Lord Walker explicitly rejected the argument advanced by the company – through its liquidator - that the auditors should be liable in respect of all such losses as were occasioned by the fraud from the time when auditors should have uncovered it.<sup>52</sup> Such a liability cannot be imposed on auditors because such a duty - of detection of fraud - is not the responsibility of auditors, and therefore would be counter to the principle established in *Caparo*.<sup>53</sup> Auditors cannot be held liable for relying on management's representations and company records<sup>54</sup> if they showed professional scepticism regarding the accounts.<sup>55</sup>

In this case, the House of Lords attributed the fraud to the 'directing mind and will' of the company. Nevertheless, it is unclear whether the negligent auditors will still be discharged of the liability for undetected fraud if there were non-fraudulent shareholders or directors.<sup>56</sup> It may be useful to discuss here what if it was not a one-man company but there was a powerful fraudster director with a 'directing mind and will' and also there were current shareholders that did not involve in fraud.

The scenario reads as follows: there is a 'directing mind and will' who is the perpetrator of the fraud, and the auditors failed to detect the fraud. If the company sued the auditors, the auditors might be able to invoke a defence based on *ex turpi causa*. Shareholders, however, cannot sue the *auditors* on behalf of the company (as opposed to derivative actions due to *directors'* misconduct).<sup>57</sup>

What if the current shareholders decide to sue the auditors in their own names? To make a successful claim, innocent shareholders have to meet the three criteria

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<sup>52</sup> Lord Brown of Eaton-Under-Heywood para. 202 and Lord Walker para 241 in *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43). See also Sealy and Worthington (n 51) pp. 442-3.

<sup>53</sup> Lord Brown of Eaton-Under-Heywood para 202 in *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43).

<sup>54</sup> See *Re Kingston Cotton Mill Co.* (n 38).

<sup>55</sup> See Section 1 above.

<sup>56</sup> Davies and Worthington (n 14) pp. 843-4. See also Sealy and Worthington (n 51) pp. 165-73.

<sup>57</sup> A derivative claim must be brought for the actions arise from an actual or proposed act or omission involving negligence, default, and breach of duty or breach of trust by a director of the company. See Companies Act 2006, Part 11, ss. 260(3) and 265(3).

established by *Caparo*<sup>58</sup> (i.e. (i) foreseeability of damage, (ii) proximity of relationship, and (iii) reasonableness to owe a duty of care). If some of the shareholders are involved in fraud, the Court may reject the claim, arguing that it is not fair and reasonable to make a claim because of the possibility of “...*the fraudulent shareholders profiting from their dishonesty*”,<sup>59</sup> as Lord Philips stated. In other words, if the class action is accepted by the courts, shareholders who were involved in the wrongdoing might benefit by an increase in value of the company which would be unjust. In addition, there may be a problem due to the principle of ‘no reflective loss’: namely, that shareholders cannot bring a claim against where the loss they claim to have suffered is itself simply a consequence of a loss first suffered by the company.<sup>60</sup>

Thus, it seems that it is difficult to sue auditors on behalf of the company and in the personal claim of the shareholder’s damages where a ‘directing mind and will’ (e.g. a powerful CEO) was involved in fraud whilst controlling the company. This decision of the House of Lords is, in fact, in line with the professional standards that attribute primary responsibility for detecting fraud to the company management instead of the auditors. Thus, the decision on *Stone & Ross v Moore* seems legitimate. Otherwise, it would be unjust to allow compensation to the company management for a loss resultant from their own wrongdoings where their main role was to prevent such misconduct.

### ***Conclusion***

With regards the contractual relationship, an auditor could be held liable if he (or she) failed to meet his (or her) duty of care in the completion of his duties to the company. For instance, if the auditor fails to discover irregular or misleading information in the accounts, not to disclose or late disclose of fraud, and not to complete other duties, he (or she) could be held liable. Yet, for a class action in negligence it must be shown that auditors owe a duty of care to the company (based on contract) or misstatements were made intentionally and recklessly (based on tort).

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<sup>58</sup> *Caparo Industries plc v Dickman* [1990] 2 A.C. 605. See also Section 3.2.1 below.

<sup>59</sup> Lord Philips of Worth Matravers para. 61 in *Stone & Rolls Ltd (In Liq) v Moore Stephens (A Firm)* (n 43).

<sup>60</sup> See *Johnson v Gore Wood & Co.* [2002] 2 A.C 1, House of Lords.

Therefore, auditors' liability to the company is limited in accordance with the scope of their duty of care to the company as based on their contractual relationship.<sup>61</sup>

Other than a claim based on contract, a claimant can take a class action based on the tort of negligence. Tortious auditor liability is often used for third parties other than the company, such as investors. Although common law established auditor liability to the company in principle, auditor liability to third parties is limited under common law rules. Hence, the statutory provisions of FSMA 2000 also determined the elements of the auditor liability to third parties. Next, auditor liability to third parties under common law and statutory law will be examined respectively.

### **3.2. Auditor Liability to Third Parties**

The question under this auditor liability regime is whether an auditor owes a duty of care to a creditor or a shareholder who relies on its audit report to get funds for the company or to buy shares of the company in financial markets. In financial markets, audited accounts are required to be available to the public,<sup>62</sup> for the use of prospective purchasers of shares, or potential creditors. It should be considered cautiously how wide the scope of auditor liability for negligence and fraud to third parties should be. Otherwise, auditors would be liable to a very large number of persons. If liability on the part of auditors were unrestricted, this would cause a liability, as famously described, of “*a liability in an indeterminate amount for an indeterminate time to an indeterminate class*”.<sup>63</sup>

In line with this argument, UK common law established that auditors owe no general duty to third parties, but owe a duty of care to a third party in a tort of negligence, if special conditions exist. Common law and FSMA rules will be examined separately as they verify auditor liability differently.

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<sup>61</sup> Davies and Worthington (n 14) p. 841.

<sup>62</sup> Listing Rules require that companies provide full information when shares are first offered to the public, and on a continuing basis.

<sup>63</sup> Cardozo C.J. in *Ultramares Corp v Touche* (1931) 174 N.E. 441.

### 3.2.1. Auditor Liability to Third Parties under Common Law

UK common law rules establish a duty of care for auditors to the company and provide a relatively clear view on the scope of such duty.<sup>64</sup> However, the common law approach on auditor liability to third parties is rather complicated. Besides, common law imposes a limited duty of care on auditors to third parties by binding liability to special circumstances and conditions.

*Derry v Peek*<sup>65</sup> recognised auditor liability to third parties if only a tortious act exists, meaning that any third party may sue the auditor in principle, but that the auditor could be liable only if the claimant proves that the auditor owed a duty in tort of deceit. Moreover, this liability is subject to two conditions: the liability arises only if the fraudulent auditor is aware that statements are misrepresented, and that some investors are going to rely on them.

In *Derry v Peek*,<sup>66</sup> the company showed in its prospectus that it had permission to use steam trams, although there was no such permission. After the prospectus was issued, the company did not get permission and went into liquidation. Shareholders, who had purchased stakes in the company after relying on the statement's truth, sued the company. The House of Lords decided that liability in the tort of negligence caused by misstatements could not be accepted because the company honestly believed that it would get permission.<sup>67</sup> The House of Lords reported that in an action of deceit, the plaintiff must prove actual fraud.<sup>68</sup> If the person made such statement in the honest belief of its truth, this cannot be considered as fraud and therefore, the person cannot be held liable because of the economic loss. Therefore, the liability imposed by *Derry v Peek* required false statements. In other words, if the defendant honestly (even if unreasonably) believed that the statements were true, he (or she) could not be held liable for fraud.<sup>69</sup> In addition, the fraudulent auditor will escape liability if he (or she) did not intend the claimant to rely on that false statement. These limitations

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<sup>64</sup> See Section 3.1 above.

<sup>65</sup> *Derry v Peek* (1889) 14 A.C. 337, House of Lords.

<sup>66</sup> *Ibid.*

<sup>67</sup> Davies and Worthington (n 14) p. 930.

<sup>68</sup> *Derry v Peek* (n 65).

<sup>69</sup> For criminal liability, auditors must knowingly or recklessly misstate the accounts in the audit report that are misleading, false or deceptive. See Companies Act 2006, s.507 (1), (3). See also Section 3.1 above.

for liability limited the range of potential claimants and the circumstances in which liability for deceit will arise.<sup>70</sup>

Later, the decision in *Hedley Byrne*<sup>71</sup> overruled these limitations by recognising a general duty to take care to avoid negligent misstatements causing economic loss.<sup>72</sup> This means that a contractual relationship was not necessary for tortious liability claims.<sup>73</sup> In *Hedley Byrne*, it was held that a duty of care will arise and a person could be held liable if he negligently makes a false statement and this causes a financial loss to another.<sup>74</sup> However, it was not clear from *Hedley Byrne* (a case not involving an auditor) in what conditions a duty of care to avoid misstatements causing economic loss would be imposed on auditors.<sup>75</sup> Instead, *Caparo*<sup>76</sup> is accepted as the leading case on the application of a general duty of care of auditors to third parties. *Caparo* viewed auditor liability to third parties in a rather limited way, holding that auditors owe no general duty of care to third parties, thus favouring auditors over investors.

*Caparo Industries Plc.* launched a takeover bid for *Fidelity Plc.* but later discovered that the company's profits had been overstated by its auditor (Dickman who was a partner in *Touche Ross*). *Caparo* unsuccessfully sued the auditor, claiming that it had paid too much for shares in relying on the certification of the auditor who negligently stated a profit of £1.2 million when there had in reality been a loss of £0.4 million.<sup>77</sup> However, this case held that auditors owed no general duty of care to members of the public who relied on the company's audited accounts when deciding to buy shares and subsequently suffered loss.<sup>78</sup>

In *Caparo*, the House of Lords stated that auditors owed a duty of care to the company and to its shareholders (collectively), but not to individual shareholders or any other third parties. The reason for this is that the audit work is performed under

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<sup>70</sup> Davies and Worthington (n 14) p. 847.

<sup>71</sup> *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A.C. 465, House of Lords.

<sup>72</sup> Davies and Worthington (n 14) p. 847.

<sup>73</sup> Roach (n 44) p. 139.

<sup>74</sup> *Hedley Byrne* (n 71) at 514.

<sup>75</sup> Davies and Worthington (n 14) p. 847.

<sup>76</sup> *Caparo* (n 58).

<sup>77</sup> Carl Pacini, William Hillison, Ratnam Alagiah, and Sally Gunz, 'Commonwealth Convergence Toward a Narrower Scope of Auditor Liability to Third Parties for Negligent Misstatements' (2002) 38(3) *Abacus* 425 p. 461.

<sup>78</sup> *Caparo* (n 58).

contract between the auditor and the company as a separate person, and hence auditors owe a contractual duty of care to the company but not to individual shareholders.<sup>79</sup>

However, the House of Lords determined that auditors owe a duty of care in negligence to third parties if three special conditions exist, with the burden of proof placed on the defendant.<sup>80</sup> This three-stage test of *Caparo* requires: first, the defendant must know, or ought to know, that a third party would rely on their work (foreseeability of damage); second, there should be a relationship of sufficient proximity between the claimant and respondent (e.g. the auditor knew that the statement or information would be communicated to the respondent directly or indirectly and knew that it was very likely that the claimant would rely on it in deciding whether or not to engage in transactions<sup>81</sup>); and third, it must be just and reasonable to impose a duty of care (e.g. auditors of a subsidiary might be assumed to have responsibility in owing a duty of care to a client's parent company<sup>82</sup>).

The judge's decision was based on the argument that auditors owed no duty of care to anyone who relied on the accounts and audit reports and purchased company shares regardless of whether this person is an existing shareholder or non-shareholder.<sup>83</sup> In other words, the judgement stated that auditors owe a duty to the company (arising from their contractual relationship) but not to creditors or to any single shareholder.<sup>84</sup> Therefore, auditors owed *Caparo* no duty of care in negligence because liability did not arise since there was no proximity of relationship. Of course, auditors would be held liable if these special conditions existed; say, if the auditor knew that the information would be communicated to the claimant and knew that the claimant would rely on that information when making a transaction and resultantly suffered a loss.

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<sup>79</sup> In principle, individual members may have a claim based on tort for negligent misstatements. See *Sealy and Worthington* (n 51) p.434. See also Section 3.1 above.

<sup>80</sup> *Davies and Worthington* (n 14) p. 925.

<sup>81</sup> Lord Bridge of Harwich in *Caparo* (n 58). See also Alan Dignam, *Hicks and Goo's Cases and Materials on Company Law* (7<sup>th</sup> edn, OUP 2011) p. 534.

<sup>82</sup> For a discussion on assumption of responsibility, see *Davies and Worthington* (n 14) pp. 850-1.

<sup>83</sup> HM Treasury, 'Davies Review of Issuer Liability: Liability for misstatements to the market' A discussion paper by Professor Paul Davies, March 2007 (Davies Review) para. 36.

<sup>84</sup> See *Al Saudi Banque* (n 51). See also *Giudici* (n 32) p. 532.

According to the ruling in *Caparo*, auditors of a public company owe no general duty of care to non-clients (i.e. third parties, such as individual shareholders, creditors, or prospective purchasers of shares of the company) who relied upon the accounts in deciding to buy shares in the company. To make a claim based on negligence, it is necessary to prove that the defendant was fully aware and knew that the information would be communicated to the plaintiff directly (or indirectly) and knew that it was very likely that the plaintiff would rely on that information in deciding whether or not to make a transaction. Without such limitation, auditors would be subject to unlimited liability towards unlimited persons who suffered economic loss (i.e. the floodgate argument<sup>85</sup>).

The *Caparo* judgement was later applied by other courts. In the *Al Nakib*<sup>86</sup> case, the prospectus was issued in connection with a rights issue (the opportunity for existing shareholders to buy additional shares in a company) but the claimants used the prospectus for buying shares in the market. It was held that as the prospectus addressed existing shareholders only, the duty of care notion should not cover the relationship between the issuer and purchasers on the open market.

Both in *ADT Ltd v BDO Binder Hamlyn*<sup>87</sup> and in *Yorkshire Enterprise Ltd et al v Robson Rhodes*<sup>88</sup> the Courts granted damages to investors where the auditors certified that the annual financial accounts were free from material misstatement although they were actually misstated.

In *ADT Ltd v BDO*, the plaintiff completed the acquisition of the targeted company in reliance on the statutory auditor's (BDO Binder Hamlyn) confirmation that the audited accounts presented a true picture of the company. By orally confirming the accuracy of the audited accounts, the auditor assumed responsibility towards to the plaintiff.<sup>89</sup> Therefore, the Court found auditors negligent and concluded the plaintiff's damages should be compensated. BDO Binder Hamlyn entered an appeal, but later withdrew it and settled for a payment of £50 million.<sup>90</sup>

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<sup>85</sup> See Guidici (n 32) p. 532.

<sup>86</sup> *Al Nakib Inv (Jersey) Ltd. v Longcroft* [1990] 1 W.L.R. 1390.

<sup>87</sup> *ADT Ltd v BDO Binder Hamlyn* [1996] BCC 808.

<sup>88</sup> *Yorkshire Enterprise Ltd et al v Robson Rhodes* [1990] QB, HC.

<sup>89</sup> Dignam (n 81) p. 537.

<sup>90</sup> *Ibid.*

In *Yorkshire Enterprise Ltd et al v Robson Rhodes*,<sup>91</sup> auditors were held liable for negligently misinforming a company who relied on the financial reports of statutory auditors for their investment. The ‘special relationship’ required by *Caparo*<sup>92</sup> existed, since the auditors were aware that the final decision to invest in the company would be based on those reports.

In *Possfund v Diamond*,<sup>93</sup> the Chancery Division of the High Court suggested the application of liability for negligence regarding third parties in a broader way. The court stated that although a prospectus is issued to give information for existing shareholders, the information in prospectuses is also used in aftermarket purchases.<sup>94</sup> Therefore, it is suggested that the scope of the duty of care owed was not only to the initial subscriber, but also extended to subsequent purchasers in the aftermarket, since the aim of a prospectus was also to induce purchasers in the aftermarket.<sup>95</sup>

It is true that companies issue prospectuses not only for subscribers but also for aftermarket interests. Hence, the view held in *Possfund* is rather satisfactory in terms of the current market practices comparing the narrow approaches held in both *Caparo* and subsequent cases. Nevertheless, the decision of the Chancery Division could not change the law established by higher courts in *Caparo*. Hence, the restricted liability of auditors to third parties under common law is standing. A broader approach to auditor liability to third parties can be found under the statutory provisions of FSMA 2000, which will be examined next.

### 3.2.2. Auditor Liability to Third Parties under Statutory Law

The Financial Conduct Authority (FCA) is the primary regulator in the financial markets area. The FCA sets the rules and standards for the disclosure requirements of companies whose shares are traded in primary and secondary markets. Previously, the FSA was the single regulatory body in the UK financial markets area.<sup>96</sup> In 2012,

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<sup>91</sup> *Yorkshire Enterprise* (n 88).

<sup>92</sup> See *Caparo* (n 58).

<sup>93</sup> *Possfund Custodian Trustee Ltd. v Diamond* [1996] 1 W.L.R. 1351.

<sup>94</sup> See *ibid* at 1365-66. See also Carsten Gerner-Beuerle, ‘The Market for Securities and Its Regulation through Gatekeepers’ (2009) 23 *Temple International and Comparative Law Journal* 317 p. 349.

<sup>95</sup> *Possfund v Diamond* (n 93).

<sup>96</sup> FSMA, s. 2(2)(a-d).

via amendments in Financial Services Act,<sup>97</sup> the role of the FSA as a single regulatory body split to three new regulatory bodies: Financial Policy Committee (FPC) of the Bank of England, FCA, and the Prudential Regulatory Authority (PRA).<sup>98</sup> However, the new Act does not provide for any substantial changes regarding the general functions of regulatory bodies. The Act determines the objectives of the FCA as stabilizing market confidence (the strategic objective) and consumer protection (the operational objective). In addition, two new objectives of efficiency and choice, and integrity, replaced the reduction of financial crime objective.<sup>99</sup>

Within this scope, the FCA issues rules and gives general guidance regarding the policy and principles of the FSMA.<sup>100</sup> The requirements of EU Directives in terms of listing requirements, public offerings, and disclosure requirements are transposed into UK domestic law through rules issued by the FCA under amendments to FSMA 2000 (i.e. Listing Rules, Prospectus Rules, and Disclosure and Transparency Rules).<sup>101</sup> Civil liability remedies are available for the non-implementation of the FCA's rules.<sup>102</sup> This section will examine civil liability of auditors for prospectuses as governed by s. 90 of FSMA.

However, it is first necessary to point out what might appear to be another statutory basis for action. The Misrepresentation Act 1967 introduced a statutory remedy for negligent misstatements contained in a document other than prospectuses, issued in connection with the offer.<sup>103</sup> The Misrepresentation Act 1967 gives a cause of action only to the other party to the contract,<sup>104</sup> such as an injured investor. Because the Misrepresentation Act 1967 requires there should be a contractual relationship for negligence liability between the claimant and the defendant, it is unlikely auditors

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<sup>97</sup> The Financial Services Act 2012 (came into force in 1 April 2013) amended the Bank of England Act 1998, the Financial Services and Markets Act 2000 and the Banking Act 2009.

<sup>98</sup> See HM Treasury website [http://www.hm-treasury.gov.uk/fin\\_financial\\_services\\_bill.htm](http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm) accessed 14/02/2013.

<sup>99</sup> Graeme Baber, 'A new approach to financial regulation: a step into correct direction?' (2012) 33(1) Company Lawyer 3 p. 6.

<sup>100</sup> The Financial Services Act 2012, Chapter 21 Amendments of the FSMA 2000 5(1).

<sup>101</sup> See also Section 2 above.

<sup>102</sup> In addition to civil liability remedies, the FCA can impose criminal and regulatory sanctions. For instance, under Listing Rules 5, the FCA may suspend or cancel listing of the securities if the issuer fails to meet its obligations for listing and may impose monetary penalties for breach under ss. 91-4 of FSMA. See also Davies and Worthington (n 14) pp. 939-42.

<sup>103</sup> Davies and Worthington (n 14) p. 935.

<sup>104</sup> The Misrepresentation Act 1967, s. 2(1).

would be sued under this Act. Therefore, this Act will not be considered further. In addition, s. 90A of FSMA concerns the liability of issuers only, and exclusively for fraudulent misstatements in, or dishonest omissions, from periodic disclosures.<sup>105</sup> Therefore, s. 90A of FSMA will not be considered here as a basis for auditor liability.

### ***Liability for prospectuses***

Any public sale of shares in the UK must have a prospectus containing information about those shares.<sup>106</sup> Such a prospectus is produced by the issuer to promote its securities to investors.<sup>107</sup> A prospectus must be available to the public whenever (a) transferable securities are to be offered to the public and (b) transferable securities are to be admitted to trade on a regulated market.<sup>108</sup> The Prospectus Rules made by the FCA govern the publication and content of prospectuses in the UK. The FCA also checks whether they are compatible with the requirements stated by the EU Directives and FSMA.

One may ask why there is liability for prospectus misstatements on the basis of negligence. A prospectus is a ‘selling document’, produced by the issuer to promote its securities to investors.<sup>109</sup> Thus, it is recognized that the issuer may be tempted to make a fraudulent misstatement in the prospectus. For instance, the issuer has an extra incentive to hide financial negativities in fund raising because he (or she) will seek to receive high offers.<sup>110</sup>

In financial markets where companies offer their securities for sale, they must appoint sponsors.<sup>111</sup> A sponsor guides the company in the admission of equity shares and meeting responsibilities under the FCA regulations.<sup>112</sup> Before submitting to the FCA for approval, information in the prospectus must be certified by an auditor, stating that no false or misleading information is included in the financial statements.

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<sup>105</sup> FSMA, s. 90A(4), (5).

<sup>106</sup> Listing Rules 2.2.10.

<sup>107</sup> See also Section 2 above for a definition of prospectuses.

<sup>108</sup> FSMA, s. 85(1), (2).

<sup>109</sup> Davies Review (n 83) para.9.

<sup>110</sup> Paul Davies, ‘Liability for Misstatements to the Market: Some Reflections’ (2009) 9(2) *Journal of Corporate Law Studies* 295, pp. 303-4.

<sup>111</sup> Listing Rules 8.2.1.

<sup>112</sup> *Ibid.*, 8.3.1.

So, a written report of the auditor on historical, prospective and interim financial information is included in the preliminary prospectus.<sup>113</sup>

### ***Civil remedies under s. 90 of FSMA***

For negligent false or misleading statements in or omissions from prospectuses s. 90 of FSMA imposes civil liability. Investors may compensate their loss caused by misstatements in or omissions from prospectuses based on negligence. The defendant may escape liability if he (or she) successfully disproves his (or her) negligence.<sup>114</sup>

S.90 imposes liability on “*any person responsible*” to pay compensation to “*a person*” who acquired securities and suffered loss caused by any untrue or misleading statements in, or omission from, prospectuses of any matter that are required to be included by FSMA.<sup>115</sup> For instance, any person responsible for issuing necessary supplementary prospectuses could be held liable to compensate.<sup>116</sup> The claimant here is anyone who acquired securities, has contracted to acquire them, or has an interest in them and who can show a loss caused by the misstatement or omission.<sup>117</sup>

Auditors are accepted responsible and can be held liable as a result of misstatements or omissions in prospectuses. Auditors are in a position to read the prospectus before the registration and to give their consent to the certification of any part of the prospectus.<sup>118</sup> Accordingly, auditors accept responsibility by issuing a report based on the financial information in the prospectus and certifying that there is no false or misleading information included in the statements. Therefore, auditors who accept responsibility in relation to specific parts of a prospectus can be considered defendants for the application of s. 90. However, certifying financial information in

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<sup>113</sup> Fédération des Experts Comptables Européens, ‘Discussion Paper on the Auditor’s Involvement with the New EU Prospectus Directive’, November 2004 p. 10.

<sup>114</sup> FSMA, s. 90.

<sup>115</sup> Requirements of any matter in the case of listing particulars are provided by sections 87A, 87G, and 87B of FSMA in the case of prospectuses. See FSMA, s. 90(1).

<sup>116</sup> A supplementary prospectus must be issued if a significant new factor arises or a material mistake or inaccuracy is noted between the time of approval of the prospectus and the final closing of the offer of securities to the public or the beginning of trading on a regulated market. See FSMA, s. 87G.

<sup>117</sup> FSMA, s. 90(1), (7).

<sup>118</sup> Giudici (n 32) pp. 540-1.

the prospectus does not mean an assurance; instead users of the auditor's report must assess whether the company shares is a good buy.<sup>119</sup>

The burden of the proof is on the defendant (i.e. “*any person responsible*”): so the defendant can escape liability under s. 90, if he (or she) satisfies the court that he reasonably believed the statements were true or not misleading.<sup>120</sup> The defendant also has to prove one or more of the conditions set by the law: (a) that he (or she) continued in his belief until the time when the securities were acquired, (b) they were acquired before it was reasonably practicable to bring a correction, and (c) before the securities acquired he had taken all such steps to make the correction.<sup>121</sup> Thereof, ‘any person responsible’ can be held liable unless he (or she) disproves negligence.

Other than the defence of negligence, the defendant might escape liability if he (or she) disproves the causal link between the defendant's conduct and the loss.<sup>122</sup> Such causal link could be disproved if the defendant proves that the claimant was aware of the false statements and the matters omitted but still made the transaction.

#### ***A comparison of liability under s. 90 and liability under common law***

Instead of a claim under s. 90 of FSMA, a claimant can make a claim under common law rules.<sup>123</sup> Civil remedies available under FSMA rules are superior to those available under general law; thus, general rules are applicable only when the special rules under FSMA are inapplicable.<sup>124</sup>

Common law rules require that there should be a contractual relationship (or a special relationship<sup>125</sup>) for negligence liability between the claimant and the defendant. However, such a contractual relationship (or ‘assumed responsibility’) is not required for a claim based on negligence under s. 90. Any person who has acquired securities on the market, whether by directly from the company or by buying shares on the market, and has shown the loss was caused by misstatement or omissions can be compensated for economic damage under s. 90.

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<sup>119</sup> See (n 113) p. 14.

<sup>120</sup> FSMA, sch.10, para.1.

<sup>121</sup> Ibid, paras.1, 3.

<sup>122</sup> Davies and Worthington (n 14) pp. 932-3.

<sup>123</sup> See Section 3.2.1 above.

<sup>124</sup> Sealy and Worthington (n 51) p. 465.

<sup>125</sup> See *Caparo* (n 58).

To make a claim under common law rules, the claimant must show that he (or she) relied on the statement and that the maker of the false statement intended the recipient to rely on it.<sup>126</sup> Moreover, for a successful claim, there should be tort of deceit, meaning that the defendant must have intentionally misstated information for the use of investors. To put it otherwise, the defendant can escape liability if he (or she) proves the existence of an honest and reasonable belief in the representation of the accounts.<sup>127</sup> These conditions make it difficult to make a claim under common law. On the contrary, according to s. 90, the claimant must only show that they suffered a loss as a result of the misstatement in or omission from prospectuses but it is not necessary to show that they relied on the misstatement. Because of the limitations on the cause of action under the common law, a claim under s. 90 would be more attractive where it is available.<sup>128</sup> It can be concluded that statutory law recognises a wider application of the compensation regime for offered shares than common law rules.<sup>129</sup>

### ***Conclusion on civil liability to third parties***

In case of negligent audits, the company, and anyone to whom auditors owe a duty of care based on their contractual relationship with the company, can claim compensation.<sup>130</sup> However, it is difficult for third parties, such as individual shareholders, to successfully sue auditors for negligent audits unless the auditor makes a false statement knowing that a specific person would rely on that statement.<sup>131</sup> In other words, common law rules established no duty of care owed by auditors to third parties unless either there is tort of deceit or the three-tier test of *Caparo* can be established. The duty owed by auditors to individual shareholders who purchased shares in the company is limited because of the special conditions established by *Caparo*. With respect of liability for prospectuses, despite the restricted scope of auditor liability in common law, under s. 90, auditors can be sued by any person who acquired shares on the regulated market and suffered a loss.<sup>132</sup>

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<sup>126</sup> See *ibid.* See also Section 3.2.1 above.

<sup>127</sup> Misrepresentation Act 1967, s. 2(1).

<sup>128</sup> Davies and Worthington (n 14) p. 935.

<sup>129</sup> *Ibid.* p. 937.

<sup>130</sup> For auditor liability to the company, see Section 3.1 above.

<sup>131</sup> See *Caparo* (n 58).

<sup>132</sup> *Ibid.*, s. 90.

Audited accounts and auditor's report are publicly available, and a very large number of people read and use those reports. A wider application of liability rules can be considered an effective tool to prompt auditors to meet their statutory responsibilities and perform high quality audits.<sup>133</sup> However, the audit market today depends highly on the services of the biggest four audit firms.<sup>134</sup> Disappearance of one of the large audit firms, followed by a major liability claim, is likely to distort audit services in the market. The issue of the civil litigation burden on auditors and its effect on the market, and possible ways of limiting liability for auditors, will be discussed next.

### 3.3. Auditor Liability Limitation and Further Issues

Previous parts have established the extent of auditors' liability to either the company, or third parties.<sup>135</sup> Further issues on auditor liability will be discussed in this part.

When an audit firm is appointed, the firm (generally formed as partnerships) will be held liable together with the auditor who signed the audit report, because of joint and several liability.<sup>136</sup> In other words, each audit partner is jointly and severally liable for the debts of the firm and can therefore be asked to pay for damages regardless of the degree of their involvement at fault. Hence, the tort doctrine of joint and several liability increases the liability risk for each individual auditor.<sup>137</sup>

Audit firms are currently obliged to make professional insurance coverage (or equivalent arrangements) for their services.<sup>138</sup> However, as reported, mandatory insurance covers less than 5% of the larger claims for the Big Four audit firms.<sup>139</sup> Therefore, it is not possible for auditors to cover the whole liability risk with insurance mechanisms.

Moreover, it is a classic case where a claimant who suffered loss as a result of damages caused by the fraudulent or negligent act of someone within the company seeks to recover the whole of the loss from the auditor, even if the auditor's part at

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<sup>133</sup> Marleen Willekens and Dan Simunic, 'Precision in Auditing Standards: Effects on Auditor and Director Liability and the Supply and Demand for Audit Services', (2007) 37 *Accounting and Business Research* 217 p. 230.

<sup>134</sup> For the domination of the Big Four, see Chapter II, Section 2.4.

<sup>135</sup> See Sections 3.1 and 3.2 above.

<sup>136</sup> Partnership Act 1890, s. 9.

<sup>137</sup> Davies and Worthington (n 14) p. 837.

<sup>138</sup> FSMA, sch. 10, para. 17.

<sup>139</sup> Study by London Economics (n 26) p. 99

fault is minor.<sup>140</sup> This is because auditors are seen, in general, as the ‘last resort for compensation’, while the fraudulent company is likely to have gone insolvent.<sup>141</sup> This situation is referred to ‘deep pockets syndrome’.<sup>142</sup>

Concerns about the liability risk for audit firms and the possible effects on concentration in the capital markets prompted the UK to allow contractual liability limitations between a company and its auditor. In 2006, the UK allowed ‘liability limitation agreements’ subject to the following conditions: (i) before making the contract the company must first get permission from the shareholders,<sup>143</sup> (ii) auditors can only agree to limit their liability to what is a fair and reasonable amount,<sup>144</sup> and (iii) the agreement may relate to only a single financial year, but it can be renewable.<sup>145</sup> Under this scheme, the company and its auditor can establish a proportionate liability scheme or maximum amounts of monetary compensation.<sup>146</sup> Nevertheless, there is no guidance on what is a reasonable amount, although it would be unreasonable, if not impossible, for the UK Government to set such a threshold, since audit risks in some certain industries are higher.<sup>147</sup> The liability limitation agreement is optional, and is only limits the liability to the company, not to third parties. Therefore, a major liability claim under either s. 90 or common law, exceeding the insurance cover, could still destroy an audit firm.

Given the insufficient capacity of insurance coverage, liability limitation agreements are necessary to protect the large audit firms from being destroyed by a major claim. Through liability limitation agreements, large audit firms will face less risk of liability.<sup>148</sup> As a result, auditors would be affected less by ‘deep pockets syndrome’, since the other parties of joint and several liability, such as directors, would also become subjects of any litigation.<sup>149</sup>

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<sup>140</sup> Davies and Worthington (n 14) p. 837.

<sup>141</sup> Michael Paterson, ‘Reform of the Law on Auditors’ Liability: An assessment’ (2012) 23(2) *International Company and Commercial Law Review* 55 p. 57.

<sup>142</sup> Roach (n 44) p. 136.

<sup>143</sup> Companies Act 2006, s. 536.

<sup>144</sup> *Ibid.*, s. 537(1).

<sup>145</sup> *Ibid.*, s. 535(1).

<sup>146</sup> FRC, *Guidance on Auditor Liability Limitation Agreements*, June 2008 para.2.9.

<sup>147</sup> Paterson (n 141) p. 58.

<sup>148</sup> Lee Roach, ‘Auditor Liability: Liability Limitation Agreements: Part 2’ (2010) 31(6) *Company Lawyer* 167.

<sup>149</sup> *Ibid.* p. 170.

According to the liability limitations agreements, as introduced under the Companies Act 2006, auditors and a company can specify either a fixed cap or a limitation based upon proportionate liability.<sup>150</sup> Accordingly, liability limitation agreements can indicate that liability will be limited to a fixed amount, or that an auditor will only be liable for the proportion of the damage that caused by him (or her). However, the drawback with the liability limitation agreements is that the Companies Act 2006 does not state any difference for deliberate and negligent acts.<sup>151</sup> One can argue that the law should not provide protection for auditors who intentionally breached their duties. In parallel with this argument, EU Recommendation 2008/473/EC indicated that liability limitations should exclude cases of intentional breach of duties by auditors.<sup>152</sup> However, UK law does not follow the EU Recommendation. It seems that the UK and EU have different approaches in liability limitation agreements: the former believes that auditor liability should not be limited for intentional breaches of duty, whereas the latter allows such a limitation. These different approaches might hinder future harmonisation attempts in the EU, if there will be any.

Other than the liability limitations agreement, audit firms can be formed as Limited Liability Partnership (LLP)<sup>153</sup> to benefit from limited liability and can reduce partners' personal liability.<sup>154</sup> Although the form of LLP can protect the personal assets of non-negligent audit partners, the audit firm is still liable for all its partners'.<sup>155</sup> As a result, a major claim that exceeded the insurance cover could still destroy an audit firm.<sup>156</sup> Moreover, it is also possible that the member firms of a network could be sued together with the global firm. Normally, the LLP structure of the network firms (i.e. the Big Four) allows member firms to operate in different countries with a global company to act as an umbrella entity of the network.<sup>157</sup> Hence, any outcome that means a member firm has to pay does not affect the other member firms. However, an action can be brought to the global company if a member firm failed to satisfy the claims due to insufficient capital.<sup>158</sup> For instance, in

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<sup>150</sup> Companies Act, 2006, s. 534(1).

<sup>151</sup> Roach (n 148) p. 170.

<sup>152</sup> EU Recommendation 2008/473/EC (n 21) para. 2.

<sup>153</sup> Limited Liability Partnership Act 2000.

<sup>154</sup> Dignam (n 81).

<sup>155</sup> Paterson (n 141) p. 58.

<sup>156</sup> Davies and Worthington (n 14) p. 839.

<sup>157</sup> Claudia Flores, 'New Trends in Auditor Liability' (2011) 12(3) European Business Organization Law Review 415.

<sup>158</sup> *Ibid.*, p.435.

the Parmalat case, the global firms Grant Thornton International and Deloitte International were sued together with US member firms Grant Thornton LLP and Deloitte LLP and Italian firms.<sup>159</sup>

Increased liability rules might be an effective tool in terms of ensuring auditor independence and audit quality.<sup>160</sup> However, in the current market conditions wherein the concentration is high and the choice of audit firms is limited, a major liability claim might result in undesirable consequences. Without any liability limitation, for instance, (i) one of the Big Four could fail or disappear as a result of a major liability claim, (ii) if one of the Big Four disappeared, the concentration and lack of choice would be worsened and statutory audit services would be disrupted, (iii) liability risks might make the audit profession less attractive and form an obstacle for mid-tier audit firms entering the market for audits for large listed companies.<sup>161</sup>

In fact, audit firms in the EU are subject to high-value actual and potential liability claims. In 2005, the biggest six audit firms (the Big Four, as well as Grant Thornton and BDO) dealt with 28 outstanding matters that could result in liability claims worth more than €75 million.<sup>162</sup> Moreover, the time and costs involved in litigation is another significant factor in addition to final settlement costs in liability claims. Given such a risk, investors would be reluctant to invest in audit firms, whereas small and mid-tier firms need to compete with the Big Four.

Debates on auditors' roles and their liability for false and misleading information regarding accounts have surfaced again since the global financial crisis that involved audit failures.<sup>163</sup> In fact, large audit firms have been exposed to civil litigation, especially in the US after negligent audits.<sup>164</sup> Audit failures during the crisis have led lawmakers to issue more laws on other subjects, such as independence and high-

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<sup>159</sup> Ibid, pp. 428-9.

<sup>160</sup> See Willekens and Simunic (n 133).

<sup>161</sup> Commission Staff Working Document Accompanying Document to The Commission Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms Brussels, SEC(2008) 1975.

<sup>162</sup> Commission Staff Working Paper, Consultation on Auditors' Liability and Its Impact on the European Capital Markets, January 2007 p. 5.

<sup>163</sup> For audit failures, see Chapter II, Section 3.3.

<sup>164</sup> After the collapse of Lehman Brothers, in 2013 Ernst & Young were held to private litigation by former Lehman Brothers investors. See *ibid*.

concentration,<sup>165</sup> whereas regulators have been reluctant to take action and issue stricter rules on auditor liability issue. The likely reason behind this is the possible risk of the liability exposure of large audit firms and the subsequent consequences on the audit services market.

## CONCLUSION

*“Because punishment for fraud and recovery of damages are so rare, prevention is the only viable course of action.”<sup>166</sup>*

Auditor liability is an area that is mostly dealt with by national laws. As a result, neither international regulators nor the EU have chosen to regulate this area. Although internationally, professional standards (namely ISAs) have found wide recognition in a number of jurisdictions, including the UK<sup>167</sup>, in terms of liability in cases of negligence, ISAs do not impose any liability on auditors. For negligent misstatements, ISAs do not issue any standards; instead, they set standards mainly on the basic principles of audit performance. In terms of false or misleading information in the statements, ISAs only set rules with regards the detection of fraud in financial statements. Nor do ISAs impose primary responsibility on statutory auditors. Nevertheless, failure in the application of auditing standards can be regarded as breach of duty.

The European Union, on the other hand, has left the regulation of auditor liability to Member States. Apart from Recommendation 2008/473/EC on liability caps, there is no harmonisation on the substance of liability rules. As for Member States, for instance, in UK, common law regarding the scope of auditors' liability can be considered relatively narrow.<sup>168</sup> Auditors owe a duty of care to the company based on a contractual relationship and owe a duty of care to third parties in tort, for negligent misstatements only under very restrictive conditions.<sup>169</sup>

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<sup>165</sup> See Chapter IV, Section 2.3 for the regulatory responses to the global financial crisis.

<sup>166</sup> Frank W. Abagnale, a famous American fraudster whose life story inspired the film *Catch Me If You Can*.

<sup>167</sup> See Chapter III, Section 3.2.2 for the application of ISAs.

<sup>168</sup> Paterson (n 141) p. 59.

<sup>169</sup> See *Caparo* (n 58).

In the UK, the auditor liability regime is set by cases (some of which are a century old) that do not pay sufficient attention to the public role of auditors. Therefore, common law rules on auditor liability do not fit well into the current needs of financial markets.<sup>170</sup> One of the functions of audited financial statements is to attract potential investors. In this respect, in case of any misrepresentation in those statements, not only the company and its shareholders but also every potential user of these statements would be affected by that false representation. However, claimants, especially those who do not have a contractual relationship with the auditor, face a difficulty in fulfilling the requirement to show the defendant owed a duty of care.<sup>171</sup>

When auditors are seen as the watchdogs of the company and serve the owners of the company as detectives, the *Caparo* judgement is applicable; here, auditors are only liable to the company. However, the auditor's role has changed, and they are now seen as professional gatekeepers, appointed by the company, who approve the financial information for potential third party users. In this respect, an auditor's role has been expanded to include a public role, namely certifying the information for third parties, mainly investors and creditors. One could therefore suggest that the liability of auditors should be extended to include anyone who can be viewed as a potential user of audited financial statements, because of the public role of auditing.

In this respect, the statutory provisions of FSMA provide a broader scope for auditor liability for negligent misstatements in terms of liability for prospectuses. Auditors fall into the "*responsible person*" definition for prospectuses under s. 90. Accordingly, an auditor could be held liable if he (or she) includes any untrue or misleading statements in specific parts of the prospectus and causes losses to persons who acquired securities in the market. It would be enough to make a claim under s. 90 if the misstatements affected the market price and caused losses. Therefore, making a liability claim under s. 90 would be more attractive than making a claim under common laws since both require a contractual relationship between the claimant and the defendant and thus have a limited scope for liability.

In conclusion, rather than making a claim under common law, the provisions of the FSMA have become more attractive as regards making a liability claim in primary

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<sup>170</sup> Giudici (n 32) p. 540.

<sup>171</sup> Paterson (n 141) p. 56.

and secondary markets. It is expected that UK financial markets would provide better investor protection through improving liability rules for statutory auditors regarding the accuracy of the financial statements in the prospectuses.

Although improved liability rules are necessary for market confidence and investor protection, the risks of major liability claims to the audit profession, in particular, the Big Four should not be disregarded. Liability claims tend to produce high litigation costs and might result in a possible loss of reputation. This situation constitutes a risk of further concentration in audit market, if one of the Big Four were to collapse as a result of major liability claims that exceed the insurance cover. Liability limitations by contract might be a remedy in this respect, but they only limit liability to the company. It is crucial that regulatory authorities should calculate litigation costs on the audit profession and take action over the consequences of those liability claims on the Big Four while improving investor confidence in the markets through increased investor protection towards false and misleading information in audited accounts. Alternatively, a better solution would be to take measures to prevent fraud in the first place, rather than to increase the liability rules.

This chapter complements previous chapters' discussions in terms of exploring the role of auditors and their duties and liabilities in financial markets. So far, the discussions in this thesis have focused on a structural and conceptual analysis of external auditing, including its regulation in the EU. Chapter VII will question the level of convergence between Turkish and the EU laws on auditing. Before that, in order to add Turkey to the discussion on convergence, the next chapter will examine Turkish laws and regulations in auditing in the light of its harmonisation with EU law. As this chapter has shown, the UK has a considerably developed liability regime and its rules have found their application widely in the field. Although there is no common approach in the EU in terms of auditor liability rules, studying the Turkish experience will show whether there are similarities in auditor liability rules. This indication will tell us more about audit regulation and whether it follows an international route.<sup>172</sup>

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<sup>172</sup> See Chapter VII for the convergence of auditing between Turkey and the EU.

# CHAPTER VI: A CRITICAL ANALYSIS OF AUDIT REGULATIONS AND REFORMS IN TURKEY

## INTRODUCTION

Turkey, as a candidate for EU membership, has launched a number of company law reforms. The main objective of these reforms is to integrate the Turkish financial market with the EU.<sup>1</sup> More specifically, there are two driving forces behind the reforms. The first is the objective of preventing audit failures similar to the Imar Bank case, which is the biggest accounting and auditing scandal in the Turkish Banking history. EU membership for Turkey is the other motivation; achieving the objective of becoming a part of international markets. Within these driving forces, Turkey has made substantial amendments in its company and capital markets laws in line with the EU *acquis* and has reformed its laws on auditing respectively.

The objective of this chapter is to study Turkish laws in the field of external auditing. In addition, this chapter provides a background to the convergence analysis studied in Chapter VII. Turkey is taken as a case study because it presents a good example for emerging economies in the context of harmonisation of rules and standards for audit profession. The EU membership aspiration of Turkey also provides room for a discussion on Turkey's ability and success in terms of the adaption of EU laws. In addition, as a major trading partner of European countries,<sup>2</sup> Turkey's integration with EU law deserves attention.

This chapter is structured as follows. The first section starts with the background to and motivations of the reforms in Turkey by examining past audit failures in the Imar Bank case. This is followed by some background information on the financial development of Turkey as well as a critical discussion on Turkey's progress in the EU accession process. The second section presents how external auditing is regulated

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<sup>1</sup> Draft Turkish Commercial Code General Justification (TCC General Justification).

<sup>2</sup> Republic of Turkey Ministry of Economy, 'International Trade Statics', *News Bulletin* No. 10967, 28 December 2012.

under Turkish law before reforms were enacted. Accordingly, the Profession Act, Capital Markets Codes, Commercial Codes, and the Capital Markets Board's (SPK) communiqués on external auditing are presented as the main sources of audit regulation in Turkey. The background to the audit profession, audit firms in Turkey and SPK monitoring over audit firms will be discussed in the third section. Lastly, the fourth section critically examines reforms of external auditing. This section also details auditor liability rules under the new Commercial Code, issued for the first time.

## **1. BACKGROUND AND MOTIVATIONS OF TURKISH LAWS ON AUDITING**

The prevention of audit failures and the aspiration of EU membership are the main motivations for audit reforms in Turkey. However, before elaborating on the motivations for these reforms, it is necessary to briefly refer to the primary elements of corporate governance system for Turkish listed firms and their relationship with external auditing.<sup>3</sup>

### **1.1. Corporate Governance in Turkey**

#### **1.1.1. Ownership and Control Structures of Turkish Listed Firms**

Public limited companies (anonim şirket) and limited liability (or private limited) companies (limited şirket) are the two most common types of business organisation in Turkey.<sup>4</sup> The corporate governance system of Turkish companies is categorised as an insider-corporate governance system wherein one or more majority shareholders own blocks of shares in the company.<sup>5</sup> The ownership structures of Turkish listed

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<sup>3</sup> See also Chapter I, Section 3.1.

<sup>4</sup> The first section of the TCC regulates five types of business organisations and they are: general partnership (kollektif şirket), limited partnership (komandit şirket), public limited company (anonim şirket), limited liability company (limited şirket), and the cooperative (kooperatif). As an important change, the new TCC now regulates the corporate groups and allows the establishment of single-member limited liability companies. See Turkish Commercial Code (TCC) No. 6102, Official Gazette No. 27846 (13.01.2011). See also Muzaffer Eroglu, 'Limited Liability in Turkish Law' (2008) 9(2) *European Business Organization Law Review* 237.

<sup>5</sup> See also Chapter I, Section 3.1.

firms are highly concentrated.<sup>6</sup> According to a report dated to 2005,<sup>7</sup> a single shareholder (either the founder of the company or a member of the funding family) controlled more than 50 per cent of voting rights in 45 per cent of each listed company on the Istanbul Stock Exchange<sup>8</sup> (ISE).

In family companies, family members dominate the board, and at least one family member is effective in the financial control of the company.<sup>9</sup> Improving the external auditing mechanism in a company can be an effective solution to the agency problem in Turkish companies,<sup>10</sup> which often occurs as dominant shareholders' (owners/managers) incentives to expropriate the rights of minority shareholders.<sup>11</sup> For the purposes of this chapter, Turkish corporate governance will be examined in terms of external auditing.<sup>12</sup>

### 1.1.2. Corporate Governance and External Auditing in Turkey

Turkey is considered an “*emerging market economy*”<sup>13</sup> that seeks investment from other countries. External auditing is one of the most important tools for investors to assess the business of the company that they want to invest in. In other words, investors rely on auditors' assurances on financial statements for their investments. In addition, in terms of its governance function, having high quality audits is regarded as a foundation for a sound governance system in Turkish listed firms.<sup>14</sup> Therefore, external auditing, carried out by independent and professional auditors, is an important element in the corporate governance of Turkish listed firms.

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<sup>6</sup> Ali Kosklu, ‘Corporate Governance in Turkey in Light of the Major Systems’ 11 January 2008 available at <http://www.mondaq.com/article.asp?articleid=56090> accessed 07/06/2013.

<sup>7</sup> Institute of International Finance's Equity Advisory Group, ‘Corporate Governance in Turkey: An Investor Perspective’, Task Force Report, April 2005 p. 7.

<sup>8</sup> With the enactment of the Capital Markets Law No. 6362 on 30 December 2012, the Istanbul Stock Exchange was renamed Borsa Istanbul (BIST) and started to operate on 3 April 2013.

<sup>9</sup> Gül Okutan Nilsson, ‘Corporate Governance in Turkey’ (2007) 8 *European Business Organization Law Reviews* 195.

<sup>10</sup> *Ibid* p. 201.

<sup>11</sup> See Chapter I, Section 3.1.

<sup>12</sup> Apart from external auditing, the new TCC introduced operational audits and special purpose audits. Operational auditing includes a report regarding the establishment of the company (Article 351). Special purpose auditing refers to the special examination of the accounts by the auditors appointed by the courts for a specific purpose, such as examination before take over (Article 406). However, in accordance with the context of this thesis, external auditing is the main subject of the evaluations throughout this chapter.

<sup>13</sup> IMF, ‘World Economic Outlook’, October 2012 p. 21.

<sup>14</sup> For the governance function of external auditing in concentrated systems see Chapter I, Section 3.2.

In Turkish companies, where the owners and the managers of the company are usually the same person (or the owner and the manager belong to the same family), external auditing plays a significant role, especially for minority shareholders. In family-owned companies, it is unlikely that managers (usually a family member) would be involved with fraud and corruption (that might eventually lead to a bankruptcy) in the company in which he (or she) has a common interest with the owners. Similarly, in cases where the company owners and the company manager are the same person, it is unlikely that the manager would corrupt his (or her) own company by engaging in fraud. However, although it is rare, there are cases where the management itself (the owners) engaged in fraud in the company, e.g. the Imar Bank case.<sup>15</sup> Hence, there is a risk that controlling shareholders might engage in fraud. They may also have an incentive to exploit the rights of minority shareholders, e.g. by restricting access to important financial information. External auditing in Turkey is particularly important for minority shareholders, who can get necessary information about the financial situation of the company through audited financial statements.<sup>16</sup>

The Turkish Commercial Code (TCC) empowers the Capital Markets Board of Turkey (SPK) as the single authority to issue corporate governance principles in Turkey.<sup>17</sup> The Corporate Governance Principles of SPK are based on a ‘comply or explain’ principle.<sup>18</sup> Since 2004, all listed companies are obliged to annually prepare a corporate governance report showing the degree of compliance with these principles and explain reasons for any departure.<sup>19</sup> Although the Corporate Governance Principles of the SPK are not obligatory, some rules within the SPK regulations and communiqués relating to corporate governance are mandatory, having been published in the Official Gazette, i.e. Serial X, No. 22 Communiqué on

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<sup>15</sup> See Section 1.2 below.

<sup>16</sup> See also Chapter I, Section 3.2.

<sup>17</sup> TCC No. 6102 (n 4), Article 1529.

<sup>18</sup> The SPK Principles were based on OECD Corporate Governance Principles and published in 2003 (updated in 2005 and in 2011). English version before the 2011 amendment is available at <http://www.cmb.gov.tr/displayfile.aspx?action=displayfile&pageid=84&fn=84.pdf&submenuheader=-1> accessed 08/03/2013.

<sup>19</sup> BIST Corporate Governance Index (XKURY) operates in Borsa Istanbul since 2007. The index includes the companies that apply the corporate governance principles. See Borsa Istanbul website <http://borsaistanbul.com/en/products-and-markets/indices/equity-indices/corporate-governance-index> accessed 30/05/2013.

independent auditing.<sup>20</sup> Similarly, the new TCC incorporated the main features of corporate governance principles throughout the Code.<sup>21</sup> For example, the new TCC aims to obtain efficient disclosure and transparency mechanisms in companies.<sup>22</sup> Accordingly, many corporate governance principles are now implemented through the new TCC.<sup>23</sup>

Strong corporate governance is a pre-condition for the establishment of an advanced efficient equity market for emerging economies.<sup>24</sup> Better corporate governance frameworks can enable access to financing and lower costs of capital,<sup>25</sup> and thereby enable companies to perform better which is important to attract investments. In addition, corporate governance principles can be used as a vehicle for the standardisation of company law in the EU.<sup>26</sup> It is also possible to use improved corporate governance standards as a tool to prevent fraud and misconduct.

## 1.2. Audit Failures

When the Enron scandal occurred in the US, similar accounting scandals appeared in Europe (e.g. Parmalat and Royal Ahold).<sup>27</sup> The US and European countries experienced these scandals despite their developed economies and advanced legal environments. One might think that experiencing such a scandal is far more hazardous for countries whose legal environment have not developed well, and economic conditions are fragile. Indeed, when the Imar Bank scandal was revealed to the markets between the years 2000-2003, the economy was unstable, the political environment was fragile, and the legal setting in Turkey was weak. This was because the Turkish banking sector experienced a financial crisis in November 2000 and February 2001, due to financial instability, weak capital, and corporate governance

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<sup>20</sup> Communiqué Series: X, No: 22 regarding independent audit standards in financial markets, Official Gazette No. 26196 (12.06.2006). See also Section 2.3 below for a detailed explanation of the Communiqué.

<sup>21</sup> Ünal Tekinalp, 'Zorunlu Hedefler Baglaminda Turk Ticaret Kanunu Tasarisi'nda Anonim Sirkete Iliskin Kurumsal ve Dogmatik Duzen' (2005) No. 4 Hukuk Perspektifleri Dergisi p. 635.

<sup>22</sup> TCC General Justification (n 1) para.102.

<sup>23</sup> See also Sections 2.4 and 4.1 below for a detailed analysis of the new TCC.

<sup>24</sup> Dennis C. Mueller, *The Corporation: Investment, Mergers, and Growth* (Rutledge, London 2003)

<sup>25</sup> Stijn Claessens and B. Burcin Yurtoglu, 'Corporate Governance in Emerging Markets: A Survey' available at: <http://ssrn.com/abstract=1988880>

<sup>26</sup> See Section 1.3.2 below.

<sup>27</sup> See Guido Ferrarini and Paolo Giudici, 'Financial Scandals and the Role of Private Enforcement: the Parmalat Case' European Corporate Governance Institute Law Working Paper No. 40/2005, May 2005. See also Michael C. Knaap and Carol A. Knaap 'Europe's Enron: Royal Ahold, N.V.' (2007) 22(4) *Issues in Accounting Education* 641.

structures.<sup>28</sup> Following the crisis, several banks were transferred to the Saving Deposits Insurance Fund (TMSF), mainly due to mismanagement. Although the weak and fragile economic structure played a role in the failure of the major banks, fraud was also involved in some of the banking failures, e.g. the Imar Bank.

The estimated amount of fraud involved in the Imar Bank scandal was \$6.4 billion;<sup>29</sup> however, some argued that the true cost was much higher, at \$11.7 billion.<sup>30</sup> When the loss created by the Imar Bank scandal is added to the total financial burden of the economic crisis to the Turkish economy, the number is huge - \$43 billion.<sup>31</sup>

### 1.1.1. The Imar Bank Case

The Banking Regulation and Supervision Agency (BDDK) was put into operation in August 2000, just after the banking crisis, to regulate and supervise the banking sector in Turkey.<sup>32</sup> As soon as the BDDK started this function, investigations into the Imar Bank began, partly due to a “*decline in profitability and the illiquidity*”, but mainly because of “*the use of almost all of the credits of Imar Bank by Uzan Group*”.<sup>33</sup> In July 2003, the BDDK took over the Imar Bank, claiming that the bank had not met its legal and financial responsibilities, and most importantly posed a risk to the entire banking sector.<sup>34</sup> Investigations revealed the unlicensed and short selling of government securities. Moreover, many transactions were left out of the records, actual amount deposits collected from customers were not reported correctly to the public authorities, and off-shore deposit accounts were transformed into domestic deposit accounts.<sup>35</sup>

The Uzan family bought the Imar Bank in 1984. In the 1990s, the Uzan family owned an “*empire*” of 260 companies under the Rumeli Holding, including 2 banks:

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<sup>28</sup> BDDK, ‘From Crisis to Financial Stability Turkey Experience’, Working Paper (Revised 2<sup>nd</sup> edn), Ankara 29.12.2009.

<sup>29</sup> Ibid p. 25.

<sup>30</sup> Mine Omurgonulsen and Ugur Omurgonulsen, ‘Critical thinking about creative accounting in the face of a recent scandal in the Turkish banking sector’ (2009) 20 *Critical Perspectives on Accounting* 651.

<sup>31</sup> Ibid p. 658.

<sup>32</sup> In addition, the BDDK enables coordination with Basel Committee regulations on the banking sector.

<sup>33</sup> BDDK, ‘Turk Bankacilik Sektorunun Guclendirilmesine Yonelik Calismalar ve Imar Bankasi Olayi, *Press Conference*, Ankara 23.10.2003.

<sup>34</sup> Omurgonulsen and Omurgonulsen (n 30) p. 660.

<sup>35</sup> BDDK Working Paper (n 28) p. 18.

Imar Bank and Adabank, hydro-electrical power stations, a mobile phone service company, 5 television channels, 12 radio stations, and 2 national newspapers.<sup>36</sup> The Uzan Group faced civil and criminal lawsuits for extortion, fraud, and unlawful transactions, including international law-suits with major companies, such as *Motorola*.<sup>37</sup>

With respect to fraud in the Imar Bank, a number of steps were enacted, including charges of being a member of a criminal organisation led by Kemal Uzan,<sup>38</sup> and failing to handing over documents to auditors and obstructing audit work.<sup>39</sup> Accordingly, the 8<sup>th</sup> High Criminal Court of Istanbul stated that:<sup>40</sup>

*“... equal to 8 billion 500 million TL<sup>41</sup> were illegally transferred into controlling shareholders: Uzan family group members and its group firms, through fraudulent, concealed and organized techniques which represent the biggest fraud in the Turkish banking sector and a highly remarkable scandal in the world banking history.”*

Uzan family members were found guilty of being “*members of a criminal organisation*” and participating in “*continuous embezzlement*”; they were sentenced to imprisonment for a minimum of 15 years.<sup>42</sup> However, some family members were released on bail a few months after the judgement.<sup>43</sup> Regarding the charges for obstructing audit work, a number of defendants, including Uzan family members were sentenced to imprisonment and monetary fines.<sup>44</sup>

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<sup>36</sup> Omurgonulsen and Omurgonulsen (n 30) p. 659.

<sup>37</sup> *Motorola Inc v. Kemal Uzan*, (2006) No. 06-1222, US District Court, Southern District of New York. In 2002, Motorola and Nokia sued the Uzan family, accusing them of borrowing \$2.7 billion in bad faith. The U.S. Court of Appeals upheld the ruling by Judge Rakoff requiring the Uzan family to pay compensatory damages of \$2.1 billion to Motorola. See David Glovin, ‘Motorola’s \$1 Billion Award in Uzan Case is Upheld (Update 4)’, *Bloomberg*, 21 November 2007.

<sup>38</sup> *Turkiye Imar Bankasi*, 8<sup>th</sup> High Criminal Court of Istanbul (Istanbul 8. Agir Ceza Mahkemesi) 21 February 2006.

<sup>39</sup> *Turkiye Imar Bankasi*, 8<sup>th</sup> High Criminal Court of Istanbul (Istanbul 8. Agir Ceza Mahkemesi) 13 August 2008.

<sup>40</sup> *Turkiye Imar Bankasi* (n 38). See Omurgonulsen and Omurgonulsen (n 30) p. 667. See also Esra Alus, ‘Mahkeme “Kemal Uzan cetesi” dedi’, *Milliyet*, 22 February 2006. There is no easy access to the original court decisions, e.g. court decisions are not available online for third parties.

<sup>41</sup> At that time, this amount was equal to approximately 1.33 billion Euros. Exchange rates announced on 02.21.2006 by the Central Bank of Turkey as EUR/TRY: 1.5623.

<sup>42</sup> See also Alus (n 40).

<sup>43</sup> Bahattin Uzan released on 500,000 YTL bail after he was sentenced to a sentence of 17 years’ 2 months’ and 20 days’ imprisonment. See ‘Bahattin Uzan tahliye oldu’, *Hurriyet*, 10 April 2006.

<sup>44</sup> *Turkiye Imar Bankasi* (n 39). See also ‘Imar Bankasi Davasi Karara Baglandi’ *SonDakika.com*, 13 August 2008.

In July 2003, management and control of the Imar Bank was transferred to the Savings Deposit Insurance Fund (TMSF), which undertook the liquidation process for the bank.<sup>45</sup> TMSF intensively examined all aspects of the Imar Bank scandal and it was realised that the actual size of the fraud could not be determined by the BDDK before the take-over.<sup>46</sup> There were also lawsuits against BDDK and its auditors, which will be examined separately in the next part.

### 1.2.2. The Role of BDDK Auditors in the Imar Bank Case

The Imar Bank was under close supervision because of the economic crisis that occurred in the banking sector in 2000. Thus, the BDDK were closely supervising the Imar Bank for the period 2000-2003.<sup>47</sup> In this period, it was BDDK's responsibility to sign public auditors to audit the bank's financial reports.<sup>48</sup> Despite close supervision by the BDDK, the Imar Bank management was able to engage in misconduct and managed to illegally transfer money to controlling shareholders and firms of the group.<sup>49</sup> One may ask how fraudulent or 'creative' accounting practices could have been carried out under such close supervision; the role of BDDK and its public auditors in this case is therefore worth examining.

There was no single contributor to the fraud in the Imar Bank case; instead, there were a number of reasons of why the fraud remained undetected for so long despite the fact that the BDDK was in close supervision with the bank.<sup>50</sup> First, internal control mechanisms were designed to operate in accordance with controlling shareholders' demands. To enable that, the Imar Bank had two separate accounting systems: one for branch records, reflecting accurate information, and the other kept in the general directorate to provide manipulated information for BDDK

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<sup>45</sup> Omurgonulsen and Omurgonulsen (n 30) p. 662.

<sup>46</sup> Ibid p. 663.

<sup>47</sup> BDDK *Press Conference* (n 33) p. 61.

<sup>48</sup> It should be mentioned that the audit carried out by BDDK auditors of the Imar Bank accounts was a kind of special purpose auditing, which included the aim of discovering any accounting malpractices in the bank.

<sup>49</sup> It is argued that Uzan group used the 80 per cent of the funds for its own companies, with Law No. 4389 letting bank owners to channel the maximum 25 per cent of total deposits to their own companies. See Recep Bahar, 'Soru ve Cevaplarla Uzan Hortumu' *Yeni Mesaj* 6 July 2003.

<sup>50</sup> Commission of Inquiry into the Supervisory Implications of the Failure of the Imar Bank by Jean-Louis Fort and Peter Hayward, August 2004 (Inquiry on Imar Bank) available at [http://www.forecasturkey.com/Articles/Government/UT/rapor\\_20040831.pdf](http://www.forecasturkey.com/Articles/Government/UT/rapor_20040831.pdf) accessed 08/05/2013.

investigations.<sup>51</sup>

Second, auditors (i.e. public auditors appointed by the BDDK) lacked experience of the specialised process for the effective audit of a financial institution.<sup>52</sup> The Imar Bank was subject to a recapitalisation program after the banking crisis in 1994. Hence, public auditors assigned by the BDDK assessed the solvency and capital needs of the bank. This process was checked by an independent audit firm (Gozlem Denetim ve Danismanlik Hizmetleri A.S.<sup>53</sup>) appointed by the BDDK. However, no questions arose at any of the three levels of the audit. This situation suggests that both public auditors and the audit firm appointed by the BDDK simply relied on the information provided by the bank but did not verify it.<sup>54</sup> It was stated by the inquiry that the examination process carried out by BDDK auditors failed to detect any misreporting.<sup>55</sup> Third, the Imar Bank failed to establish a sound corporate governance structure. For example, the board did not function properly, in that they did not receive any audit reports from the internal control services. In addition, board members had close relationships with controlling shareholders and were ready to act to serve their interests.<sup>56</sup>

In September 2003, the Prime Ministry Inspection Board launched an investigation regarding concerns about the independence of the public auditors of the BDDK. As a result, 7 staff members of BDDK, including the president, were subjected to the litigation. The accusations included a breach of auditing duty and causing embezzlement.<sup>57</sup> The inspectors of the Prime Ministry Inspection Board found that the BDDK, as a board, breached their auditing duty in the Imar Bank scandal and waived the short selling of government securities. In addition, it was determined that some public auditors engaged in bribery during the Imar Bank investigations.<sup>58</sup>

Turkish Government officials raised concerns over the findings of this investigation.

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<sup>51</sup> Bora Aktan, Omar Masood, and Senem Yilmaz, 'Financial shenanigans and the failure of ethics in banking: a review and synthesis of an unprecedented fraud' (2009) 4(1) *Banks and Banks Systems* 30.

<sup>52</sup> Inquiry on Imar Bank (n 50) p. 27.

<sup>53</sup> In 2009, the BDDK cancelled the license of the audit firm Gozlem Denetim ve Danismanlik Hizmetleri A.S, stating that the audit firm no longer met requirements. See BDDK Decision No. 3051 12.02.2009.

<sup>54</sup> Inquiry on Imar Bank (n 50) p. 11.

<sup>55</sup> Ibid pp.11-2.

<sup>56</sup> Ibid.

<sup>57</sup> Cigdem Toker, 'Imar'da "murakip" skandalı', *Hurriyet*, 22 January 2004. Court files are constituted of 40 files with almost 22 thousand pages and not available online.

<sup>58</sup> See *ibid*.

“How could auditors not detect these wrongdoings? Apparently, this case will be a real problem to the BDDK”<sup>59</sup> said then Minister of State (and current) Deputy of Prime Minister of Turkey Ali Babacan. The Minister also stated that the Imar Bank case showed similarities to the Enron case, where Arthur Andersen lost its reputation after big-scale accounting fraud was revealed.<sup>60</sup> However, the public lawsuit brought against the former president of the BDDK and its auditors ended differently. In 2006, the 24<sup>th</sup> Criminal Court of First Instance of Ankara (Ankara 24. Asliye Ceza Mahkemesi) convicted the auditors of the BDDK. However, the Supreme Court of Appeals (Yargitay) quashed this verdict. Subsequently, in February 2013, the court decided that the lawsuit is time-barred since no conclusion can be reached after 7 years and 6 months.<sup>61</sup> This result ably illustrates how cumbersome the judicial system is in Turkey. The final judgement of the courts also indicates an inefficient enforcement mechanism. Arguably, this judgement does not administer justices since it does not enact a penalty against auditors, despite their breach of auditing duty.

The Imar Bank case is a good example of a weak governance structure comprised of inefficient internal and external control mechanisms. In terms of supervision, the Imar Bank scandal demonstrated how fraud could stay undetected when supervisory mechanisms are not working well. In conclusion, the Imar Bank failure showed that there were deficiencies at all four levels: internal control, external control, corporate governance, and supervision, and how these four levels of control created opportunities for fraud and at the same time failed to detect looting.<sup>62</sup> It should be emphasised that controlling shareholders, as perpetrators of the fraud, made it even more difficult to detect that fraud. Moreover, out-dated laws, a slow judicial system, and the negligence of authorised auditors contributed to the unhindered deception.<sup>63</sup>

Such failures in governance and supervision mechanisms have been a motivation for reforms in Turkey in the fields of banking law, capital markets law and corporate governance. Correspondingly, after the Imar Bank scandal, the BDDK took measures to strengthen Banking Law No. 5411,<sup>64</sup> including measures on the audit of banks,

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<sup>59</sup> ‘Bakandan Enron misali’ *Radikal* (online issue), 10 November 2003.

<sup>60</sup> *Ibid.*

<sup>61</sup> ‘Imar Bankasi davasi dustu’ *Sabah*, 27 February 2013.

<sup>62</sup> Omurgonulsen and Omurgonulsen (n 30) p. 671.

<sup>63</sup> Inquiry on Imar Bank Failure (n 50) p. 11.

<sup>64</sup> Banking Law No. 5411, Official Gazette No. 25983 (01.11.2005).

internal audit, internal control, and transparency.<sup>65</sup> In addition, since 2003, the SPK has been introducing specific regulations on the subject of corporate governance, independence of auditing, and ethical codes of accounting.<sup>66</sup> In line with the strengthened regulations, the audit profession and external auditing have become more significant in Turkey. The next part will further discuss how the financial development and EU membership aims of Turkey have contributed to law reforms in auditing.

### **1.3. Financial Development and EU Membership of Turkey**

#### **1.3.1. Background of the Financial Development of Turkey**

Turkey's annual economic growth averaged 2.7 per cent between 1994 and 2003.<sup>67</sup> However, the negative effect of the economic crises in both 1999 and 2001 should be taken into account when evaluating this rate. Since then, annual economic growth has averaged 4.95 per cent and is expected to be 4.4 per cent in 2017.<sup>68</sup> Growth rates averaged 1.15 per cent in the Euro area and 1.96 in the US over the last ten years.<sup>69</sup>

Despite the negative effects of the 2008 global crisis, Turkey can be considered a stable economy, while other European economies (e.g. Greece, Portugal, Ireland etc.) have struggled with debt crises. Turkey's growing economy provides opportunities for new investment and this makes Turkey more attractive to direct foreign investment. Turkey is one of the fastest-growing emerging economies in Europe and its comparatively stable market conditions amongst its neighbours create an investor-friendly environment set against a liberal-market economy.<sup>70</sup> In addition, Turkey has close relations with European countries in terms of trading. For example, in 2011, 44 per cent of Turkey's international trade took place with EU countries.<sup>71</sup>

As its economic position in global markets develops and its attractiveness for foreign investments improves, Turkey aims to reform its laws and regulations for further

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<sup>65</sup> BDDK Working Paper (n 28) p. 18.

<sup>66</sup> For SPK regulations on auditing, see Sections 2.3 and 3.3.

<sup>67</sup> IMF World Economic Outlook (n 13) p. 194.

<sup>68</sup> The growth rate slowed down after the global financial crisis in 2008 but was boosted in 2010 with 9.8 per cent. See *ibid*.

<sup>69</sup> *Ibid* p. 191.

<sup>70</sup> In May 2013, Moody's – a global rating agency - placed Turkey at investment grade with a stable outlook. See Daniel Bases, 'Moody's lifts Turkey's credit rating to investment grade (Update-2)' *Reuters*, 16 May 2013.

<sup>71</sup> See Turkish Ministry of Economy's Report (n 2).

developments. In fact, reforming laws and regulations came on to Turkey's agenda in the mid-1990s. Although one of the incentives was to catch up with the privatisation trend in Europe, the main motivation behind reforms was joining the EU.<sup>72</sup>

### 1.3.2. Turkey in the Process of EU Membership

The long journey of Turkey towards EU membership started in 1987, when Turkey applied to join what was then the European Economic Committee (EEC). In 1997, the Luxemburg Council declared Turkey eligible to become a EU member. After that, the Helsinki European Council granted Turkey the status of 'candidate country' in 1999.<sup>73</sup>

Compared with previous enlargements, the Copenhagen criteria for countries seeking to join the EU after 1995 introduced stricter rules.<sup>74</sup> This is because, especially since the post-1995 enlargement, candidate countries were smaller and poorer than previous candidate countries, e.g. the Central and Eastern European (CEE) countries.<sup>75</sup> As a result, the Copenhagen criteria were established in the specific context of the CEE countries' enlargement conditions.<sup>76</sup> In addition to an expanded set of rules for accession, the European Commission brought in a monitoring mechanism for compliance with EU *acquis*.

According to the Copenhagen criteria, a candidate country has to meet 'political' and 'economic' criteria before negotiations can be opened.<sup>77</sup> Democracy and the rule of law, human rights and protection of minorities are considered as 'political' and existing of functioning market economy are considered as 'economic' criteria. Once a candidate country meets the political and economic criteria, it can start accession

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<sup>72</sup> TCC General Justification (n 1).

<sup>73</sup> See European Commission, Enlargement website [http://ec.europa.eu/enlargement/countries/detailed-country-information/turkey/index\\_en.htm](http://ec.europa.eu/enlargement/countries/detailed-country-information/turkey/index_en.htm) accessed 23/05/2013.

<sup>74</sup> Greece, Portugal, and Spain became members in the 1980s and none of these countries experienced parliamentary democracy nor operated as market economies at the time of application for membership. See Stuart Croft, John Redmond, G. Wyn Rees, and Mark Webber, *The Enlargement of Europe* (Manchester University Press, Manchester 1999) p. 57.

<sup>75</sup> Ibid p. 58.

<sup>76</sup> Christophe Hillion, 'Copenhagen Criteria and their Progeny' in Christophe Hillion (ed), *EU Enlargement: a legal approach* (Hart, Oxford 2004) p. 15.

<sup>77</sup> See European Council, 'Conclusions of the Presidency' DOC/93/3, Copenhagen, 21-22 June 1993.

negotiations.<sup>78</sup> Throughout negotiations, the Commission monitors the candidate country with regards its alignment with the EU *acquis*.<sup>79</sup>

Turkey's accession negotiations opened in 2005. Topics include the conditions of candidate's adoption, implementation, and enforcement the current EU *acquis*. The *acquis* is referred to as all EU standards and rules, as divided into thirty-five different policy chapters.<sup>80</sup> Each policy chapter is negotiated separately. So far, twelve chapters are under negotiation, one chapter is finalised, and negotiations on eight chapters were suspended in 2006 because of political conflict with the Republic of Cyprus.<sup>81</sup>

During negotiations, the European Commission monitors the Turkey's progress in applying EU legislation. As part of the monitoring process, the European Commission reports annually on Turkey's progress on alignment of the *acquis*. In May 2012, a positive agenda was launched in order to support and complement the accession negotiations.<sup>82</sup> Negotiations would be finalised once the candidate country fully and successfully completed all thirty-five policy chapters.<sup>83</sup> However, accession negotiations are an "open-ended process"<sup>84</sup> which means it is not guaranteed that Turkey will join the EU even if she fully adopted the EU *acquis*. There is therefore no expected date for EU membership for Turkey, since accession is not certain.

The average time for a candidate country to gain access to the EU membership is 7 years.<sup>85</sup> Croatia, whose started accession negotiations in the same year as Turkey, finalised the 35 policy chapters in June 2011 and became an EU member on the 1<sup>st</sup> July 2013.<sup>86</sup> Meanwhile, Turkey has completed only one chapter in these eight years, mainly because negotiations have been suspended.

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<sup>78</sup> Hillon (n 76) p.20.

<sup>79</sup> See European Council DOC93/3 (n 77).

<sup>80</sup> Ibid.

<sup>81</sup> See European Commission, EU and Turkey website <http://www.avrupa.info.tr/en/turkey-the-eu/accesion-negotiations/what-is-the-current-status.html> accessed 23/05/2013.

<sup>82</sup> Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012 - 2013 Brussels 10.10.2012 COM (2012) 600 final, p. 16.

<sup>83</sup> Stefan Engert, *EU Enlargement and Socialization Turkey and Cyprus* (Routledge, New York 2010) p.36.

<sup>84</sup> Negotiating Framework, Luxemburg, October 2005.

<sup>85</sup> 'AB yoluna beraber cikmistik Hirvatlardan fark yedik' *Zaman*, Bruksel 30 May 2013.

<sup>86</sup> EU Enlargement Factsheet, 'Close-up on Enlargement Countries: Croatia' 14 May 2013.

Although the EU suspended negotiations on eight chapters, the screening process continues.<sup>87</sup> In this respect, in 2012 the Commission issued a progress report to assess the country's level of compliance.<sup>88</sup> The European Commission's progress reports are drawn on a great variety of resources, including international and domestic non-governmental organisations' reports, local press, firms and interest groups.<sup>89</sup> The Commission's progress report considered Turkey as a functioning market economy and advanced in the area of company law.<sup>90</sup> However, in the same report, concerns are noted - especially regarding Turkey's weak progress in meeting political criteria (i.e. the Cyprus conflict).<sup>91</sup>

One could ask whether the EU requires a full compliance with the EU *acquis* or whether there is any flexibility with regards to the adoption of the rules. As stated in the 2000 Agenda, candidates should take up the EU *acquis* as a whole before accession.<sup>92</sup> In other words, the Commission requires full compliance with the EU *acquis* for the post-1995 enlargements.<sup>93</sup> Applicant countries are expected to adopt the EU *acquis* before accession. However, it is a fact that the EU allows delays of application, i.e. transitional periods - but only in exceptional cases.<sup>94</sup> For instance, the Commission recommended the use of transitional periods to help candidates' legal adaptation after accession.<sup>95</sup> Through the use of transitional arrangements, candidates can become members of the EU without fully complying with the entire *acquis*.<sup>96</sup> However, apart from these exceptional cases, the EU does require full adoption of the *acquis*.

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<sup>87</sup> Engert (n 83) p. 51.

<sup>88</sup> Communication from the Commission COM (2012) 600 final (n 82).

<sup>89</sup> Engert (n 83) p. 90.

<sup>90</sup> Communication from the Commission COM (2012) 600 final (n 82) pp. 68-70.

<sup>91</sup> Ibid pp. 17-8.

<sup>92</sup> Agenda 2000, 'The Challenge of Enlargement' Part II, COM (1997).

<sup>93</sup> In previous enlargements, Greece, Spain and Portugal were allowed into the EU without complying fully with the *acquis*. See Heather Grabbe, 'A Partnership for Accession? The Implications of Conditionally for the Central and Eastern European Applicants' Robert Schuman Centre Working Paper, RSC No.12/99, European University Institute, Florence, p. 20.

<sup>94</sup> Graham Avery, 'EU Expansion and Wider Europe' in Elizabeth Bomberg, John Peterson and Alexander Stubb (eds), *The European Union: How Does It Work?* (2<sup>nd</sup> edn, OUP, Oxford 2008) p.180.

<sup>95</sup> EC Bulletin 'The transitional period and the institutional implications of enlargement' Supplementary 2/78, 6.

<sup>96</sup> In 2003, such a transitional arrangement was signed between Member States and ten candidate countries (Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovak Republic). A year later, in 2004, these countries were admitted to the EU. See Kirstyn Inglis, 'The Accession Treaty and its Transitional Arrangements: A Twilight Zone for the New Members of

The EU *acquis* includes EU legislation to date, as well as additional standards set by the courts and practices developed by the institutions. It is a fact that EU rules and standards have been growing substantially. It seems that the level of required adaptation is now higher for candidates than for current Member States.<sup>97</sup> Therefore, it is getting more difficult for new candidates to fully adopt the EU *acquis*.<sup>98</sup> Consequently, accession is rather “arduous” and it is getting even more difficult for applicant countries.<sup>99</sup>

Moreover, it is argued that the Commission assessment on the candidate country’s readiness is not objective.<sup>100</sup> Although enlargement is an intergovernmental process where negotiations take place in a conference organised between Member States and the applicant state, in practice, the Commission’s influence on the process is strong.<sup>101</sup> It is argued that such a monitoring process by the European Commission enables the EU to assess the candidate country through an objective process so that the political arrangements are not involved in the admission process.<sup>102</sup> Nevertheless, an applicant’s readiness for membership depends heavily upon the Commission’s view, and current Member States might have an impact on the process.<sup>103</sup> Furthermore, the assessment of the progress of candidates is not entirely objective because it is evident that the Commission has previously disregarded full compliance with the *acquis*.<sup>104</sup>

To conclude, as Arikan stated, the general argument of the EU regarding Turkey’s membership of the EU lies in two arguments that balance each other.<sup>105</sup> On the one

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the Union’ in Christophe Hillion (ed), *EU Enlargement: a legal approach* (Hart, Oxford 2004) pp. 77-8

<sup>97</sup> Hillion (n 76) pp. 11-2.

<sup>98</sup> Ibid p. 15.

<sup>99</sup> Avery (n 94) p. 137.

<sup>100</sup> Arikan argues that the EU’s policy towards Turkey has not been fair and objective. See Hakan Arikan, *Turkey and the EU: An awkward candidate for EU membership* (Ashgate, Great Britain 2006).

<sup>101</sup> Avery (n 94) p. 184.

<sup>102</sup> Hillion (n 76) p. 14.

<sup>103</sup> For instance, the French government led by Nicholas Sarkozy – known for its strong opposition to Turkey’s membership - vetoed negotiations on 5 chapters as soon as the government was established, in December 2006. See *Zaman* article (n 85).

<sup>104</sup> The Commission recommended that negotiations start with five of the EEC countries and Cyprus, despite the Commission not questioning whether they fully complied with the economic criteria. See Grabbe (n 94) p. 13.

<sup>105</sup> Arikan (n 100) p. 3.

hand, according to the first argument, economic, political, and cultural<sup>106</sup> issues work against Turkey's accession to the Union.<sup>107</sup> The second argument views centres on security issues, e.g. Turkey's powerful army forces as a member of NATO work in her favour.<sup>108</sup> As these two main arguments dominate the EU's view on Turkey's accession to the Union, it is difficult to estimate when Turkey will join the EU. At first, Turkey needs to settle political issues with Cyprus so that the negotiations can start again. After that the decision heavily relies upon the Commission's view as to whether Turkey fully aligned her legislation with the EU *acquis* or not. Even after that is achieved, it is not certain that Turkey would be granted full membership status, as the accession negotiations are 'open-ended'.

Regardless of the result of this process, Turkey will not act independently of developments in European law. In other words, Turkey sees the EU *acquis* as a benchmark for its law reforms. Reformation efforts in Turkey in terms of aligning the law with the *acquis* can be considered condition to join the EU, but EU membership will also be a guarantee for ensuring consistency in the reforms. Before beginning a discussion on the reforms in Turkey, it is necessary to show how auditing was regulated before the recent reforms.

## 2. THE DEVELOPMENT OF EXTERNAL AUDITING IN TURKISH LAW

In Turkey, there is no single set of standards or a single standard setting body in the field of external auditing. Public companies and banks are subject to different regulatory arrangements. For instance, the SPK regulates the audits of publicly held companies while the BDDK governs and supervises the audits of banks and insurance companies. Regarding oversight mechanisms, oversight of those who are excluded in the list of SPK and BDDK is the responsibility of the Public Oversight

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<sup>106</sup> In addition, other elements are applied to explain the non-inclusion of Turkey, such as geographic and religion conditions. These elements are used to suggest that Turkey is not located on the European continent and is therefore not a part of Europe (geographic condition) and is a Muslim country and is therefore not acceptable to a community in which the majority of its members are Christian (religion condition). See Engert (n 83) pp. 32-3. Also, see Chapter VII for the comparison of Turkey with EU countries in terms of socio-economic and cultural differences and similarities.

<sup>107</sup> Arikan (n 100) p. 3.

<sup>108</sup> Ibid.

Authority of Turkey (KGK)<sup>109</sup>. An audit firm may be subject to double oversight as a result of this multi-headed structure.

Since there is no single audit authority in Turkey, laws on external auditing are numerous as well. Listed companies, including public limited and private limited companies in Turkey are subject to a number of regulations and codes issued by different institutions. As a result, companies are subject to the TCC as the main source of Turkish company law, Capital Markets Law (CML) as the second source, alongside the regulations and communiqués issued by the SPK, including the Corporate Governance Principles. In addition, financial institutions, such as banks, are subject to the Banking Code and the supervision of BDDK.<sup>110</sup> This means that financial institution may be subject to the provisions of Capital Markets Law and supervision by SPK if it is listed on Borsa Istanbul.<sup>111</sup>

This section presents an overview of the laws on auditing and briefly discusses them. Throughout this section, previous arrangements on external auditing are compared with the audit law reforms; however, a general discussion on audit law reforms will be given in Section 4.

## **2.1. The Profession Act**

Law No. 3568 of 1989 (amended in 2008)<sup>112</sup> was the very first code that recognized accounting and auditing as professions, and hence famous as the ‘Profession Act’. The Chamber of Accountants of Turkey (TURMOB) was founded by this Act. TURMOB is a non-governmental unified chamber of certified and chartered accountants in Turkey and has been a member of the IFAC since 1994.

TURMOB has the responsibility to issue accounting and auditing standards that are compatible with international standards. Later, in 1999, the Turkish Accounting Standards Board (TMSK) was authorised to develop accounting standards in Turkey. For the development of auditing standards, the Turkish Auditing Standards Board

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<sup>109</sup> For the role of the KGK and its relationship with other regulatory authorities, see Section 3.3.2 below.

<sup>110</sup> Banking Code No. 5411 (n 64).

<sup>111</sup> Capital Markets Law No. 2499 amended with Law No. 6362, Official Gazette No. 28513 (06.12.2012), Article 136 (5).

<sup>112</sup> The Law of Certified Public Accountancy and Sworn in Certified Public Accountancy No. 3568 01.06.1989 Official Gazette No. 20194 amended in 10.07.2008 with Law No. 5786 (The Profession Act).

(TDSK) was created by TURMOB in 2003.<sup>113</sup> In addition, in 2008, TURMOB issued rules and principles for auditors based on honesty, reliability, and independence.<sup>114</sup>

The Profession Act specifies who should conduct independent audits, although it does not govern the conduct of independent auditing. Under the Profession Act, the Certified Public Accountants (SMMM) and Sworn-in Certified Public Accountants (YMM) are authorized to perform independent audit.<sup>115</sup> YMM is a sworn-in chartered public accountant and SMM is a certified public accountant (CPA). The law specifies the conditions to an SMMM or YMM (e.g. having a university or equal level, undergone practical training, and passed an examination).<sup>116</sup> An SMMM could be qualified as an YMM if he (or she) passed the exam following ten years' experience in the field.<sup>117</sup> According to the Profession Act, every accountant must register and be a member of the chamber under TURMOB after qualifying as an SMMM and/or YMM.<sup>118</sup>

Back in the days when the 'Profession Act' came into force, an auditor mostly undertook public auditing (e.g. auditing undertaken by Ministry of Finance, Treasury that mostly investigated the tax compliance of public institutions), and was different from external auditing. Therefore, at the time the Act came into force, the auditing profession had not developed as much as it has today.<sup>119</sup> The Act only defined general conditions to meet to be qualified as an accountant. Issues such as general principles, objectives, and the ethics of an audit were not covered by the Act. Moreover, auditing was limited to tax auditing that was based on the declaration that accounting records are in line with the tax law. Therefore, external auditing carried out in Turkey back then was not in accordance with EU standards.<sup>120</sup>

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<sup>113</sup> Serafettin Sevim, Tansel Cetinoglu, and Niyazi Kurnaz, 'Avrupa Birliđi Müzakereleri Sürecinde AB 8. Yönergesi Kapsamında Türkiye'de Denetim ve Denetçilik Mesleđinin Durumu: AB müzakereleri gelişim için bir fırsatmidir?' (2006) Ocak-Mart Mali Cozum.

<sup>114</sup> TURMOB, Rules that Members of the Profession must comply with, 02.09.2008.

<sup>115</sup> Professions Act (n 112), Article 2.

<sup>116</sup> Ibid, Articles 4-5.

<sup>117</sup> Ibid, Article 9(a).

<sup>118</sup> Ibid, Article 15.

<sup>119</sup> For the development of audit profession, see also Section 3.1 below.

<sup>120</sup> Umit Gucenme, Gulsun Isseveroglu, and Yasemin Ertan, 'Audit and Oversight of Audit in terms of Commerce Law of Turkey' (2011) 2(1) Business and Economics Research Journal 109.

## 2.2. Capital Markets Codes

Capital Markets Law No. 2499<sup>121</sup> came into force in 1981. This law regulated the functioning of the financial market and its institutions. In this respect, the SPK was created by the Act in the same year. The SPK, in cooperation with TURMOB, was authorised to issue regulations regarding the external auditing and publish the list of qualified audit firms.<sup>122</sup> In 2012, the Law was amended with law No. 6362.<sup>123</sup> An important development for external auditing in Turkey, new law No. 6362 assigned the role of audit supervision to the Public Oversight Accounting and Auditing Standards Authority (KGK), the Turkish public oversight body.<sup>124</sup> With the establishment of the KGK, the role of issuing rules in auditing is no longer applicable for the TURMOB, yet the SPK has still its authority in capital markets.

Independent audit was outlined in Capital Markets Law and communiqués by the SPK back in 1996. Although these regulations provided guidance on independent auditing, only a limited number of companies (e.g. listed companies) were subject to these regulations. As a result of the little attention given to related laws, public awareness of external auditing was not well developed, and the concept of independent auditing was not entirely understood by the top managers of companies.<sup>125</sup> External auditing did not receive enough attention by the industry until 2006, when the SPK issued a Communiqué parallel to ISAs: Communiqué Series: X, No: 22.<sup>126</sup>

## 2.3. SPK Communiqués on External Auditing

The Capital Markets Law authorized the SPK to issue communiqués and regulations on external auditing.<sup>127</sup> The very first regulation of corporate audits was drafted in 1982 by a SPK Communiqué that determined general rules and principles regarding

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<sup>121</sup> Capital Markets Law No. 2499, Official Gazette No. 17416 (28.07.1981).

<sup>122</sup> Ibid, Article 22.

<sup>123</sup> Section 6, Articles 62-64 of the new law regulates external auditing. See Capital Markets Law No. 6362 (n 111).

<sup>124</sup> Also the new TCC authorizes the KGK in the field of auditing. For the role of KGK see Section 4.2 below.

<sup>125</sup> Guçenme *et al* (n 120) p. 117.

<sup>126</sup> Communiqué Series: X, No: 22 (n 20).

<sup>127</sup> CML No. 6362 (n 111), Article 128.

the auditing and auditors.<sup>128</sup> In 1987, the SPK issued a regulation on independent external auditing that governs the audits of capital market players in Turkey.<sup>129</sup> Thereafter, the regulation and supervision of audits of public companies and their auditors have been governed by these communiqués and other regulations issued by the SPK.

SPK regulations and communiqués that start with X are the primary regulatory tools with regards external auditing in Turkey. The very first regulation on independent auditing governed by a communiqué was the Communiqué Series: X, No: 16 issued in 1996.<sup>130</sup> Corresponding to the Enron scandal, the SPK issued Communiqué Series: X, No: 19<sup>131</sup> in 2002, introducing similar provisions to SOX, especially with respect of independence requirements. Accordingly, providing consulting and legal services was forbidden for independent auditors (or audit firms) that provided audit services at the same time.<sup>132</sup> The mandatory rotation of audit firms every 5 years,<sup>133</sup> and the requirement to establish an audit committee for listed companies,<sup>134</sup> were also introduced by the same Communiqué.

The SPK is obliged to set the principles of external auditing in financial markets in accordance with international standards. In 2006, the SPK issued Communiqué Series: X, No: 22, which governs the general principles of independent auditing, detailing institutions that are subject to independent audits, the objectives of an audit, the terms of audit engagements, and responsibility of auditors.<sup>135</sup> It required that annual and half-year financial statements of listed firms<sup>136</sup> be subject to statutory

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<sup>128</sup> Communiqué Series: VIII, No: 1 on Principles to be Followed by the Joint Stock Corporations Subject to Capital Market Law, (1982).

<sup>129</sup> SPK Regulation on independent external auditing in capital markets, Official Gazette No. 19663 (13.12.1987).

<sup>130</sup> Communiqué Series: X, No: 16 Regarding Independent Auditing in Capital Markets, Official Gazette No. 22570 (04.03.1996).

<sup>131</sup> Communiqué Series: X, No: 19 Amending the Communiqué Regarding Independent Auditing in Capital Markets, Official Gazette No. 24924 (02.11.2002).

<sup>132</sup> Ibid, Article 11.

<sup>133</sup> Ibid, Article 24.

<sup>134</sup> Ibid, Article 28/A.

<sup>135</sup> Communiqué Series: X, No: 22 (n 20).

<sup>136</sup> In addition to the listed firms, investment and pension funds, portfolio investment firms, and financial intermediaries are subject to statutory auditing under Article 5 of Communiqué Series: X, No: 22.

auditing.<sup>137</sup> In addition, financial statements were henceforth to be subject to external auditing in case of merger, take-over, and liquidation.<sup>138</sup> With 35 sections, the Communiqué broadly covers the regulation of independent auditing in capital markets. Most importantly, Communiqué Series: X, No: 22 sets a similar outline with ISAs. All of the 35 sections outlined in the Communiqué have a purpose and objective that match ISA's.

Since 2006, Communiqué Series: X, No: 22 has been amended several times, which has brought about substantial changes. In 2008, the SPK updated the Communiqué in accordance with the Clarification Project of ISAs.<sup>139</sup> In 2009, the Communiqué established a 7-year rule for the engagements with the same audit firm.<sup>140</sup> In addition, the same year, a mandatory audit rotation exemption was introduced for audit firms that are institutionalised enough to ensure their independence. For an audit firm to be exempt from mandatory audit rotation, it should staff 75 audit partners, 25 of whom should be key audit partners and should rotate the audit partners every 7 years.<sup>141</sup>

#### **2.4. Commercial Codes**

The Commercial Code of 1956<sup>142</sup> did not regulate external audits of joint stock companies' (anonim şirket). The 1956 Code only issued rules related to internal auditing. For the first time, the new Commercial Code No. 6102 of 2012<sup>143</sup> requires all companies (listed or not) be audited by an external independent auditor if they meet the requirements set by the cabinet.<sup>144</sup> Three criteria determine if companies are subject to statutory auditing: (i) total assets are 150 million TL or over, (ii) net sales revenues are 200 million TL or over, and (iii) staff members are 500 or over.<sup>145</sup> Accordingly, a company will be subject to statutory auditing if it meets the two of these criteria in two consecutive accounting periods. The new Code No. 6102 has broadened the scope of external auditing. This will be discussed further in Section 4.

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<sup>137</sup> Communiqué Series: X, No: 22 (n 20), Article 5(1); Communiqué Series: X, No: 24 Amending the Communiqué regarding independent auditing in capital markets, Official Gazette No. 26980 (27.08.2008), Article 5(2).

<sup>138</sup> Ibid, Article 6(1).

<sup>139</sup> For the Clarification Project of ISAs, see Chapter III, Section 3.2.2.

<sup>140</sup> Communiqué Series: X, No: 25 Amending the Communiqué regarding independent auditing in capital markets, Official Gazette No. 27387 (25.10.2009), Article 10(3).

<sup>141</sup> Ibid, Article 10(3)(a).

<sup>142</sup> Turkish Commercial Code No. 6762, Official Gazette No. 9353 (29.06.1956).

<sup>143</sup> TCC No. 6102 (n 4).

<sup>144</sup> Ibid, Article 397 (4).

<sup>145</sup> Cabinet Decision No. 2012/4213, Official Gazette No. 28537 (23.01.2013).

### 3. THE AUDIT MARKET STRUCTURE IN TURKEY

#### 3.1. Background of the Audit Profession in Turkey

The very first financial auditing practices in Turkey took place in the years between 1926 and 1934.<sup>146</sup> However, these practices had a limited scope, with mainly tax auditing.<sup>147</sup> During the 1950s, the number of family companies had increased, but auditing was not being undertaken by family companies.<sup>148</sup> Instead, auditing found its application in special-purpose audits conducted by state organs.<sup>149</sup> In the 1960s, foreign companies started to make investments in Turkey. Following the rapid growth of foreign currency flow, financial auditing emerged as a need for system consultancy, especially for tax laws and for the Turkish Commercial Code (TCC).<sup>150</sup> Auditors were seen as the persons to do the compulsory work required by the Ministry of Finance. Audits used to mainly involve checking whether the accounting works complied with the requirements of the component authorities. Financial auditing started to develop in the light of the capital market regulations mainly issued by the SPK. In 1987, the first rules in terms of financial auditing were issued for capital markets to conduct independent audits.<sup>151</sup> By then, banks and public companies started to get audited by registered audit firms.

As it is the case in Europe, external auditing and its role in capital markets have received significant attention during and after the financial crisis in Turkey. Previously, Turkish companies paid less attention to external auditing. Due to common tradition of unregistered economic transactions, less-developed financial markets, and inadequate information regarding the benefits of external auditing, companies created a budget for external auditing only when it was necessary (e.g. when they are planning to apply for bank loans).<sup>152</sup> Moreover, the insufficient

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<sup>146</sup> Masum Turker, 'Turkiye'de Muhasebe Denetim Faaliyetlerinin Gelismisi' (2006) 89 *Dayanisma Dergisi*, Izmir Serbest Muhasebeci Mali Musavirler Odasi Dergisi pp. 5-7.

<sup>147</sup> *Ibid.*

<sup>148</sup> Saban Uzay, Ahmet Tanc, and Mehmet Erciyes, 'Financial Auditing in Turkey: Historical Context and Expectations' 12<sup>th</sup> World Congress of Accounting Historians, 20-24 July 2008.

<sup>149</sup> Inspection staff members of the Ministry of Finance perform special purpose audits. See Umit Guenme and Aylin Arsoy, 'Turkiye'de Cumhuriyet Doneminde Muhasebe Egitimi' (2006) 76 (*Ozel Sayi*) *Mali Cozum Dergisi* 308.

<sup>150</sup> Uzay *et al* (n 148) p. 4.

<sup>151</sup> See also Section 2.3 above.

<sup>152</sup> Adnan Donmez and Ayten Ersoy, 'Bagimsiz Denetim Firmalari Bakis Acisiyla Turkiye Bagimsiz Dis Denetim Sisteminin Degerlendirilmesi' (2006) 36 *Kis Bilig* 69.

regulation of auditing was another reason for the lack of attention paid to external auditing by Turkish companies. In parallel to the development of financial markets, the audit industry also developed in Turkey. It might be useful to examine whether the audit market in Turkey shares similarities with the global audit industry.

### 3.2. Audit Firms in Turkey

The LLP organisation structure is common amongst audit firms in Europe, whereas in Turkey, audit firms have to be organized as joint-stock companies.<sup>153</sup> Currently, there are 91 auditing firms operating and certified by the SPK.<sup>154</sup> The practices of independent audit firms are subject to surveillance by the SPK in the field of capital markets. In addition, the role of setting the establishment requirements and working principles of statutory auditors and audit firms is assigned to the KGK by law.<sup>155</sup>

The very first audit firm established in Turkey was an international audit firm - Touch Ross, established in 1967 with Turkish partners. In 1982, international audit firm Coopers and Lybrand merged with local audit firm Güven Muhasebe A.S.<sup>156</sup> PwC has been giving service in Turkey since then. The other two largest global audit firms (i.e. EY and KPMG) are also actively involved in the Turkish audit market. In fact, currently, the Turkish audit market is dominated by branches of the Big Four audit firms even though their domination is not substantial as in the EU audit market. For the period 2008-2009, more than 50 per cent of companies listed in the ISE, now the Borsa Istanbul, were audited by the branches of the Big Four.<sup>157</sup> Apart from the Big Four audit firms, other global audit firms also operate in Turkey, e.g. Grant Thornton and BDO International, to name but two. The domination of the big audit firms is expected to create a competitive disadvantage for local audit firms. However, a study revealed that almost 50 per cent of audit firms in Turkey are local

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<sup>153</sup> Regulation on independent auditing licensing, Official Gazette No.28539 (25.01.2013), Article 5.

<sup>154</sup> The list of audit firms certified by the SPK is available online at <http://www.spk.gov.tr/apps/msd/iletisim.aspx?submenuheader=9> accessed 14/01/2013.

<sup>155</sup> Statutory Decree on the organisation and duties of the public oversight, accounting and auditing standards No. 660, Official Gazette No. 28103, (06.04.2011), Article 9(d). Previously, this role was assigned to the Ministry of Science, Industry and Technology by law (Commercial Code, Article 400) and the Ministry of Customs and Trade by Decree Law, No. 640 14.02.2011.

<sup>156</sup> Uzay *et al* (n 148) p. 4.

<sup>157</sup> 162 out of 314 companies listed in the ISE were audited by Big Four branches between 2008 and 2009. See *Forbes Turkiye*, Kasim 2009 pp. 80-9.

audit firms.<sup>158</sup> According to the same study, as of 2009, there are 46 local and 48 international audit firms in Turkey.<sup>159</sup>

In terms of the size of assets of audited listed firms for the period 2008-2009, the biggest local auditing firm in Turkey was Kavram Bagimsiz Denetim A.S., established in 1987.<sup>160</sup> Kavram Bagimsiz Denetim is the only local audit firm included in the list of the biggest 10 independent audit firms in Turkey, holding 8<sup>th</sup> position in that list.<sup>161</sup>

Biggest Audit Firms (world ranking by revenues) <sup>162</sup>	Biggest Audit Firms in Turkey <sup>163</sup>		
	Audit Firms	Branches	Foundation Year <sup>164</sup>
PwC	PwC	Basaran Nas	1981
Deloitte & Touché	KPMG	Akis	1982
KPMG	Deloitte & Touché	Drt Bagimsiz Denetim	1986
Ernst & Young	Ernst & Young	Guney	2006
BDO International	Grant Thornton	Engin	1999
Grant Thornton	BDO International	Denet	1981
RSM International	BDO International	Baylan	1987

**Table 6.1:** The biggest audit firms and their branches in Turkey

As seen, the largest global audit firms are active in the Turkish audit market and they audit the majority of listed companies. However, indicators (going concern reporting accuracy and detecting fraud and material misstatements in the accounts<sup>165</sup>) regarding the quality of their audits are mixed.

<sup>158</sup> Seçkin Gönen and Şaban Uzay, 'Türkiye'de Bağımsız Denetim Kuruluşlarının Görünüm' Trakya Üniversitesi, İktisadi ve İdari Bilimler Fakültesi, 1. Ulusal Kurumsal Yönetim, Yolsuzluk, Etik ve Sosyal Sorumluluk Konferansı, 11-14 July 2009, Edirne, Bildiri Kitabı, Editör: Kıymet Tunca Çalıyurt 1.

<sup>159</sup> Ibid.

<sup>160</sup> *Forbes Türkiye*, Kasım 2008.

<sup>161</sup> *Forbes Türkiye*, Kasım 2009.

<sup>162</sup> An Accounting Bulletin survey indicated the biggest audit firms by audit fees earned in 2012. See Huw Jones, 'PwC, Deloitte keep top spots in global audit market', *Reuters*, London, 30 January 2013.

<sup>163</sup> The ranking order of the big audit firms' branches in Turkey was determined in terms of the size of assets of audited IMKB firms for the period 2008-2009. See *Forbes Türkiye*, Kasım 2009 p. 82.

<sup>164</sup> Gönen and Uzay (n 158) p. 19.

<sup>165</sup> These indicators can be used to measure audit quality. See Chapter II.

Before the global financial crisis, between the years 1996 and 2006, there were 33 distressed firms listed in the ISE.<sup>166</sup> In the audit reports, a going concern opinion was issued for only 5 firms, while there were no going concern opinions, issued for the remaining 28 firms.<sup>167</sup> These findings revealed that firms with financial difficulties received audit reports without disclosing going concern uncertainty.

In 2008, a study found that 37 out of 342 ISE firms were financially distressed.<sup>168</sup> 7 out of 37 audit reports issued unmodified (clear) opinions and 19 of them stated conditions to stay as a going-concern.<sup>169</sup> However, none of the audit reports issued modified or adverse opinions, and 11 audit reports had no statements on going concern. In subsequent years, 11 of the 37 firms went bankrupt.

Another study investigated the audit reports of firms listed on the ISE to identify whether they provided misleading or corrupted information in the financial statements of listed firms.<sup>170</sup> The study investigated 344 firms listed on the ISE and their audit reports, issued in 2009. It was found that none of the audit reports of 344 firms issued a modified opinion on the financial statements.<sup>171</sup> This means that either there was no misleading information in the accounts, or auditors failed to detect misstatements. The other possibility is that the auditor found a misstatement but did not report it. It is rather unrealistic to assume that none of the 344 firms engaged in fraudulent financial reporting. It is more likely that auditors were avoiding issuing modified reports.

Auditors are required by law to issue modified reports when financial statements do not present a true and fair view, or the auditor is unable obtain sufficient appropriate audit evidence to form an audit opinion.<sup>172</sup> In this respect, an auditor may modify the audit report by issuing a 'qualified opinion' when there are material misstatements,

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<sup>166</sup> Burcu Adilođlu and Bengü Vuran, 'A Multicriterion Decision Support Methodology for Audit Opinions: The Case of Audit Reports of Distressed Firms in Turkey' (2011) 10(12) *International Business and Economics Research Journal* 37.

<sup>167</sup> *Ibid.*

<sup>168</sup> Şaban Uzay and Şükran Güngör Tanc, 'Analyzing the concept of going concern in independent audit companies trading on the Istanbul Stock Exchange' in MODAV 6<sup>th</sup> Annual International Accounting Conference, 3-5 December 2009, Istanbul.

<sup>169</sup> *Ibid.*

<sup>170</sup> Idris Varici, 'Hileli Finansal Raporlama Acısından Denetcinin Sorumluluđu: IMKB'de Faaliyet Gosteren İşletmelerin Denetim Raporlarının İncelenmesi' (2012) 5 *Gumushane Üniversitesi Sosyal Bilimler Elektronik Dergisi* 122.

<sup>171</sup> *Ibid.* p. 137.

<sup>172</sup> SPK Communiqué Series: X, No: 22 (n 20), Section 30, Chapter 3.

but ones which are not pervasive to the financial statements; an ‘adverse opinion’ when misstatements are both material and pervasive to the financial statements; or a ‘disclaimer of opinion’ when the auditor is unable to obtain sufficient audit evidence to form an audit opinion.<sup>173</sup>

Qualified audit opinions and disclaimers of opinion can be taken into account when questioning the reason behind the auditors’ avoidance of issuing modified reports. The study carried out by Varici determined that 38 audit reports were potentially involved in fraudulent financial reporting. It was found that 50 per cent (19 of 38) of these reports were qualified audit opinions or disclaimers of opinion despite the fact that there was sufficient appropriate evidence to issue modified opinions.<sup>174</sup> These findings illustrate that fraudulent financial reporting exists amongst listed firms in Turkey. However, external auditors do not have a tendency to issue modified audit opinions. These findings may be relied upon as evidence of low-quality audit reports in Turkey.

In response to the global financial crisis, the SPK issued amendments on Communiqué Series: X, No: 22. In 2011, and the requirement of establishment of quality assurance system for audit firms was introduced.<sup>175</sup> In this respect, audit firms are required to control independent audit activities over certain periods in order to increase audit quality. In addition to strengthened regulations on audit quality, auditors and audit firms are subject to oversight of the SPK.

### **3.3. SPK Monitoring Over Audit Firms**

Although the role of supervision and investigation of audit profession was given to the KGK with the enactment of Statutory Decree No. 660,<sup>176</sup> the SPK can provide additional conditions for the approval of audit firms or cancel the approval of the licence of audit firms governed by the KGK.<sup>177</sup> Moreover, the SPK still has statutory rights to supervise audit practices and audit firms that operate in capital markets.<sup>178</sup> In this respect, the SPK is the responsible body for the supervision and regulation of

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<sup>173</sup> Ibid, Article 5 (3)-(4)-(5).

<sup>174</sup> Varici (n 170) p. 140.

<sup>175</sup> Communiqué Series: X, No: 27 amending communiqué on independent audit standards in capital markets, Official Gazette No. 27886 (26.03.2011), Article 20.

<sup>176</sup> For the objectives and duties of the KGK, see Section 4.2 below.

<sup>177</sup> CML No. 6362 (n 111), Article 62(1).

<sup>178</sup> Ibid, Article 62(2).

the audits of a number of institutions, including listed firms, rating and credit agencies, and investment institutions.<sup>179</sup> The regulation of auditing practices of listed companies, except banks and insurance companies, is the responsibility of the SPK.<sup>180</sup>

The SPK is an independent regulatory authority in capital markets and is empowered by law to issue regulations in capital markets as well as to supervise compliance with the law and apply administrative sanctions in case of any breach of its rules.<sup>181</sup> Within this context, audits of listed companies are subject to inspections of the SPK under the quality control reviews. The SPK can launch inspections of audit firms as a form of regular routine or as a result of a complaint or a denouncement. The most common sanctions are warnings, administrative fines, cancellation of licences, or issuing criminal reports to the Chief Public Prosecutor's Office (Cumhuriyet Bassavciligi).<sup>182</sup>

SPK monitoring over audit firms operates under the Distance Data Collection (Uzaktan Veri Alim) project. Within this project, the SPK gathers information electronically. In accordance with the collected data and reports, the SPK conducts quality reviews on specified audit firms. Following inspections, the SPK can issue penalties if any violation of SPK legislation is detected.<sup>183</sup> The list of penalties or any other regulatory sanctions is issued annually in the activity report.<sup>184</sup>

Table 6.2 below presents the administrative fines and other sanctions issued to audit firms by the SPK for the period 2008-2011. The data are collected from the annual activity reports of SPK between 2008 and 2011.

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<sup>179</sup> Cabinet Decision No. 2012/4213 (n 145).

<sup>180</sup> Banks and insurance companies' regulations regarding their establishment, accounting, auditing, and financial tables and reporting standards are subject to specific banking regulations of the BDDK. See CML No. 6362 (n 111), Article 50 a(4).

<sup>181</sup> For SPK's mission statement and goals and objectives see its website <http://www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=0&pid=0&submenuheader=-1> accessed 08/03/2013.

<sup>182</sup> Gonen and Uzay (n 158).

<sup>183</sup> The quality control reviews used to take place as onsite reviews; however, as of 2010, SPK launched a project called Distant Data Collection (Uzaktan Veri Alim Projesi) that enables SPK to collect data online.

<sup>184</sup> SPK's Annual Activity Reports are available online at <http://www.spk.gov.tr/indexcont.aspx?action=showpage&menuid=7&pid=5> accessed 03/04/2013.

Years	Investigated firms	Legal Warning	Administrative fine	De-listing	Total administrative fine (TL)
2008	12 out of 94	4	3	4	80.880
2009	16 out of 95	7	7	3 <sup>185</sup>	97.552
2010	16 out of 92	-	8	1	153.420
2011	11 out of 91	14 <sup>186</sup>	2	-	35.662

**Table 6.2:** Quality Control Reviews by SPK for the period 2008-2011

The sanctions the SPK imposes on audit firms are based on de-listing, administrative fines, and legal warnings. All of these sanctions are issued as a result of breach of the SPK Communiqués Series: X, No: 22 and Series: VIII, No: 45. However, it is questionable how effective the quality control reviews of the SPK are. As can be seen from Table 6.2, only 12-15 per cent of audit firms were investigated each year.<sup>187</sup> There is no other information about the rest of the audit firms' audit quality. Moreover, in the SPK Quality Control Reviews, there is no specific information regarding sanctions for the Big Four audit firms' branches in Turkey. Although some SPK reports revealed the name of the audit firms who received an administrative fine or a legal warning, none of these audit firms was one of the Big Four branches in Turkey.

In 2010, Kavram Bagimsiz Denetim, the eighth biggest audit firm in Turkey, was levied with 17,170 TL in administrative fines due to low audit quality.<sup>188</sup> The SPK fined Kavram Bagimsiz Denetim over activities that breached SPK Communiqué Series: X, No: 22 Section 1, Article 7; Section 2, Article 14; Section 4, Article 13; Section 5, Articles 4, 10, 11, 12; Section 6, Article 3; Section 9, Articles 3, 4; Section 1, Article 7; and Section 29, Article 4,5,9.<sup>189</sup> In summary, the fines were levied due to a breach of requirements on the calculation of audit risk and on the requirement of showing due care when performing an audit.

<sup>185</sup> Four audit firms were applied for de-listing. As a result, 3 of them were de-listed in 2009, and one of them was de-listed in 2010. See the SPK Annual Activity Report of 2009, Ankara 2010, p. 73.

<sup>186</sup> There is an incompatibility between the numbers of investigated audit firms and the number of sanctions. For instance, 11 audit firms were investigated in 2011, but there were 14 legal warnings. There is no clarification of this issue in the SPK activity reports. The reason for this may be that some of the audit firms might have received more than one warning (or fine).

<sup>187</sup> As table 6.2 illustrates, in 2008, 12%; in 2009, 16%; and over 2010-2011, 17% of audit firms were investigated by the SPK.

<sup>188</sup> SPK Weekly Bulletin 2010/45, 25-28 October 2010.

<sup>189</sup> Ibid p. 5

It can be concluded that the audit market in Turkey shares some similarities with the global audit industry. To begin with, auditors and audit firms that audit listed companies' accounts are subject to surveillance by an oversight body, namely the SPK. Second, the audit market is dominated by the Big Four audit firms - although this domination is not prominent as it is in European markets.<sup>190</sup> It is possible that the SPK's mandatory rotation rule on audit firms might have positively influenced this relatively moderate concentration level in Turkey. Third, as well as examples from the US and Europe,<sup>191</sup> audit firms in Turkey were reluctant to issue modified audit reports for financially-distressed companies.

#### 4. CRITICAL ANALYSIS OF THE REFORMS ON EXTERNAL AUDITING

##### 4.1. New Turkish Commercial Code of 2012

According to the General Justification of the new TCC, the Commercial Code of 1956 provided modern, reliable, and effective solutions to the commercial problems of the time. However, it was not able to keep up with the developments that have taken place over the last fifty years.<sup>192</sup> Neither there were major amendments in accordance with these financial developments in the Act. Therefore, it was judged necessary to create a new law.

The Turkish Commercial Code Draft (the Draft) was the outcome of 5 years' work of a commission appointed for drafting the new TCC.<sup>193</sup> The Draft included a detailed comparative overview of developments in the commercial law of European countries.<sup>194</sup> It can be said that the provisions of the new Code have been inspired by EU jurisdictions.<sup>195</sup> In addition, the new TCC was created in the context of a number of EU regulations, directives, recommendations, and communications in order to be in compliance with the EU *acquis*.<sup>196</sup>

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<sup>190</sup> For the Big Four concentration in Europe, see Chapter II, Section 2.4.

<sup>191</sup> See Chapter II, Section 3.2.

<sup>192</sup> TCC General Justification (n 1), para.2.

<sup>193</sup> The members of this commission are agents of the Turkish Ministry of Justice, the Turkish Supreme Court, academic members from various universities in Turkey, agents of the SPK, BDDK and the Turkish Accounting Standards Board.

<sup>194</sup> See in general TCC General Justification (n 1).

<sup>195</sup> Eroglu (n 4) p. 257.

<sup>196</sup> These references are namely the EU Green Paper on the role, the position and the liability of the statutory auditor within the European Union OJ 96/C 321/1 (28.10.1996) and Communications from

The Draft examines developments in commercial law in different jurisdictions in Europe, because of Turkey's objective to adopt EU regulations as an official EU candidate country. Therefore, the new TCC is a part of the process of embracing European law, as Turkey is already required to harmonise its law with the EU *acquis*.<sup>197</sup> In terms of auditing, it is said that countries that reform their financial markets usually need to adopt audit practices from more advanced markets.<sup>198</sup> The new TCC, in this respect, provides similar provisions with EU laws on auditing. In addition to provisions to harmonise EU law, the new Code also reflects changes in doing business in the 21<sup>st</sup> century.<sup>199</sup> For example, the new Code now requires companies to have websites,<sup>200</sup> includes provisions for e-commerce, and enables online general assemblies and online board meetings.<sup>201</sup>

After a number of amendments on the draft version, the new Code was accepted in the Turkish parliament in January 2011. The new TCC was issued on 13.01.2011 and largely came into force on 01.07.2012; yet, its provisions on external auditing only came into force on 01.01.2013. The new Code regulates external auditing in the third section with 10 articles: Articles 397-406. Within the context of the new TCC, the external auditing reforms were as follows: The auditor shall investigate whether the financial statements are in line with Turkish Auditing Standards (TDS).<sup>202</sup> In addition, the auditor shall examine whether the financial reports of the board of directors present a true view of the financial situation of the company to its shareholders.<sup>203</sup> Financial statements that were not audited by an independent external auditor would be considered as though they were not prepared.<sup>204</sup>

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the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, Brussels, COM (2003) 284 final (21.5.2003) and Reinforcing the statutory audit in the EU Brussels, COM (2003) 286 final (21.5.2003). See TCC General Justification (n 1), paras.221, 222, 224, and 225.

<sup>197</sup> In addition to modernizing of the Commercial Law, the Turkish Civil Code and Criminal Codes have been subject to on-going amendments since 2001.

<sup>198</sup> Joseph P. H. Fan and T. J. Wong, 'Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia', (2005) 43(1) *Journal of Accounting Research* 35.

<sup>199</sup> Caleb Lauer, 'Turkey's new commercial code to have broad impact on M&A', *Financial Times*, 5 March 2012.

<sup>200</sup> TCC No. 6102 (n 4), Article 1524.

<sup>201</sup> *Ibid*, Article 1527.

<sup>202</sup> *Ibid*, Article 397(1).

<sup>203</sup> *Ibid*.

<sup>204</sup> *Ibid*, Article 397(2).

The main objective of independent external auditing is to examine a company's internal audit system and its financial accounts, and to check compliance with Turkish Accounting Standards and the law.<sup>205</sup> Following the new TCC, auditing in Turkey should now develop based on international professional standards. A detailed evaluation of these reforms will be given next.

*i. Expanded application for external auditing*

Previously, since the TCC did not regulate external auditing, only listed companies were subject to external auditing under CML and SPK regulations. The new TCC requires all types of companies<sup>206</sup> to be audited by an independent auditor (or an audit firm).<sup>207</sup>

The other reform of the new TCC is that all companies subject to external auditing are obliged to have a website<sup>208</sup> displaying important information about the company that might affect stock prices, e.g. securing or selling of stock shares that are more than 5 per cent of the company shares.<sup>209</sup> In addition, all financial reports, including audit reports, are to be published on the company's website.<sup>210</sup> With respect of this new regulation, the intention is to provide easy access for existing shareholders and investors to audited financial information.

*ii. Increased qualifications for external auditors*

Previously, auditors worked as members of the company and they were not professionals who were specifically qualified to perform the audit work. This situation was raising serious doubts about the quality and reliability of audit reports. The new TCC regulated who can perform audit work through setting requirements to be an independent auditor. These requirements are in line with EU Directive 2006/43/EC.<sup>211</sup> According to the new TCC, auditors will no longer work as a member of the audited company; instead, an audit firm whose partners are SMMM

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<sup>205</sup> Ibid, Article 398.

<sup>206</sup> All companies may be subject to external auditing if they meet the requirements set by the cabinet. See Cabinet Decision No. 2012/4213 (n 149). See also Section 2.4 above.

<sup>207</sup> TCC No. 6102 (n 4), Article 397(1).

<sup>208</sup> Ibid, Article 1524.

<sup>209</sup> Ibid, Article 198.

<sup>210</sup> Ibid, Article 1524(1)(j).

<sup>211</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87, Article 6.

or YMM could be appointed as an independent auditor. For SMEs, one or more SMMM or YMM could be appointed as an independent auditor.<sup>212</sup> Auditors and audit firms are to be elected by the general assembly.<sup>213</sup> Specialised Courts on Commercial Law (Asliye Ticaret Mahkemeleri) can remove an auditor at the request of the board and shareholders who hold at least 5 per cent of the stocks, based on a good reason.<sup>214</sup>

Furthermore, Statutory Decree No. 660 has to be read together with the Article 400 of the new TCC, since it sets extra conditions to be an independent auditor. This regulation makes a distinction for the first time as to audits of public-interest-entities' (PIEs)<sup>215</sup> and audits of other firms'. Accordingly, audits of the PIEs must be carried out only by audit firms, while other firms' audits could be carried out either by auditors or audit firms.<sup>216</sup> In addition, the law also states that only audit firms may carry out large entities' audits.<sup>217</sup> Accordingly, an SMMM and/or YMM cannot be appointed as an independent auditor for PIEs or large-entity audits. Instead, only audit firms can carry out large-entity and PIE audits. For audits of PIEs, a minimum of 15 years' professional experience is set as an extra requirement.<sup>218</sup> Auditors (SMMM or YMM) who have met the 15-year requirement have to take an exam to qualify as an independent auditor.<sup>219</sup>

Another requirement is set for key audit partners. The Statutory Decree makes a distinction again to be a key audit partner for the audits of PIEs' and other firms'. Accordingly, to be a key audit partner of PIEs, an SMMM or YMMM has to work as an auditor or senior auditor for a minimum of 2 years (1 year for audits of other firms), in addition to having 15 years professional experience (10-year professional experience for audits of other firms).<sup>220</sup> Under these requirements, the new TCC aimed to construct a well-qualified audit profession in the field.

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<sup>212</sup> TC No. 6102 (n 4), Article 400(1).

<sup>213</sup> Ibid, Article 399(1).

<sup>214</sup> Ibid, Article 399(4).

<sup>215</sup> PIEs defined as follows: listed firms, banks, insurance, reinsurance and pension firms, factoring and financing firms and pension funds. See Statutory Decree No. 660 (n 155), Article 2(i).

<sup>216</sup> Regulation on independent auditing, Official Gazette No.28509 (26.12.2012), Article 11(3).

<sup>217</sup> TCC No. 6102 (n 4), Article 400.

<sup>218</sup> Regulation No.28509 (n 216), Article 28(1).

<sup>219</sup> Ibid, Article 16.

<sup>220</sup> Ibid, Article 28(1)(a)-(b).

*iii. Auditor independence ensured by law*

Article 400 of the new TCC sets the conditions for those who can carry out statutory audits. The same article also states circumstances that might jeopardize auditor independence. In the presence of any direct or indirect financial, business, employment, or other relationship between the auditor and the audited firm, the auditor or its partners must not carry out the audit.<sup>221</sup> In this provision, the new TCC sets independence as a requirement for external auditing. In other words, the audit work will not be carried out unless the independence requirement is satisfied.

In addition to the auditor independence, the TCC states that audit partners and other persons who work with the auditor are independent and not involved in decision taking in the audited company. Any economic dependence on the audited company jeopardizes auditor independence. Hence, the TCC states that the auditor shall not carry out the audit if 30 per cent of their total revenue in the last 5 years has been generated from the audited company, or another company affiliated to the audited company with more than 20 per cent shares.<sup>222</sup>

In summary, the new TCC expanded the application of external auditing through the requirement of statutory auditing for all companies who has met the requirements set by the law. In addition, the new Code aimed at increasing audit quality level. For this purpose, it increased the requirements to qualify as a statutory auditor in line with international standards. Thereby, the new TCC requires financial statements to be produced by independent, well-qualified, and professional auditors who have relevant expertise and experience in the field.

**4.2. The Establishment of Public Oversight Accounting and Auditing Standards Authority (KGK)**

EU Directive 2006/43/EC requires Member States to establish a public oversight board to supervise auditors and audit firms and implement sanctions in case of any violation of related law.<sup>223</sup> In line with this requirement, in 2011, Turkey established its public oversight body: the Public Oversight Accounting and Auditing Standards

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<sup>221</sup> TCC No. 6102 (n 4), Article 400(a)-(g).

<sup>222</sup> Ibid, Article 400(h).

<sup>223</sup> Directive 2006/43/EC (n 211), Chapter VIII.

Authority (KGK). The KGK is authorised as responsible for the oversight over auditors and audit firms.<sup>224</sup> The KGK was also established in accordance with the principles set by Directive 2006/43/EC, i.e. the principles on qualification, expertise, and conditions for the approval of auditor.<sup>225</sup> In this respect, the duties and responsibilities of the KGK are to set and issue Turkish accounting standards in compliance with international standards, govern the establishment and working principles of independent audit firms, certify auditors, supervise compliance to standards and regulations by auditors (and audit firms), to suspend or withdraw the approval of statutory auditors (and audit firms),<sup>226</sup> and to issue penalties in case a contradictory situation is determined.<sup>227</sup>

The KGK started its activities as of December 2011. However, its establishment and activities in the field have received a mixed reaction from the profession and the market. This is because the establishment of the KGK was a major development in Turkish audit sector; most of the operational field of the KGK was already regulated under existing law, i.e. the Profession Act and SPK regulations. There were also other regulatory authorities that existed in the market, i.e. the TURMOB, SPK and BDDK. The establishment of the KGK was expected to repeal some existing law and limit the role of existing authorities to a degree. These issues will be examined in detail.

*i. The regulation on qualifications of auditors*

In financial markets, auditors and audit firms must first be certified by the KGK to conduct audits in financial markets.<sup>228</sup> To be an independent auditor, the KGK regulations brought additional conditions. 15 years' experience in the field was required to be an independent auditor' otherwise, a 3-year period of education followed by an exam is required to qualify as an external auditor.<sup>229</sup>

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<sup>224</sup> Statutory Decree No. 660 (n 155).

<sup>225</sup> Directive 2006/43/EC (n 211), Article 32.

<sup>226</sup> KGK shall consult to the component authorities (e.g. the SKP and BDDK) on the approval of independent auditing firms. See Statutory Decree No. 660 (n 155), Article 23(2).

<sup>227</sup> *Ibid*, Article 9.

<sup>228</sup> Communiqué Series: X, No: 28 amending communiqué on independent audit standards in capital markets, Official Gazette No. 28691 (28.06.2013), Section 2, Article 3.

<sup>229</sup> Regulation No. 28509 (n 216), Article 28.

These additional conditions attracted criticism, especially from the accounting and auditing profession. Critics felt that this regulation was issued without the approval of the accounting and auditing professions.<sup>230</sup> In addition, the regulation disregarded existing law since, at the time, the Profession Act approved SMMM and YMM as independent auditors and set the standards for auditors.<sup>231</sup>

*ii. The role of the KGK in standard setting*

The role of issuing standards on accounting and auditing was first given to the boards established under TURMOB: TMSK and TDSK.<sup>232</sup> Now, that role was given to a sole authority: the Public Oversight Authority of Turkey (KGK).<sup>233</sup>

Similar to the Profession Act itself, TURMOB also overlooked recent developments in Europe and in the world and failed to guide the profession in the light of these developments. It has been suggested that 'Profession Act' be revised in accordance with the new TCC,<sup>234</sup> however, this is not necessary, since the primary rules on auditing are now issued by the new TCC and other details are set by KGK regulations. TURMOB and its management body highly criticised the establishment of the KGK because of the extensive authority given to the KGK in terms of issuing accounting and auditing standards. The reason for this strong objection is the fact that the establishment of the KGK has now abolished the role of TURMOB in standard setting.

*iii. The role of the KGK in supervision over profession*

In terms of monitoring over audit firms, KGK regulations set requirements for the quality assurance system and investigations into audit firms.<sup>235</sup> These provisions were in line with EU Directive 2006/43/EC.<sup>236</sup> Accordingly, investigations into audit firms that audit PIEs are to take place every 3 years, while the oversight of other

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<sup>230</sup> TURMOB, 'Turk Ticaret Kanunu Merkezinden Oynatildi Amacindan Uzaklasti', *Press Release* No. 01BB 05.01.2013.

<sup>231</sup> Profession Act (n 112); TCC No. 6102 (n 4), Article 2. See also Section 2.1 above.

<sup>232</sup> See Section 2.1 above.

<sup>233</sup> Statutory Decree No. 660 (n 155).

<sup>234</sup> Erdogan Arslan, 'Yeni Turk Ticaret Kanunu'na Gore Denetcinin Niteligi' (2011) March-April Mali Cozum 73.

<sup>235</sup> Statutory Decree No. 660 (n 155).

<sup>236</sup> Directive 2006/43/EC (n 211), Articles 29, 30.

audit firms will take place every 6 years.<sup>237</sup> Since the new TCC requires all PIEs to have external audits, the oversight of supervision of the audits should be expanded too. Through the establishment of the KGK, the supervision of audits that fall outside of the authority of SPK and BDDK is obtained.

*iv. The KGK and its relationship with other authorities*

Before the establishment of the KGK, the supervision of audit firms had a multi-headed structure. The SPK used to govern audit firms that audited firms listed on the Borsa Istanbul,<sup>238</sup> the BDDK used to govern firms that audited banks and financial institutions,<sup>239</sup> and the Energy Market Regulatory Authority (EPDK) used to govern audit firms and their conduct regarding firms in the energy market.<sup>240</sup> The supervision of an audit firm who was registered with SPK used to required registration to other authorities if they performed audits of banks and other financial institutions. For instance, an audit firm used to have to register to the BDDK as well if it performed an audit of a bank.<sup>241</sup>

This multi-headed regulatory structure resulted in inefficiencies in monitoring mechanisms of auditing. Also, coordination between regulatory agencies was not efficient at all times in terms of the supervision of audit practices. Thus, this multi-headed regulatory structure was desired to be terminated through establishment of a Turkish public oversight authority: the KGK, a single body that would govern audit practices. Figure 6.1 illustrates the role of the KGK and its relationship with other component authorities.

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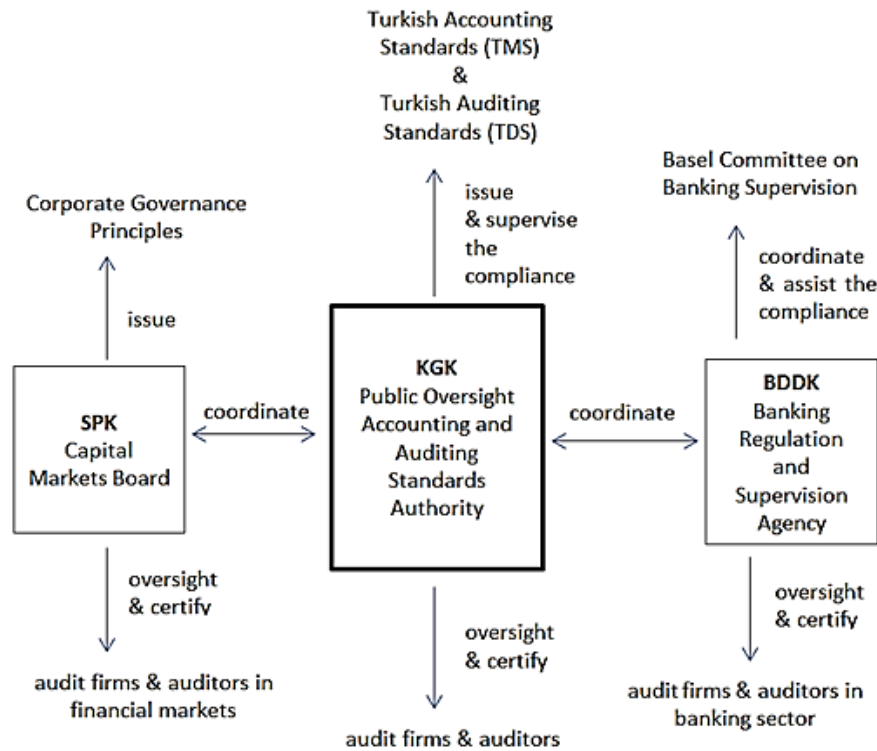
<sup>237</sup> Statutory Decree No. 660 (n 155), Article 25(1).

<sup>238</sup> CML No. 2499 (n 121), Article 22/I-d, e.

<sup>239</sup> Banking Law No. 5411 (n 64), Articles 15, 33, and 36; Insurance Law No. 5684, Article 18/II.

<sup>240</sup> Regulation on audits of natural persons and corporates on energy markets, Official Gazette No. 25248.

<sup>241</sup> Similarly, an audit firm who registered to the SPK had to get approval from the EPDK if they performed the audit of a company that operated in the energy sector.



**Figure 6.1:** The role of the KGK and its relationship with other regulatory authorities

As Figure 6.1 shows, while the SPK and the BDDK govern audits in their subject areas (i.e. respectively financial markets, and banking sector), the KGK governs the audit firms and auditors that fall outside of the scope of SPK and BDDK (e.g. the audits of non-listed firms). Yet, the SPK has the right to withdraw approval of an audit firm approved by the KGK.<sup>242</sup> So, the KGK carries out its duty in coordination with the SPK and the BDDK. In terms of standard-setting, the role of issuing the TMS and TDS was first assigned to the TURMOB.<sup>243</sup> However, this role was granted to the KGK after its establishment in 2011.

As regards the certification of auditors, since 2013, auditors and audit firms are required to be certified by the KGK initially, in order to perform audits in financial markets.<sup>244</sup> It seems that the KGK has been given primary responsible authority in the auditing field. However, the KGK receives opinions from the SPK and the

<sup>242</sup> CML No. 6362 (n 111), Article 62.

<sup>243</sup> See Section 2.1 above.

<sup>244</sup> Communiqué Series: X, No: 28 (n 228), Section 2, Article 3.

BDDK on the approval of audit firms that audit PIEs.<sup>245</sup> This provision reserves the rights of the SPK and the BDDK as to external audits of PIEs in the sectors that they are authorised to regulate and supervise.

The establishment of a single regulatory and supervisory authority in the audit market is important in a number of ways. First, the establishment of such a public authority is in compliance with EU Directive 2006/43/EC. This is a significant development in the progress of harmonisation with the *acquis*. Second, the establishment of the KGK is especially important for audit firms who have international licence agreements anywhere other than Turkey. If there were no component authority in the home country, audit firms who have international licence agreements and sought to perform audits internationally would be subject to the examination of national oversight bodies (e.g. PCAOB in the US).<sup>246</sup> Therefore, the establishment of a public oversight authority in Turkey would prevent double oversight over audit firms. Third, the establishment of the KGK is critical for audit quality and transparency. Annual examinations of the KGK over audit firms will be followed by evaluation reports that would be available online.<sup>247</sup> It is expected that the establishment of the KGK would increase audit quality through enhanced transparency. Nevertheless, the establishment of the KGK has not terminated the multi-headed regulatory structure entirely, since the SPK and BDDK still have supervisory rights over audits in their regulatory area. Therefore, it is necessary for these authorities to work in close co-operation and prevent any regulatory chaos that might be created over the legislative tangle.

### 4.3. Auditor Liability in Turkish Law

No specific legislation exists regarding auditor liability in Turkey. Because Turkey is a civil law country, court decisions do not have wide application, as is the case in common law countries, such as the UK.<sup>248</sup> Instead, auditor liability might arise from related provisions under TCC No. 6102 and CML No. 6362. Turkey's public

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<sup>245</sup> Also, the Capital Markets Law and Banking Law provisions with respect of the regulation of external auditing and audit firms are reserved. See Statutory Decree No.660 (n 155), Article 23(2)-(4).

<sup>246</sup> The Sarbanes-Oxley Act (SOX), US Congress (2002) An act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. 107<sup>th</sup> Congress, H.R. 3763, s. 106.

<sup>247</sup> Regulation No.28509 (n 216), Article 38.

<sup>248</sup> For UK common law rules on auditor liability, see Chapter V.

oversight authority, the KGK also provides rules related to auditor liability under Statutory Decree No. 660. In addition, in line with ISA 240, SPK Communiqué Series: X, No: 22 governed the responsibility of auditors with respect of fraud and material misstatement detection in financial accounts.

#### 4.3.1. Auditor Liability in the Turkish Commercial Code

Elements of auditor liability are constituted by auditors' statutory duties as outlined in the new TCC. Accordingly, auditors are responsible for checking whether the financial statements of companies are prepared in accordance with Turkish Accounting Standards (TMS) and TCC.<sup>249</sup> Auditors are also responsible for reporting to the board of directors regarding risks that the company may encounter and whether a mechanism is installed in the company to detect those risks.<sup>250</sup> Therefore, external auditors could be held liable if they found faulty when performing their statutory duties and subsequently cause a financial loss.<sup>251</sup> The law also requires auditors and audit firms to conclude a liability insurance arrangement.<sup>252</sup> The SPK Communiqué set the minimum level of this liability insurance arrangement at 200,000 TL.<sup>253</sup>

##### *i. Auditor liability arising from the responsibility to keep a secret*

Section 3 of the new TCC states that auditors are responsible for acting in an honest and unbiased manner to keep private those facts and documents seen during the audit which relate to the business and business secrets.<sup>254</sup> The liability specified by the law is liability to the company itself. The law sets a maximum threshold for liability to the company. Accordingly, auditors could be charged to pay compensation up to 300,000 TL.<sup>255</sup> Also, the persons who suffered losses can make a claim under criminal law provisions.<sup>256</sup>

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<sup>249</sup> TCC No. 6102 (n 4), Article 398(2)(a).

<sup>250</sup> Ibid, Article 398(4).

<sup>251</sup> Mustafa Yavuz, 'Yeni Turk Ticaret Kanunu'na Gore Bagimsiz Denetçilerin Hukuki Sorumlulugu' (2012) 230 February Yaklasim.

<sup>252</sup> Mustafa Yavuz, 'Bagimsiz Denetim Kuruluslari ve Bagimsiz Denetçiler Uzerinde Kamu Denetimi ve Gozetimi' (2011) September-October Mali Cozum Dergisi p.156.

<sup>253</sup> Communiqué Series: X, No: 22 (n 20), Section 2, Article 3.

<sup>254</sup> TCC No. 6102 (n 4), Article 404(1).

<sup>255</sup> Ibid, Article 404(2).

<sup>256</sup> Ibid, Article 402(6).

*ii. Civil liability of auditors*

The TCC regulates the civil liability of auditors in Section 11. Accordingly, with the burden of proof on the claimant, auditors are liable to the company itself, company shareholders, and creditors (only in the case of insolvency<sup>257</sup>) if found faulty<sup>258</sup> when performing statutory audits.<sup>259</sup> It is important that the new Code enables each shareholder to make a claim. However, shareholders can only request compensation is paid to the company.<sup>260</sup> Article 554 does not state any liability limitation on auditors, while Article 404 sets an upper limit for compensation to be paid by auditors arising from their responsibility to keep a secret. In other words, the new TCC introduced a liability limitation for auditors with a limited scope.

*iii. Liability rules under Statutory Decree No. 660*

In addition to the provisions of the TCC, KGK regulations provide rules regarding auditor liability. Accordingly, auditors and audit firms are liable for the damages resulting from wrong, incomplete, or misleading information in financial statements.<sup>261</sup> However, Statutory Decree No. 660 does not state to whom auditors are liable. Therefore, Statutory Decree No. 660 and the TCC provisions should be read together when determining the conditions of auditor liability.

As the TCC requires, there must be ‘wrongful acts’<sup>262</sup> for a successful liability claim against auditors for damages caused by wrong, incomplete, or misleading information in financial statements. Under the TCC, the company itself, company shareholders, and creditors (only in case of insolvency) can seek compensation for damages.<sup>263</sup> However, claimants must prove the auditors were negligent.

Nevertheless, the provisions of Statutory Decree No. 660, even if read with the TCC, are not comprehensive enough to cover all the issues regarding auditor liability. It is

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<sup>257</sup> Ibid, Article 556.

<sup>258</sup> Faulty principle is based on wrongful acts that include both wilful misconduct and negligent acts. See Yavuz (2012) (n 251).

<sup>259</sup> TCC No. 6102 (n 4), Article 554.

<sup>260</sup> Ibid, Article 555.

<sup>261</sup> See Statutory Decree No. 660 (n 155), Article 24. Also, the Regulation on independent auditing issued that auditors and audit firms are liable for the damages resulting from the wrong, incomplete, and misleading information caused by violations to the TDS. See Regulation No.28509 (n 216), Article 44.

<sup>262</sup> TCC No. 6102 (n 4), Article 554.

<sup>263</sup> Ibid, Article 556.

because the law does not impose any liability on auditors to third parties (e.g. a person apart from shareholders) for the economic loss caused by wrongful acts.

#### **4.3.2. Auditor Liability in Capital Markets Law**

Auditor liability to third parties is regulated under CML No. 6362. Similar to UK regulations,<sup>264</sup> liability rules for prospectuses and other disclosure requirements are outlined separately, within the same code but under different articles.

##### *i. Liability for prospectuses*

Similar to the UK, any shares in Turkey must have a prospectus that contains information about securities.<sup>265</sup> In this respect, the CML requires prospectuses be issued before securities are promoted to investors.<sup>266</sup> In addition, as a new condition, prospectuses must be approved by the SPK before they offered to the public.<sup>267</sup>

The SPK issues regulations for listed companies regarding disclosure requirements in financial markets.<sup>268</sup> If the issuer fails to meet obligations set by the regulations, the SPK may impose sanctions or cancel the listing of securities. In case of any wrong or misleading information in the prospectuses, investors may sue the responsible persons and institutions under the CML.<sup>269</sup> The law explicitly states audit firms as responsible for wrong or misleading information included in the prospectuses.<sup>270</sup>

##### *ii. Liability for other disclosure requirements*

CML No. 6362 introduces requirements for disclosing other public disclosure statements for the first time.<sup>271</sup> Accordingly, issuers are liable for any wrong, misleading, or incomplete information in the periodic disclosure statements. The periodic disclosure statements are annual reports, financial reports, and other disclosure reports including information on mergers and takeovers.<sup>272</sup> Again, the law explicitly imposes liability on auditors (together with other issuers) who are involved

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<sup>264</sup> See s. 90 of FSMA. See also Chapter V, Section 3.2.2.

<sup>265</sup> CML, No. 6362 (n 111), Section 2, Article 4.

<sup>266</sup> Ibid, Article 4(1).

<sup>267</sup> Ibid.

<sup>268</sup> Communiqué Series: VIII, No: 39 on the disclosure of material events (RG, 20 July 2003, No. 25174), replacing the previous communiqué issued in 1993.

<sup>269</sup> CML No. 6362 (n 111), Article 10(1).

<sup>270</sup> Ibid, Article 10(2).

<sup>271</sup> Ibid, Article 32.

<sup>272</sup> Ibid, Article 32(1).

in presentation of wrong, misleading, or incomplete disclosures of reports.<sup>273</sup> In this respect, audit firms and auditors are liable for damages to the persons who purchased or sold securities after the reports (consisting of wrong, incomplete, or misleading information) disclosed to the markets.<sup>274</sup> Compensation claims would be rejected if the claimant knew the reports were wrong, incomplete, or misleading.<sup>275</sup>

As is the case in the UK,<sup>276</sup> a fraudulent act or gross negligence is necessary to make a claim under this provision. Therefore, the auditor could not be held liable if he (or she) did not know that the statements were untrue. However, the burden of proof is on the auditor. If the auditor proves that there was no gross negligence or fraudulent intention involved in the wrong (or misleading, or incomplete) information stated in the reports, he (or she) can escape liability.<sup>277</sup>

Moreover, the CML states that the SPK can issue additional requirements for auditors and audit firms. In this context, audit firms would be liable for economic loss caused by the audits of financial statements that were not audited in accordance with the SPK rules.<sup>278</sup>

### *iii. Auditors' responsibility under Communiqué Series: X, No: 22*

The SPK governs the responsibility of auditors with respect of the detection of fraud and material misstatement in financial accounts. SPK provisions on auditors' responsibilities to detect fraud and material misstatements in accounts are in line with ISAs' approach to this issue.<sup>279</sup> In this respect, like ISAs, SPK communiqués do not place a direct responsibility on auditors but they provide a guidance to build an audit mechanism for effective fraud detection.

According to Communiqué Series: X, No: 22, auditors should evaluate “*fraud risk factors*” and provide “*reasonable*” assurances on financial reports that financial statements are free from material misstatement and fraud.<sup>280</sup> Fraud risk factors

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<sup>273</sup> Auditors and issuers of the prospectuses are subject to joint liability. See *ibid*, Article 32(2).

<sup>274</sup> *Ibid*, Article 32(4).

<sup>275</sup> *Ibid*, Article 329(5)(b).

<sup>276</sup> See Chapter V, Section 3.

<sup>277</sup> CML No. 6362 (n 111), Article 32(3).

<sup>278</sup> *Ibid*, Article 63.

<sup>279</sup> See Chapter V, Section 1

<sup>280</sup> Communiqué Series: X, No: 22 (n 20), Article 6(2).

include pressure, incentives and opportunities for fraud. Therefore, auditors should assess fraud risk factors even if there is no actual fraud.<sup>281</sup> Due to inherent limitations in the nature of auditing (e.g. sampling methods; time pressure on auditors),<sup>282</sup> auditors are expected to provide only ‘reasonable’ assurance though their professional opinion keeping with professional scepticism.<sup>283</sup> Hence, the liability of auditors in detecting fraud and material misstatement in financial reports is limited to ‘reasonable assurance’, which means that, despite assurances by auditors, there may still be some unavoidable risks.

In addition to the civil liability rules outlined in the CML, auditors are also liable for any criminal actions, such as providing audit services without the approval of the KGK or SPK, or issuing false or misleading audit reports with intention or without taking reasonable care. The SPK is authorised to issue a number of sanctions on these audit firms, such as administrative (or judicial) fines and cancellation of licences.<sup>284</sup>

Furthermore, following a complaint, the SPK can launch an investigation into these audit firms and can issue a criminal report to the Chief Public Prosecutor’s Office (Cumhuriyet Savciligi). Cumhuriyet Savciligi then commences a public prosecution. In 2011, the SPK issued 21 criminal reports to Cumhuriyet Savciligi with regards insider dealing and manipulation activities in financial markets.<sup>285</sup> However, none of these public prosecutions have yet concluded.<sup>286</sup>

### ***Conclusion on auditor liability rules in Turkey***

Previously, the external auditing and liability of auditors did not find their applications under the TCC of 1956. Following these law reforms, Turkish law regulates auditor liability both to the company and to third parties under the TCC and

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<sup>281</sup> Ibid.

<sup>282</sup> Mehmet Erkan and Nuray Demirel Arici, ‘Regulations on Fraud Audit in Publicly-Held Companies: A Comparative Study on Turkish and US Capital Markets’ (2011) 2(15) *International Journal of Business and Social Science* 251.

<sup>283</sup> Providing reasonable assurances may be understood as auditors having critically evaluated existing information, sought evidence of misreporting and concluded an assurance that there is no important misstatement that may affect the quality or reliability of financial statements. See also professional scepticism under ISA in Chapter V, Section 1.

<sup>284</sup> For SPK sanctions over audit firms, see also Section 3.3 above.

<sup>285</sup> SPK Annual Activity Report of 2011, Ankara April 2012, p. 70.

<sup>286</sup> In 2010, there were 69 complaints made by SPK to Cumhuriyet Savciligi and only 2 cases concluded with nonsuit decision. See SPK Annual Activity Report of 2010, Ankara 2011, p. 93.

CML in general. Also, the KGK and SPK issue additional rules regarding misleading information in accounts and responsibility to detect fraud.

It can be said that law reforms under the new TCC and CML are significant for external auditing in Turkey. As submitted, liability rules in Turkish law are in line with the general context of UK law. Nevertheless, private litigation, in terms of auditor liability in Turkey, has not been applied as it has been in the UK.<sup>287</sup> Sufficient liability rules and effective compensation mechanisms are necessary for investor trust and confidence in markets. There has been reluctance on shareholders' and other investors' parts to make a claim for their losses caused by wrongful acts of auditors. The reason behind this might be a lack of sufficient attention by the previous TCC on this issue. With the liability rules under the new TCC and CML, a system of compensation being paid by auditors can operate in Turkey. Therefore, companies and investors are encouraged to redress their losses caused by any negligence by auditors under the new set of rules. Nevertheless, time may be required for these rules to find their application in the field. Similarly, time will tell as to whether these liability rules are efficient in Turkish financial markets.

## **CONCLUSION**

This chapter has submitted that audit reforms in Turkey are motivated by the objective of achieving EU membership and the aim of preventing major audit scandals, such as were experienced in the Imar Bank case. Previously, laws on auditing in Turkey were insufficient in a number of ways. First, the previous Commercial Code did not address external auditing, in particular auditor liability. Second, supervision of auditors and audit firms was limited to listed firms. The reforms have covered these issues under the new TCC and respective provisions under CML. Since Turkey aspires to be a part of the world economy and to become a full member of the EU, Turkish companies' financial statements must provide clear, understandable, transparent and reliable information in order to operate in an efficient, reliable, and competitive way in international financial markets.<sup>288</sup> Reforms are important in this respect, as the new TCC and CML have changed the audit

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<sup>287</sup> An internet-based search, including journal and case databases (e.g. Westlaw and Heinonline) is made, however no civil litigation case in Turkey found in this area.

<sup>288</sup> TCC General Justification (n 1) para.5.

system to be compatible with EU laws on auditing<sup>289</sup> and have expanded its application. With reforms on auditing, external auditing has turned into a more transparent, quality system of auditing carried out by qualified experts who perform under internationally compatible standards and are supervised by a public authority under the KGK.

Nevertheless, there are drawbacks to the reforms in a number of areas and thus further amendments may be needed. First, private litigation mechanisms for damages caused by the wrongful acts of auditors should be introduced in Turkey. For this purpose, as the European Commission has suggested, the capacity of commercial courts has to be increased.<sup>290</sup> Second, there is no regulatory strategy stated by lawmakers regarding concentration in the audit market. The concentration level can be considered as moderate today. However, as financial markets continue to develop in Turkey, the need for independent audit will grow as well. In the light of these considerations, regulatory action should be taken before the concentration level rises further. Third, there is a multi-headed regulatory structure in Turkey. Even the establishment of the KGK has not eliminated this structure completely. In contrast, the establishment of a new public oversight authority (i.e. the KGK) is likely to introduce new issues with respect of existing authorities, and might therefore result in regulatory tangle. In order to prevent regulatory conflict, the KGK should take a primary role in the field and be actively involved in the regulatory arena in the external auditing field.

This chapter examined Turkish law reforms in the field of auditing. It is submitted that Turkish law reforms on auditing are in line with EU laws. The analyses in this chapter provide background information for the next chapter. In that chapter, the audit reforms of Turkey will be further examined with respect of approximation with EU laws on auditing.

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<sup>289</sup> See also Chapter VII for a comparative analysis of Turkish and EU laws in auditing.

<sup>290</sup> European Commission Staff Working Document Turkey 2012 Progress Report accompanying the document Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012-2013 Brussels 10.10.2012 SWD(2012) 336 final, p. 50.

# CHAPTER VII: COMPARATIVE ANALYSIS OF EU AND TURKISH LAWS ON AUDITING IN TERMS OF CONVERGENCE

## INTRODUCTION

So far, this thesis tried to answer the following questions: why auditing has an important role in corporate governance,<sup>1</sup> how it actually works today,<sup>2</sup> why it need to be regulated,<sup>3</sup> how, in particular, the EU governs statutory audit rules and practices in the EU,<sup>4</sup> and how the liability of auditors is governed by law.<sup>5</sup> As previous chapters have shown, EU laws on auditing are diverse among Member States.<sup>6</sup>

The aim of this chapter is to identify whether there is a convergence of auditing between Turkey and the EU.<sup>7</sup> The main research question in this chapter is as follows: to what extent is Turkey successful in terms of adopting EU laws as a candidate country? In addition, this chapter will discuss whether there is an approximation on legal systems and how this affects laws on auditing internationally.

This chapter is structured as follows: the first section looks at the debates on legal systems differences<sup>8</sup> and questions whether traditional grouping on legal systems<sup>9</sup> are valid for laws on external auditing. The second section examines Turkey as a case study and sets the framework for a possible convergence of auditing between

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<sup>1</sup> See Chapter I.

<sup>2</sup> See Chapter II.

<sup>3</sup> See Chapter III.

<sup>4</sup> See Chapter IV.

<sup>5</sup> See Chapter V.

<sup>6</sup> See Chapters IV and V.

<sup>7</sup> For the analysis on Turkish laws on auditing, see Chapter VI.

<sup>8</sup> David René and John E. C. Brierley, *Major legal systems in the world today: an introduction to the comparative study of law* (Stevens, London 1985); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Legal Determinants of External Finance' (1997) 52(3) *Journal of Finance* 1131; K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (translated by Tony Weir, 3rd edn, OUP 1998).

<sup>9</sup> Esin Öricü, 'A General View of "Legal Families" and of "Mixing Systems"' in Esin Öricü and David Nelken (eds), *Comparative Law: a Handbook* (Hart 2007) 169. See also Mathias M. Siems, *Convergence in Shareholder Law* (Cambridge University Press 2008).

Turkey and the EU. In this respect, the forces for convergence, and the methods and feasibility of convergence will be questioned.

## 1. DIFFERENT LEGAL SYSTEMS AND EXTERNAL AUDITING

### 1.1. Do Legal Differences Matter?

Traditionally, the world's legal systems are grouped under common (Anglo-Saxon) and civil (Romanic-German) law families.<sup>10</sup> According to the theory of legal families, broadly, the US and UK belong to the common-law family group while Germany and France belong to the civil-law family group. Based on this theory, a number of studies carried out by La Porta *et al* controversially argued that differences in legal systems have influenced the economic development of these countries and their governance functions.<sup>11</sup> In short, La Porta *et al* established a general distinction of family groups arguing that capital markets in countries that belong to the civil law legal systems are less developed because of their weak legal protection of minority shareholders,<sup>12</sup> whereas common law legal systems offer more protection of minority shareholders, and therefore the legal environment is more suitable for market growth in these countries.<sup>13</sup>

However, such general categorizations are questionable, as legal systems change through time and not all areas of law share the same patterns within a particular legal family. To be sure, there are differences in legal systems in different parts of the world; these differences might be derived from geographical, social, economic, traditional, historical, or other differences that might have affected the course of a country's history and the way its legal system works. This could be war, revolution,

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<sup>10</sup> René and Brierley (n 8). There are also other approaches in the taxonomy of legal systems, such as cultural taxonomy, which distinguishes four broad cultures: the African, the Asian, the Islamic and the Western (Europe, America, and Oceania). See Mark van Hoecke and Mark Warrington, 'Legal Cultures and Legal Paradigms: Towards a New Model for Comparative Law' (1998) 47 *International and Comparative Law Quarterly* 495.

<sup>11</sup> La Porta *et al* (1997) (n 8). See also Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54(2) *Journal of Finance* 471.

<sup>12</sup> La Porta *et al* (1997) (n 8) p. 1142.

<sup>13</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, 'Law and Finance' (1998) 106(6) *Journal of Political Economy* 1113; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 3; Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Investor Protection and Corporate Valuation' (2002) 57 *Journal of Finance* 1147.

colonisation, or other factors originating from religion, ethics, or the influence of the interest groups and parties.<sup>14</sup> Although there might be a direct impact of these factors on the characteristics of a country's legal system, sharing a particular historical or geographical element does not automatically suggest parity between two countries' legal systems. In other words, the fact that two countries belong to the same geographic region or to the same religion does not automatically mean that both would have identical legal systems. Generalisations such as 'European countries on continental Europe belong to the European law family'<sup>15</sup> or 'Arabic countries in the Arabian Peninsula follow Islamic law traditions' are also not very helpful. Some geographical taxonomy might be true in terms of a shared cultural history. However, social, political, and economic developments through time might have different influences on countries that share the same geography. Therefore, their legal systems might remain distinct (or, alternatively, come closer over time).

Moreover, a kind of taxonomy based on geographical or regional similarities does not necessarily apply to different areas of law within a particular legal system. For example, Arabic countries belong to Islamic law tradition with respect of family law; however there is a great influence from European jurisdictions, namely France and Italy, in terms of commercial law due to their colonial history in Arabic countries<sup>16</sup> (i.e. Algeria; Tunisia). Furthermore, apart from geographical, religious, or colonial influences, there might be a voluntarily reception of foreign law, as it is the case in Turkish legal system. For instance, at the beginning of the 20<sup>th</sup> century, with the establishment of the Turkish Republic, Turkey voluntarily adopted Swiss civil law under the reformist package of Mustafa Kemal Atatürk, and abandoned Islamic law. The legal system in Turkey can be categorised as a hybrid (mixed) system where both legal and socio-cultural transmission is still on-going.<sup>17</sup> Ogus approached this transition of Turkey from a legal and economic perspective, explaining that Turkey needed to import legal cultures from abroad to provide a more "*sophisticated legal input*" for industrialisation and commercial development.<sup>18</sup> More recently, in the

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<sup>14</sup> Zweigert and Kötz (n 8) p. 36.

<sup>15</sup> European law reflects a combination of both common law (Irish, English, and American laws) and civil law (German, French, Dutch, and Danish laws). See Örucü (2007) (n 9) p. 175.

<sup>16</sup> Zweigert and Kötz (n 8) p. 65.

<sup>17</sup> Örucü (2007) (n 9) p. 181.

<sup>18</sup> Anthony Ogus, 'The Economic Approach: Competition between Legal Systems' p. 165 in Esin Örucü and David Nelken (eds), *Comparative Law: a Handbook* (Hart 2007) 155.

pursuit of full membership of the EU, Turkey has begun harmonising its law with the EU *acquis*.<sup>19</sup> In this respect, Turkey is in the process of modernisation in improving its legal system. It is likely that the process of the EU membership will also have an impact on legal transmission in Turkey. To conclude, legal systems cannot be categorised under solely geographical, religion or cultural since each country has its own legal development influenced by a number of variations.

The above examples may suggest that one should not rely solely on the classic ‘legal family’ categorizations.<sup>20</sup> Örucü sees all legal systems as mixed and overlapping, meaning that all legal systems are combinations of various legal sources.<sup>21</sup> Moreover, in the current conditions of the 21<sup>st</sup> century, with worldwide globalisation of systems occurring, categorising legal systems into strict groups is not valid anymore. Although reasons and intentions can differ, the “*legal systems are crosses*”.<sup>22</sup> An approximation of legal systems can be seen, especially in commercial law due to internationalisation of economy around the world.<sup>23</sup> Next, whether similar approximations are possible in terms of external auditing will be examined.

## 1.2. Do Legal Differences in the Law of Auditing Matter?

The governance function of external auditing is closely linked to the ownership structures of firms.<sup>24</sup> Before going into detail, it might be useful to review the literature on the different legal systems and the use of external auditing.

La Porta *et al* found that common law countries offer better protection for investors than code (civil) law countries.<sup>25</sup> According to La Porta *et al*, concentrated systems are associated with weak legal environment (e.g. a lack of sufficient legal rules and enforcement mechanisms).<sup>26</sup> Based on these findings, Francis *et al* suggested that countries with stronger investor protection are more likely to have higher quality

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<sup>19</sup> See Chapter VI.

<sup>20</sup> Zweigert and Kötz (n 10) p. 41.

<sup>21</sup> Örucü (2007) (n 9) p. 177.

<sup>22</sup> Esin Örucü, ‘Family Trees for Legal Systems: Towards a Contemporary Approach’ in Mark van Hoecke (ed), *Epistemology and Methodology of Comparative Law* (Hart, Oxford 2004) 359.

<sup>23</sup> Siems (n 9) pp. 250-96.

<sup>24</sup> See Chapter I.

<sup>25</sup> La Porta *et al* (1998) (n 13) pp.1133-4.

<sup>26</sup> *Ibid* pp. 1141, 1146.

auditing, while countries with weak investor protection have a lower demand for external audits.<sup>27</sup>

However, this conclusion cannot be fully accepted for a number of reasons. First, the relevance of legal families has been challenged. For example, it is argued that the UK law on shareholder protection is closer to the Continental European legal system than it is to US law.<sup>28</sup> Second, such categorization of dispersed and concentrated ownership structures with strong and weak legal systems is misleading, since controlling shareholders may exist in countries with good laws (e.g. Sweden).<sup>29</sup> Third, the effects of legal systems on the quality of accounting might not be that clear. Instead of a common *versus* civil law distinction, other factors (e.g. language, ownership concentration, management powers and incentives, auditor quality, regulation, enforcement, and other institutional factors) may have a greater effect on accounting quality.<sup>30</sup> Moreover, cultural factors might also have an influence on accounting standards and practices.<sup>31</sup> Fourth, the distinction between common and civil law is becoming less relevant after increased regulatory scrutiny over auditing (and securities) regulation and harmonisation forces, in particular at EU level. Lastly, developments in the international economy might eventually lead to a convergence between legal systems,<sup>32</sup> including in auditing.

Nevertheless, the role of external auditing might still vary in different market systems. In market-based governance systems, such as in the US and UK, high-quality public financial disclosures and reporting are much more developed because public disclosure plays a more central role in outsider systems.<sup>33</sup> In contrast, in civil

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<sup>27</sup> Jere R. Francis, Inder K. Khurana, and Raynolde Pereira, 'The role of accounting and auditing in corporate governance and the development of financial markets around the world' (2003) 10 *Asia-Pacific Journal of Accounting and Economics* 1.

<sup>28</sup> Priya P. Lele, and Mathias M. Siems, 'Shareholder Protection: A Leximetric Approach' (2007) 7 *Journal of Corporate Law Studies* 17.

<sup>29</sup> Sweden is a good example of controlling shareholder structure and effective monitoring mechanisms that prevent the exploitation of minority shareholders. See Ronald J. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119(6) *Harvard Law Review* 1641.

<sup>30</sup> Frederick Lindahl and Hannu Schädewitz, 'Are Legal Families Related to Financial Reporting Quality' (2013) 49(2) *Abacus* 242.

<sup>31</sup> S. J. Gray, 'Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally' (1988) 24(1) *Abacus* 1.

<sup>32</sup> Siems explained this approximation as 'convergence through congruence'. See Siems (n 9) pp. 250-96. For convergence, see also Section 2 below.

<sup>33</sup> Ray Ball, 'Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure' (2001) *Brookings-Wharton Papers on Financial Services* 127.

law legal regimes, where political influences are greater, financial reporting is much more focused on taxation.<sup>34</sup> Chapter I already discussed and examined the differences in terms of the use of external auditing in different ownership structures. It is submitted that external auditing functions as a monitoring device and can help to reduce information asymmetry in dispersed systems.<sup>35</sup> In concentrated systems, where the other monitoring mechanisms and the legal protection of investors are relatively weak, firms tend to use external auditing as an assurance of the credibility of the information in the financial reports and subsequently gaining public confidence to attract small investors.<sup>36</sup>

However, these findings do not suggest that different corporate governance systems cannot approximate in terms of laws in auditing. In addition to a common- or civil-law origin, political, economic and social developments are also likely to influence the accounting and auditing infrastructure in a country. Moreover, one should also consider developments at the global level that might have an effect on a country's legal development in terms of auditing. The effects of international developments on accounting and auditing are enormous because of their growing importance in international markets. Public financial reporting (audited accounting information) is crucial for global markets in terms of ensuring trust in the markets via ensuring the accuracy of financial information.<sup>37</sup> For a country that seeks to be a part of the global investment area it is essential to keep up with international developments and provide a secure and trustworthy investment environment for foreign investors. Regardless of its legal origin, a country might like to voluntarily adopt laws on auditing in line with the highest standards, as in the US and UK. How successful this adoption depends on a number of factors related to the country's economic adaptability, reception of legal rules, and historical and cultural elements. This chapter takes Turkey as a case example in the adoption of laws in auditing with the EU *acquis*. In this respect, this chapter will investigate the obstacles for a successful adoption of these rules, and will illustrate the limitations of and forces for convergence in the law of auditing between Turkey and the EU.

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<sup>34</sup> Ibid p. 146.

<sup>35</sup> Ross L. Watts and Jerold L. Zimmerman, 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' (1983) 26(3) *Journal of Law and Economics* 613. See also Chapter I, Section 2.2.

<sup>36</sup> For a discussion on the governance function of external auditing in different governance systems, see Chapter I, Section 3.2.

<sup>37</sup> See Chapter I, Section 2.3.

## 2. CONVERGENCE OF AUDITING BETWEEN EU AND TURKISH LAW

There are a number of justifications for the convergence of auditing in Turkey with EU laws. These are the EU membership aspiration, globalisation and capital market integration, and the reformation of commercial and capital markets laws. These in fact are closely linked to each other. This section will discuss drivers and obstacles for convergence in auditing between Turkish and EU law. The theoretical underpinnings of this discussion will be based on Hansmann and Kraakman's explanation of important economic forces for convergence with respect to the drivers of convergence, as well as Bebchuk and Roe's path dependency theory with respect to obstacles for convergence. Berkowitz *et al*'s 'transplant effect' theory will also be applied to explain whether legal families could be obstacle for auditing convergence.

This section will first examine the forces for the convergence of auditing. Second, methods that may secure convergence will be examined. In addition to the theoretical discussion of auditing convergence, the third section will question whether convergence between EU and Turkish laws on auditing is actually possible. Lastly, the results of the analyses will be evaluated to provide a conclusion.

### 2.1. Forces for Convergence

This section will adopt Hansmann and Kraakman's<sup>38</sup> explanation of important economic forces on convergence to auditing convergence with respect to Turkish and EU laws. Within this context, this paper will try to give the theoretical underpinnings of a possible convergence of auditing between Turkish and the EU law. Apart from the important economic forces, this paper submits harmonisation with the EU law as another force for auditing convergence in Turkey. These two principal forces for auditing convergence will be explained respectively.

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<sup>38</sup> They also noted (i) failure of alternative models and (ii) the rise of shareholder group as the other drivers for convergence. See Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 Georgetown Law Journal 439, pp. 443-51. The reference to this article is not meant to endorse all views presented by Hansmann and Kraakman (such as that of 'the end of history for corporate law').

*i. Important economic forces*

International mergers, foreign investors, and cross-listings prompt internationalisation of the economy, and therefore result in more integrated financial markets. On the one hand, the integration of financial markets results in legal similarities, in particular in securities regulation and corporate governance regimes.<sup>39</sup> In case of cross-border mergers and acquisitions, the home country's securities regulation and governance structures can affect the governance practices of an acquired firm or, alternatively, new models may be imported from other systems and two models may co-exist. Therefore, convergence through cross-border mergers and acquisitions is possible.<sup>40</sup>

On the other hand, global capital markets prompt firms and jurisdictions to adopt more efficient governance mechanisms. For example, most of advanced economies require listed firms to make regular financial disclosure and to have audit committees. In global capital markets, to compete with other jurisdictions, lawmakers may choose to demand less in order to make the law easier for businesses and to attract new investors. This may lead to a "race to the bottom".<sup>41</sup> In terms of disclosure and best practice (e.g. effective protection of shareholder rights<sup>42</sup>), it seems that regulatory competition leads in the opposite direction.<sup>43</sup> It is said that if domestic law or domestic firms fail to sustain the application of the best governance mechanism, investment capital can flow to other jurisdictions that can offer better standards.<sup>44</sup>

A similar justification can also apply to auditing. Investors would not invest in a company whose external audit mechanism does not assure investors in terms of

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<sup>39</sup> Ibid.

<sup>40</sup> Toru Yoshikawa and Abdul A. Rasheed, 'Convergence of Corporate Governance: Critical Review and Future Directions' (2009) 17(3) *Corporate Governance: An International Review* 388.

<sup>41</sup> Reiner Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B. Hansmann, Gérard Hertig Klaus J. Hopt, Hideki Kanda, and Edward B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, OUP, Oxford 2009).

<sup>42</sup> As Armour suggested, regulatory competition will lead to a 'race to the top' because businesses will choose a state whose laws are most protective in terms of the rights of shareholders. See John Armour, 'Who Should Make Corporate Law? EC Legislation versus Regulatory Competition' (2005) 58 *Current Legal Problems* 369.

<sup>43</sup> Abdul A. Rasheed and Toru Yoshikawa, 'The Convergence of Corporate Governance: Promise and Prospects' in Abdul A. Rasheed and Toru Yoshikawa (eds), *The Convergence of Corporate Governance* (Palgrave Macmillan, 2012) p. 7.

<sup>44</sup> Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) pp. 212-18.

reliability of the financial statements. In such case, investors would choose other companies in an alternative country who offer better disclosure standards. As a result, public companies that seek to attract investors would voluntarily adapt the highest auditing standards in their home country. Alternatively, public companies may voluntarily choose to bind themselves to comply with the highest standards by listing on a foreign exchange.<sup>45</sup> Firms choose to list on foreign stock exchanges because of the expectation of the so-called ‘bonding effect’: it is believed that listing abroad increases the share value of the firm.<sup>46</sup> The other reasons for listing abroad might be to reach a broader range of investors, to easily acquire foreign firms, and/or to increase the prestige of firms.<sup>47</sup> Thus, public companies that seek to be listed on foreign exchanges and seek to raise external capital have to improve their governance and disclosure practices to gain advantages in the global market. Similarly, jurisdictions that seek to attract foreign direct investment would promote the best governance mechanisms, including the adoption of the highest auditing standards.

The other force for convergence is the advantages of having a single set of standards in global capital markets. Having a single set of standards would reduce companies’ transactions costs and offer them the advantage of comparability.<sup>48</sup> International investors who seek to reduce transaction costs and benefit from comparability advantage might prefer to invest in countries that have adapted accepted professional standards (e.g. ISAs). Listing on a foreign market with higher standards would increase the reliability of audited financial reports, and investors would therefore be ensured that their investments were secure.

These economic factors may force firms and jurisdictions whose auditing standards and regulations are weaker to make their standards and regulations similar with advanced governance mechanisms. In short, internationalisation of the economy can lead to the integration of capital markets. This can be via cross-listing and/or

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<sup>45</sup> Hansmann and Kraakman (n 38) pp. 463-4.

<sup>46</sup> John C. Coffee, Jr., ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications’ (1999) 93(3) *Northwestern University Law Review* 641.

<sup>47</sup> Amir N. Licht, ‘Regulatory Arbitrage for Real: International Securities Regulation in A World Interacting Securities Markets’ (1998) 38 *Virginia Journal of International Law* 563.

<sup>48</sup> Uri Geiger, ‘The Case for the Harmonization of Securities Disclosure Rules in the Global Market’ (1997) *Columbia Business Law Review* 241. See also Lawrence J. White, ‘Competition versus Harmonization-An Overview of International Regulation of Financial Services’ in Claude E. Barfield (ed), *International Financial Markets: Harmonization Versus Competition* (AEI Press 1996).

acquisitions and mergers. Both prompt the use of uniform auditing standards and regulations. This may suggest that integrated markets facilitate the use of uniform standards that can lead to convergence in auditing.

These theoretical underpinnings can be applied to auditing convergence between Turkish and EU law, explaining the economic forces for Turkey to adopt similar rules with EU laws in terms of auditing. Turkey is an emerging country with increasing annual economic growth rates.<sup>49</sup> If Turkey wants to use its growing market advantage and to be an attractive venue for foreign direct investment, she should use an international language that anybody who is interested to invest can understand for business in Turkey. Today, major states in the world, including EU Member States, have adopted ISAs.<sup>50</sup> Uniform accounting and auditing standards are advantageous for all major economies in terms of comparability, but they are much more crucial for emerging economies, such as Turkey. Through the adoption of international standards, investors in Turkey will benefit from the same standards as are applied in other major countries. Moreover, the use of improved laws on auditing would be a signal for foreign direct investment, as it will increase the reliability of financial reports.

In addition to the important economic forces, internationalisation of professional intermediaries, such as the Big Four audit firms, has also played a role for auditing convergence. As the previous chapters have shown, the Big Four audit firms dominate the audits of largest listed firms globally, as well as in Turkey.<sup>51</sup> Moreover, as a result of this market control they have gained power both financially and politically. They use this power in the audit standard setting process. This has been discussed elsewhere in this thesis.<sup>52</sup> This influence of the Big Four may also be relevant in terms of convergence. For instance, the influence of the Big Four audit firms in societies which they provide services has a significant importance. Their global networks help the Big Four to have considerable influence on the identity of accountants, participation in standard setting and involvement in the expansion of

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<sup>49</sup> IMF, 'World Economic Outlook' 2012. See also Chapter VI, Section 1.3.

<sup>50</sup> See Chapter III, Section 3.2.2.

<sup>51</sup> See Chapter VI, Section 3.2, for audit firms in Turkey. See also Chapter III, Sections 2.4 and 3 for a discussion on the Big Four dominations in the markets.

<sup>52</sup> See Chapter III, Section 3.2.

globalisation around the world.<sup>53</sup> The pressure of these international firms and other interest groups (e.g. via lobbying) can contribute to the convergence of laws.<sup>54</sup> To provide an example, it is possible that international auditing standards accepted by a global network can help in the diffusion of ISAs among the audit firms that competing with the Big Four and public firms who are willing to be audited by the Big Four.<sup>55</sup>

*ii. Harmonisation with EU law*

Harmonisation with EU law, such as the adoption of Directive 2006/43/EC, and also of some recommendations (e.g. auditor independence and liability limitation) can also be a driver for convergence.<sup>56</sup> Member States (and candidate countries) are obliged to comply with EU law. As a candidate EU member, Turkey is obliged to adopt the EU *acquis*. Approximation of the laws on auditing will help Turkey to move its law closer to the EU *acquis* and may help to adopt other areas of law more easily.

Turkey aspires to be a part of the world economic, investment, and trade communities. Full EU membership for Turkey is an important pillar in the pursuit of this objective.<sup>57</sup> In this respect, the new Commercial Code<sup>58</sup> came into force in July 2012 with more harmonised provisions with EU law, especially in auditing and financial reporting fields. In short, the new Code expands the application of external auditing, authorising the Turkish public oversight body KGK to oversight the audit profession, requiring the use of Turkish Financial Reporting Standards (TMS) in the financial reports of listed companies and to have audited those reports by an independent external auditor (SMMM or YMM)<sup>59</sup> in accordance with ISAs.<sup>60</sup>

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<sup>53</sup> David J. Cooper and Keith Robinson, 'Accounting, professions and regulation: Locating the sites of professionalization' (2006) 31 *Accounting, Organizations and Society* 415, p. 432. See also Siems (n 9) p. 267 (noting that the internationalisation of private institutions, namely law firms, investment banks, rating agencies, and audit firms can play a role in convergence).

<sup>54</sup> Cooper and Robinson (n 53) pp. 433-4.

<sup>55</sup> See also Chapter III, Section 3.2.2 and Chapter IV, Section 2.2 for the adoption of ISAs.

<sup>56</sup> For a more detailed examination of EU audit policy and laws, see Chapter IV, Section 2.

<sup>57</sup> See Chapter VI in general.

<sup>58</sup> Turkish Commercial Code (TCC) No. 6102, Official Gazette No. 27846 (13.01.2011), Article 69.

<sup>59</sup> SMMM and YMM are certified auditors in Turkey. See also Chapter VI in general.

<sup>60</sup> See Chapter VI in general.

One could question the efficiency of a possible convergence of Turkish laws in auditing with the EU *acquis*. There are a number of advantages of approximation with the EU *acquis*. First, it is believed that harmonisation of disclosure standards would mitigate transaction costs while providing a comparability advantage. Second, an improved legal environment would provide greater protection for minority shareholders and other investors, while the risk of expropriation by insiders would be reduced.<sup>61</sup> This is particularly important for Turkey, where controlling shareholders are dominant and can potentially use company assets for private benefits.<sup>62</sup> Due to the lack of legal protections for minority shareholders, investors would depend on relationships, not law. As a consequence, the governance of companies would be based on relationships that would discourage new investors.<sup>63</sup> Therefore, advanced auditing laws are crucial, especially for the protection of (minority) shareholders and investors.

The combination of these forces may result in a market-driven convergence. However, it needs to be examined whether Turkish laws on auditing have actually converged with the EU law. The evidence of this will be detailed in Section 2.4 below. Before that, the methods of convergence will be discussed next.

## **2.2. Methods for Convergence**

In Turkey, harmonisation with EU laws on auditing has been through the adoption of international accounting and auditing standards and recent law reforms issued in the field of company and capital markets law.

The SPK, the regulatory authority in capital markets in Turkey, issued a regulation requiring public companies in Turkey to prepare financial statements in accordance with IFRS as of 2005.<sup>64</sup> Since 2005, public companies are required to report according to SPK's IFRS-compatible accounting standards.<sup>65</sup> Also, the TCC now requires every merchant to report in accordance with Turkish Accounting Standards

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<sup>61</sup> Coffee (1999) (n 46) p. 705.

<sup>62</sup> See Chapter VI, Section 1.1.

<sup>63</sup> Coffee (1999) (n 46) p. 706.

<sup>64</sup> Communiqué Series: XI, No: 25 on accounting standards in the capital market, last amended by Communiqué Series: XI, No: 26.

<sup>65</sup> In 2006, Turkish Accounting Standards Board (TMK) translated the IFRS and named as Turkish Financial Reporting Standards (TMS). Since 2011, the responsibility to issue accounting and auditing standards is overtaken by the KGK. See Chapter VI.

(TMS).<sup>66</sup> In terms of auditing standards, for the first time in 2006, the SPK introduced ISAs to Turkish capital markets by the Communiqué Series: X, No: 22.<sup>67</sup> Also, the new TCC requires audits of financial reports to be conducted in accordance with Turkish Auditing Standards (TDS): the Turkish translation of ISAs.<sup>68</sup> Before the TDS was introduced to the capital markets in 2006, there had been no uniform standard in external auditing. This situation was especially difficult for international audit firms who were not familiar with the accounting system in Turkey. TDS are compatible with ISAs, and therefore both international audit firms and international users of the audit reports can take advantage of that compatibility - not only the foreign and/or multinational firms who aspire to invest in Turkey, but also Turkish companies, who will benefit from the use of those uniform standards. Therefore, the adoption of international standards through TMS and TDS can be considered an effective tool for convergence.

In light of the objective to achieve full EU membership, Turkey has sought to reform its Commercial Code and Capital Markets Law in accordance with EU law. These reforms also have important applications for audit regulation in Turkey.<sup>69</sup> In this respect, the new TCC No. 6102 and CML No. 6362 can be seen as regulatory tools for convergence with EU law. The new reforms have brought a number of improvements into the area of auditing in Turkey. To begin with, according to the TCC, statutory audits can only be assigned to professional and independent auditors whose requirements are set by law.<sup>70</sup> In this respect, the public oversight auditory body of Turkey, the KGK, sets specific requirements for the audits of PIEs.<sup>71</sup> Second, the independence requirements were strengthened. A maximum 7-year period for auditors performing audits for the same client was introduced.<sup>72</sup> These requirements for statutory auditors under law reforms are in line with EU law.

Also, as EU law requires, auditors are subject to a public oversight mechanism in Turkey under the KGK. The establishment of the public oversight body of Turkey

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<sup>66</sup> TCC No. 6102 (n 58), Article 69.

<sup>67</sup> Communiqué Series: X, No: 22 regarding Independent Audit Standards in Capital Markets.

<sup>68</sup> TCC No. 6102 (n 58), Article 397.

<sup>69</sup> See Chapter VI.

<sup>70</sup> TCC No. 6102 (n 58), Article 400.

<sup>71</sup> Regulation on independent auditing, Official Gazette No. 28509 (26.12.2012), Article 11. See also Chapter VI, Section 4.2.

<sup>72</sup> TCC No. 6102 (n 58), Article 400(2).

can also be considered as tools for convergence, since the KGK was established in accordance with the principles set by EU Directive 2006/43/EC, in terms of principles on qualification, expertise, and conditions for the approval of auditor.<sup>73</sup> In this respect, the European Commission considered the establishment of the KGK as a good progress for Turkey as regards complying with the EU *acquis*.<sup>74</sup> According to the Commission, the establishment of the KGK improved the legal and institutional framework in auditing.<sup>75</sup>

### 2.3. The Feasibility of Convergence

Previous sections submitted that auditing convergence is necessary for Turkey especially regarding its EU membership objective and the aim to be a part of global financial markets.<sup>76</sup> The latest law reforms under TCC No. 6102 and CML No. 6362 are the methods using for auditing convergence.<sup>77</sup> Despite these reforms and formal approximation of laws and regulations on auditing, actual convergence may still not be possible.

This section will explain the feasibility of auditing convergence between Turkish and the EU law in accordance to the path dependency theory of Bebhuk and Roe<sup>78</sup> and the transplant effect theory of Berkowitz *et al*<sup>79</sup>. Within this context, this section will question Turkey's adoption of EU law on auditing with respect to first, its path dependencies (reasons arising from the initial conditions with which countries started) and second, its institutional capacity to receive the imported law.

To begin with, Turkey and the countries of the EU are at different levels of economic development. The adoption of EU law may be hindered due to institutional differences resulted from unequal economic development. Less developed

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<sup>73</sup> See Chapter VI, Section 4.2.

<sup>74</sup> European Commission Staff Working Document Turkey 2012 Progress Report accompanying the document Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012-2013 Brussels 10.10.2012 SWD (2012) 336 final.

<sup>75</sup> *Ibid.*

<sup>76</sup> See Section 2.1 above.

<sup>77</sup> See Section 2.2 above.

<sup>78</sup> Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Governance and Ownership' (1999) 52 *Stanford Law Review* 127, p. 157.

<sup>79</sup> Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'Economic Development, Legality, and the Transplant Effect' (2003a) 47 *European Economic Review* 165, p. 167.

institutional infrastructure, such as insufficient capacity of economic institutions, e.g. deficient budget and expertise, can be seen in less economically developed countries.

Ineffective institutional frameworks can also be found in other countries than Turkey. Pistor *et al* found that the failure of the former Soviet Union countries' legal reform on the protection of shareholder and creditor rights was caused by the absence of effective legal institutions.<sup>80</sup> Despite the fact that these countries have adopted advanced laws on the protection of shareholder and creditor rights, ineffective legal institutions failed to enforce these laws.<sup>81</sup>

Political incentives as well as the incentives of interest groups also play a role in understanding a country's legal development. As public choice theory notes, politicians, namely governments and bureaucrats, do not often pursue to increase the social welfare when law-making.<sup>82</sup> Instead, politicians are self-interested and pursue, for example, political power, re-election, and rent-seeking.<sup>83</sup> In addition, other interest groups, for example, lawyers and auditors, may have political influence in the law-making process through lobbying.<sup>84</sup> There might also be other influential actors, such as the EU that might have role in the law-making process, as in the case in Turkey.

Institutional transformation is considered as one of the issues that challenged most the political economy of Turkey in terms of forming the country's institutional structure.<sup>85</sup> Institutional reform in Turkey has mainly started following the crisis of 2000 to 2001; only the Capital Markets Board of Turkey (the SPK) was already established in 1981. International influence through the IMF and World Bank has also encouraged Turkey to reform its economic institutions.<sup>86</sup> The main principle of institutionalising in Turkey is isolating the regulatory process from political influence.<sup>87</sup> To achieve this, independent regulatory authorities are established to

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<sup>80</sup> Katharina Pistor, Martin Raiser, and Stanislaw Gelfer, 'Law and Finance in Transition Economies' (2000) 8 (2) *Economic of Transition* 325.

<sup>81</sup> *Ibid* p. 356.

<sup>82</sup> Siems (n 9) p. 235.

<sup>83</sup> See also Chapter III, Section 1 for a discussion on regulation theory.

<sup>84</sup> Siems (n 9) p. 239.

<sup>85</sup> Ziya Onis and Mustafa Kutluay, 'Rising Powers in a Changing Global Order: the political economy of Turkey in the age of BRICS' (2013) 34(8) *Third World Quarterly* 1409, p. 1417.

<sup>86</sup> Izak Atiyas, 'Economic Institutions and Economic Change in Turkey during the Neoliberal Era' (2012) 14 *New Perspectives on Turkey* 45, p.54.

<sup>87</sup> *Ibid* p. 60.

operate in respective sectors, such as banking, finance, energy, and telecommunications.<sup>88</sup> A rule on independence ensures that these agencies are given financial autonomy and their decisions cannot be overturned by the ministries, but are subject to appeal mechanism undertaken by the Council of State (Danistay).<sup>89</sup>

In line with the institutional independence policy, in the field of auditing, the public oversight body of Turkey (the KGK) was established as an independent body that is free from political pressure. However, it has been argued that political intervention on the regulatory authorities has been the case in Turkey.<sup>90</sup> Politicians and bureaucrats have been involved in the control of the regulatory agencies, for example, through the appointment of the board members of these bodies as these agencies are ‘affiliated’ to the respective ministries,<sup>91</sup> e.g. KGK, as well as SPK and BDDK, are affiliated to Prime Ministry of Turkey. This arrangement may suggest that operations of these institutions cannot be separated from the incentives and politics of the politicians and bureaucrats since there is a link between these institutions and the political institutions, i.e. ministries.

In addition to the independence issue, the fragmented institutional structure is the other shortcoming in auditing sector in Turkey. As this thesis already stated, having more than one regulatory in the field of auditing, may cause obstruction, in particular with respect to the application of the standards and investigations over audit firms.<sup>92</sup> The Turkish Government aimed to end the existence of different authorities in the auditing field by the establishment of the KGK. This was also in with the EU law on auditing,<sup>93</sup> so the Government has chosen to establish such body despite the oppositions from the members of the Chamber of Accountants in Turkey.<sup>94</sup> Yet, the fragmented institutional structure has not been removed since other institutional

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<sup>88</sup> For the development of regulatory agencies in Turkey, see Isik Ozel and IzakAtiyas, ‘Regulatory Diffusion in Turkey: A Cross-Sectoral Assessment’ in Tamer Cetin and Fuat Oguz (eds), *The Political Economy of Regulation in Turkey* (Springer, New York 2011) pp. 51-73.

<sup>89</sup> Atiyas (n 86) p. 61.

<sup>90</sup> Isik Ozel, ‘The Politics of De-delegation: Regulatory (In)dependence in Turkey’ (2012) 6 *Regulation and Governance* 119, p. 122.

<sup>91</sup> *Ibid* p. 124.

<sup>92</sup> See also Chapter VI, Section 4.2.

<sup>93</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits and annual consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC OJ L 157/87, Article 32.

<sup>94</sup> The Chamber of Accountants in Turkey (the TURMOB) opposed the establishment of the KGK reasoning that consultation process was not carried out. See also Chapter VI, Section 4.2.

bodies, such as SPK and BDDK have still regulatory powers in their fields.<sup>95</sup> One should take into account that it would be politically and economically difficult to abolish the roles of the other institutions. This would make existing institutional and professional infrastructure ill fitting and clearly would require new investments. Overall, the government has chosen to avoid these costs however, in turn; this has resulted in a fragmented supervisory framework in the field of auditing.

Furthermore, Turkey is not yet a member of the EU. In terms of the implementation and enforcement of the rules, Turkey therefore does not have the same options and choices as current Member States. For instance, other areas of law show that differences and institutional infrastructure of other institutions are not at the same level as in the EU Member States.<sup>96</sup> Furthermore, practices and relations prevailing in the business environment might be another reason for differences that still persist after the adoption of the EU law.

So far, this section argued that the insufficient institutional structure in Turkey could be the basis for differences that still persist. One could also question the reasons for these institutional impediments. Turkey is a transplant country and the current legal system of Turkey has been shaped by different European legal sources, mainly German, Swiss, French and Italian<sup>97</sup> over the period 1850-1927.<sup>98</sup> For instance, the Commercial Code of 1926, the first modern commercial code of Turkey, was based on the German Code of 1897.<sup>99</sup> It is difficult, however, to put the Turkish legal system into a general legal system group, such as the German legal system.<sup>100</sup>

Berkowitz *et al* acknowledged that there would be social, economic, and institutional differences between an origin and the transplant country. To reduce the effects of

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<sup>95</sup> See Chapter VI, Section 4.2.

<sup>96</sup> There is controversy regarding the level of independence and delegation of the authority of economic institutions in Turkey. For example, it is argued that the independence of telecommunication regulatory institution of Turkey has been impaired and institutional quality of the regulatory agency in the electricity sector has been insufficient. See Atiyas (n 86) p. 65.

<sup>97</sup> The Civil Code of 1926 from the Swiss Civil Code and the Code of Obligations, the Penal Code of 1926 from the Italian Code of 1889, the Italian Codes, the Code of Civil Procedure of 1929 from the Swiss Canton of Neuchatel, the Code of Criminal Procedure of 1929 from the German Code of 1877 and others again from Swiss and German sources. See Esin Orucu, 'Turkey facing the European Union- old and new harmonies' (2000) 25(5) European Law Review 523, p. 524.

<sup>98</sup> Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, 'The Transplant Effect' (2003b) 51 The American Journal of Comparative Law 163, p. 199.

<sup>99</sup> Orucu (2000) (n 97) p. 525.

<sup>100</sup> La Porta *et al* classified Turkey into the French legal family. See La Porta *et al* (1998) (n 13) p. 1131.

these differences in the adoption of the new law, a transplant country has to meet with familiarity and/or adaptability. In their explanation, they claimed that countries with familiarity (who share a legal history or belong to the same legal family) and/or adaptation would have more effective institutions compared those who do not share a common legal history with the transplanted concepts or have not made necessary modifications to adapt its initial conditions with the origin country.<sup>101</sup> If the necessary modifications were not made to adapt the local conditions, there would be “a substantial mismatch between pre-existing and the imported legal order” causing the “*transplant effect*”.<sup>102</sup> The ‘transplant effect’ would cause the malfunction of the imported legal order and legal intermediaries (e.g. judges, lawyers, politicians) would also be affected negatively in terms of reception of the new law.<sup>103</sup> These findings may suggest that the transplant effect theory can be used to explain the ineffective institutions in a transplant country.

In terms of Turkey’s adoption of the EU law, it is necessary for Turkey to make the appropriate modifications. To give an example, the EU requirement for the establishment of a public oversight body should not be attributed only to the mere establishment of such body. Adequate resource allocation, including an adequate budget for inspections, and the employment of sufficient number of experts for these inspections, and the continuing training of the member staff are important pillars for the efficient functioning of such body. They are also crucial for serving the ultimate objective to form such body, i.e. increased audit quality and improve investor protection.

Another example is the rule on private litigation in terms of auditor liability. Although, the law on auditor liability has now been improved with the enactment of the new TCC and Capital Markets Law, there have not yet been any published cases on auditor liability.<sup>104</sup> It is said that for imported rules to be functional, there should be a demand for it in the first place and legal intermediaries should understand the real meaning of the law.<sup>105</sup> Accordingly, the private litigation on auditor liability to be functional in Turkey, first, there should be a demand for it second, investors

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<sup>101</sup> Berkowitz *et al* (2003a) (n 79) pp. 180-1.

<sup>102</sup> *Ibid* pp. 167-8.

<sup>103</sup> *Ibid*.

<sup>104</sup> See also Chapter VI, Section 4.3.

<sup>105</sup> Berkowitz *et al* (2003a) (n 79) pp. 173-4.

should be informed with the new rule, and third both the investors and the legal intermediaries should be able to understand the meaning of the private litigation on auditor liability and its relevance with the cases in capital markets. If necessary, lawyers could be trained in the application of the private litigation. If the real meanings of the auditor liability rules were not understood properly, there is a risk that these rules would not be applied or could be applied in a way that is against its principal intention.<sup>106</sup> Nevertheless, before drawing a direct conclusion, it should also be acknowledged that some time might be required after the enactment of the new laws for the society in Turkey to understand and to observe their meaning and to apply them when necessary.

From another perspective, it may be also questionable to what extent Turkey is subject to the transplant effect. Berkowitz *et al* categorised Turkey as an “*unreceptive*” transplant.<sup>107</sup> However, they made this categorization based on the findings from data collected during 1980-1995. This is the period when Turkey was in the process of transmission, and had therefore not completed its economic and legal development. After this period, Turkey’s legal environment developed rapidly and shifted to another era, the so-called ‘Europeanisation period’ that helped Turkey make breakthroughs in economic and political developments. After the Customs Union agreement between Turkey and the EU in 1995, the European Council granted Turkey EU candidacy status in 1999.<sup>108</sup> Since then, Turkey has issued major reforms and adopted a number of adjustment packages under the National Programme for the Adoption of the EU *acquis*.<sup>109</sup> The regulatory measures in the fields of business law and financial markets under the Europeanisation process have helped Turkey to move its legal system closer to EU law. Thus, a categorization that places Turkey as ‘unreceptive’ cannot be applied today after Turkey’s on-going financial and legal development since then are taken into account.

In terms of auditing convergence, the ‘transplant effect’ might be less valid for auditing convergence between the EU and Turkish laws because auditing

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<sup>106</sup> Ibid p. 174.

<sup>107</sup> Berkowitz *et al* (2003b) (n 97) p. 195.

<sup>108</sup> See Chapter VI, Section 1.3.

<sup>109</sup> Meltem Müftüler Baç, ‘Turkey’s Political Reforms and the Impact of the European Union’ (2005) 10 South European Society and Politics 17. See also Chapter VI, Section 1.3 for a brief summary of these developments.

convergence is mostly market-driven (e.g. international auditing standards, internationalised audit firms, integrated audit market). It can be expected that the audit and business society would be eager to support and also to adapt the reforms on auditing in the expectations of positive economic outcomes of integration of financial markets. Yet, it should be highlighted that necessary adaptations will still be required for the law and institutions to be operated effectively.

#### **2.4. A Conceptual Framework for the Convergence between the EU and Turkish Laws on Auditing**

Turkey has made good progress in the areas of company law and financial markets over the last twenty years in terms of increasing the level of its law and regulations to world standards.<sup>110</sup> In this respect, the alignment of company law regulations with the EU *acquis* is almost complete, as the European Commission has stated that Turkey is “*advanced*” in the company law area with “*significant progress in auditing*”.<sup>111</sup> It appears that Turkey made distinctive changes in its laws in auditing similar to EU Directive 2006/43/EC.<sup>112</sup> This could probably result in formal convergence that requires a political support and a change in legal infrastructure. Siems called convergence through international or regional organisations (i.e. here, the EU Audit Directive) as “*convergence from above*”.<sup>113</sup>

In the previous section, three factors, namely the EU membership aspiration, the objective of the integration of capital markets, and the need for improvement of laws were discussed in justifying the need for convergence.<sup>114</sup> These three factors can also be considered as drivers for convergence between EU and Turkish laws on auditing. Nevertheless, there could still be differences in terms of legal mentalities in national preferences. For instance, a weak legal environment, a multi-headed supervision mechanism, and functional dissimilarities (e.g. not being an EU member country)<sup>115</sup> may stand in the way of actual convergence. As Table 7.1 details, there are four dimensions of audit convergence that need to be considered when evaluating convergence between Turkish and EU laws on auditing. The following will show that

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<sup>110</sup> See Chapter VI in general.

<sup>111</sup> Commission Progress Report (n 74) p. 50.

<sup>112</sup> For a detailed analysis of Turkish law reforms, see Chapter VI, Section 4.

<sup>113</sup> Siems (n 9) p. 375.

<sup>114</sup> See Section 2.1 above.

<sup>115</sup> See also Section 2.3 above pp. 236-7.

there are reasons that support each of those four dimensions; thus, overall, it will be concluded that the Turkish situation is a mixed one.

		Convergence in law	
		Yes	No
Convergence in practice	Yes	<p><b>Level 1</b></p> <p>Harmonisation with the EU <i>acquis</i>, e.g. adoption of ISAs, and aim to integrate markets</p>	<p><b>Level 2</b></p> <p>Path dependencies of law (including case law), e.g., reflecting differences in the role of courts</p>
	No	<p><b>Level 3</b></p> <p>Differences in practice, e.g., due to 'multi-headed supervision', ineffective monitoring mechanisms and cultural factors</p>	<p><b>Level 4</b></p> <p>Functional dissimilarities: Turkey being a candidate country and having a less developed capital market, as well as costs of harmonisation</p>

**Table 7.1:** Dimensions of auditing convergence between EU and Turkish laws

At level 1, harmonisation attempts are carried out through two general factors: the EU membership process and the integration of markets. Turkish law is being harmonising with the EU *acquis* as a requirement for EU membership. Also, the integration of markets forced Turkey to adopt international professional standards in accounting and auditing. At this level, the influence of EU membership and internationalisation of the economy on convergence is very high. Nevertheless, the rules and their functions may still be different due to cultural, legal, and institutional differences in the legal order, as the following will explain.

At level 2, path dependencies may stand in the way of legal convergence despite harmonisation attempts, in particular as regards the relevance of 'case law'. To begin with, Turkey is a transplant country whose legal order is based on a civil law legal system. Therefore, there might be differences in the application of laws and rules. For instance, in the field of auditing, laws are applied mainly through statutory laws and regulations, e.g. the provisions of the TCC, CML, and KGK regulations, and

SPK communiqués. Although the effects of this may not directly obstruct the convergence of auditing rules, this may generate institutional and legislative issues that may indirectly result in differences in rules or its application. For instance, due to institutional and legislative differences, private litigation practice has not developed well in Turkey. Although the law issued liability on auditors to third parties under CML No. 6362, there is currently no common practice in redressing auditor liability.<sup>116</sup>

As in other countries, in Turkey courts deal with commercial disputes. Even though their application is rare, alternative dispute resolution methods, such as arbitration and mediation are also available in Turkey. For instance, the Union of Chambers and Commodity Exchanges of Turkey offers arbitration services under the Arbitration Council (TOBB Tahkim Kurulu) to ensure the settlement of economic, commercial and industrial disputes among the firms.<sup>117</sup> Mediation is another alternative method.<sup>118</sup> However, so far, these methods are not seen as popular practices in Turkey compared to court litigation.<sup>119</sup>

The new TCC assigns commercial courts, e.g. Commercial Courts (Asliye Ticaret Mahkemeleri) to deal with auditor liability claims. As the European Commission noted, the capacity of these courts is not sufficient to handle this task.<sup>120</sup> There are 113 commercial courts in Turkey – 18 of them were put in operation in 2011.<sup>121</sup> The average number of judges per 100.000 persons in Turkey was 8.30 in 2010.<sup>122</sup> This is below to the average rates in European countries.<sup>123</sup> In 2011, the number of cases per judge was 1136<sup>124</sup> and most of these trials lasted more than a year.<sup>125</sup> The workload

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<sup>116</sup> For auditor liability rules under Turkish law, see Chapter VI, Section 4.3.

<sup>117</sup> For more information, see TOBB Arbitration website available at <http://www.tobb.org.tr/HukukMusavirligi/Sayfalar/Eng/Arbitration.php> accessed 02/09/2014

<sup>118</sup> In order to make the application more effective Turkey has initiated recent legislative changes with the enactment of the Code of Mediation in Legal Disputes No. 6325 that is available for disputes arising from business operations, including those having a foreign element. See The Code of Mediation in Legal Disputes No. 6325, Official Gazette No. 28331 (07.06.2012), Article 1.

<sup>119</sup> For example, in 2008, there were only 36 commercial disputes that settled with mediation. See Avrupa Adaletin Etkililigi Komisyonu (CEPEJ), 'Avrupa Yargi Sistemleri: Adaletin Etkililigi ve Kalitesi' 2010 Basimi (2008 verileriyle), p. 126.

<sup>120</sup> Communication from the Commission to the European Parliament and the Council Enlargement Strategy and Main Challenges 2012 - 2013 Brussels, 10.10.2012 COM (2012) 600 final, p. 69.

<sup>121</sup> High Council of Judges and Prosecutors (HCJP), Annual Report 2011, January 2012, p. 35.

<sup>122</sup> Ibid p. 30.

<sup>123</sup> In 2008, the number of professional judges that fall into 100.000 people was 9.1 in France, 10.2 in Italy, and 33.3 in Greece. See *ibid* p. 129.

<sup>124</sup> *Ibid* p. 45.

of the courts results in long trials and lengthy procedures in the courts and subsequently creates a cumbersome judicial system in Turkey.<sup>126</sup>

In addition to the capacity of the courts, court fees and the duration of the trials are the main obstacles that might hinder the wide application of private litigation in Turkey. A claimant has to pay 25, 20 TL (approximately £ 7, 10) for filling an action in Commercial Courts (Asliye Ticaret Mahkemeleri) and 6.831 per cent relative fee of the dispute value for written judicial decree. Another 123, 60 TL (approximately £ 35) has to be paid to file an appeal in Supreme Court of Appeals (Yargitay).<sup>127</sup> There will be attorney fees and other expenses during the court proceedings as well, such as expert fees and other charges that the claimant needs to pay.<sup>128</sup> This can create a burden on investors who seeks justice. As a result, they may choose not to sue.

To conclude, inadequacies in institutional setting of Turkish judiciary system, for example the number of judges, the structure of courts, the cost of litigation, and long trials and lengthy procedures could be the factors that affect the low litigation rates in Turkey. In addition, the reason for the non-application of auditor liability rules in Turkey could be the lack of understanding of the law by the lawyers and investors.<sup>129</sup>

Differences in practice are seen at level 3. Some of these differences are related to the failure of the Turkish law-maker to consider the practicality of new laws. For instance, prior to the adoption of the new TCC no regulatory impact analysis was carried out in order to foresee the effects of the rules and predict the outcomes.<sup>130</sup> If carried out, such assessment would have been beneficial in order to understand whether the rules are appropriate in the present institutional framework. Lack of such prior assessment may result in non-application of the rules, or rules that are applied differently than intended. Instead of carrying out such regulatory impact analysis, the law-makers set different dates for the enactment of the law and for their application.

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<sup>125</sup> The average duration judgment was 266 days, nearly 9 months in 2010. See '2010'da 1 milyon 902 bin dava acildi' *Zaman*, 24 March 2012.

<sup>126</sup> For an example of the slow judicial system of Turkey, see *Imar Bank* case as discussed in Chapter VI, Section 1.2.

<sup>127</sup> The law determines the litigation fees and updates them each year. See Fees Act No. 71, Official Gazette No. 28867 (39.12.2013).

<sup>128</sup> The claimant has to meet the litigation cost. However, if the claims were successful, the defendant must compensate the costs that the claimant was subject to during the litigation proceedings.

<sup>129</sup> This issue is discussed also in Section 2.3 above pp. 238-9.

<sup>130</sup> An impact analysis was carried out at EU level regarding the proposals for amending Directive 2006/43/EC and Regulation for the audits of PIEs. See also Chapter IV, Section 3.

For instance, the new TCC was issued in January 2011 while rules on external auditing were only applicable as of January 2013. The law-makers made an assumption that 2 years would be enough for adjustments of the existence institutions (e.g. commercial courts) and establishment of new institutions (e.g. the public oversight body: the KGK) and the adaptation of the rules (e.g. including the education of accountants and auditors<sup>131</sup>). However, these assumptions were not conclusive as they were only predictions and therefore, it should not be a surprise that institutional transformation may not be achieved during this period.<sup>132</sup> As a result, although the law seems to have converged, practices may still differ during this adaptation period. This could be the reason of differences in practice even after the adoption. It is therefore necessary before drawing a conclusion, to take into account this adaptation process and their results on differences in practice.

In line with EU Directive 2006/43/EC,<sup>133</sup> a public oversight authority on statutory audit practices in Turkey was created: the KGK. As this paper already explained, the establishment of the KGK has not exterminated the existence of more than one regulatory authority in the field. In addition to the supervision of the KGK, other regulatory authorities in the field also have supervision powers in their subject areas.<sup>134</sup> The existence of more than one regulatory authority in the field may cause obstruction and create a cumbersome enforcement mechanism.<sup>135</sup> In fact, the enforcement mechanism in Turkey is already weak and unwieldy. For instance, SPK monitoring over audit firms seems to be ineffective in terms of the number of investigations and sanctions issued to audit firms.<sup>136</sup> This situation is a drawback for the law in action. In such circumstances, the function of the law would be hindered by an inefficient enforcement mechanism. Therefore, at level 2, differences in practice are likely to obstruct an actual convergence.

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<sup>131</sup> Especially firms who had not adopted the international standards on accounting and auditing had to train their accountants for the application of these standards.

<sup>132</sup> This was also the case in energy market where the Electricity Market Law first introduced the national electricity price mechanism in 2006. Before making a necessary market analysis, it was estimated that the differences in electricity rates would be eliminated in five years. However, this could not be achieved due to regional differences in electricity rates resulted from regional cost differences. Transition to the price equalization process postponed for another five-year and 31.12.2015 is set for the introduction of national electricity price mechanism. See Electricity Market Law No. 6446, Official Gazette No. 28603 (14.03.2013), section 6, provisional clause article 1.

<sup>133</sup> Directive 2006/43/EC (n 93), Recital 20.

<sup>134</sup> For the role of the KGK and its relationship with other authorities in terms of audit supervision, see Chapter VI, Section 4.2.

<sup>135</sup> For an analysis on institutional transformation in Turkey, see Section 2.3. pp. 235-6.

<sup>136</sup> See also Chapter VI, Section 3.3.

Last but not least, cultural differences may stand in the way of convergence in practice. Coffee remarked that cultural norms might help managers to refrain from the expropriation of minority shareholders' interests.<sup>137</sup> This influence is said to be more relevant where the legal rules on minority shareholder protection are weaker.<sup>138</sup> As Coffee claims, in civil law regimes where the law is weaker, the influence of cultural norms can be more relevant than legal rules on the business.<sup>139</sup> It is because in common law countries where legal rules provide more protection for minority shareholders<sup>140</sup> cultural norms become less important.<sup>141</sup> Similarly to Coffee, Hofstede suggested that cultural values might influence managers' decisions and behaviours.<sup>142</sup> To give an example from Turkey, in the Imar Bank case the family connections and government contacts played a great role in the bank's businesses. The Uzan family members had a great control over the managers and they had close relations with the political actors of that time.<sup>143</sup> They expected that having close relations with the powerful bureaucrats at that time would provide them a greater comfort for their illegal transactions.<sup>144</sup> The family members had the absolute control over the bank's management and had no incentives to disclose business information to the public or government's officials, including the BDDK auditors. It seems clear that the cultural values that play a role in business relations could influence managers' behaviours. One could also question the relation between cultural values and auditors' behaviours. To put as a question, did cultural factors affect the work of the auditors,<sup>145</sup> for instance in Imar Bank case?

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<sup>137</sup> John C. Coffee Jr., 'Do Norms Matter? A Cross-Country Evaluation' (2000) 149(6) University of Pennsylvania Law Review 2151, p. 2155.

<sup>138</sup> Ibid p. 2175.

<sup>139</sup> Coffee noted that differences in corporate behavior could be explained by the existence of compliance of strong social norms in a society. See *ibid* pp. 2165-6.

<sup>140</sup> La Porta *et al* (2000) (n 13) p. 8.

<sup>141</sup> Coffee (2000) (n 136) p. 2175.

<sup>142</sup> Hofstede identified four societal value dimensions when explaining cultural differences: power distance, uncertainty avoidance, individualism, and masculinity. See Geert Hofstede, *Culture's Consequences* (Sage, 1980) p. 11.

<sup>143</sup> The Uzan family group benefited from close relations with then Prime Ministers Turgut Ozal (during the 1970s and 1980s) and Suleyman Demirel (in the 1990s). See Mine Omurgonulsen and Ugur Omurgonulsen, 'Critical thinking about creative accounting in the face of a recent scandal in the Turkish banking sector' (2009) 20 *Critical Perspectives on Accounting* 651, p. 659. See also Chapter VI, Section 1.2.1 for the Imar Bank case.

<sup>144</sup> See Chapter VI, Section 1.2.1.

<sup>145</sup> The intention of asking this question is not to start a discussion on behavioral analysis of auditors. The aim here is to point out how can cultural factors in business relations – other than law – affect the work of the auditor.

The quality of the audit work highly depends on auditors' professional judgement that should be exercised with a questioning mind. As important as the professional expertise, it is important that auditors adopt an independent attitude when performing the audit work.<sup>146</sup> Auditors' ability to exercise their individual and independent professional judgement depends on the development of the accounting profession in a country. Gray identified that accounting values in a country can be related to the professionalism dimension of the society in question.<sup>147</sup> Accordingly, in societies with high professionalism there is more emphasis on independence in individual decisions.<sup>148</sup> For instance, countries such as the UK, adopt a principle-based accounting regulation and the concept of 'a true and fair view' heavily depends on auditors' judgement on the financial accounts.<sup>149</sup> In addition, the role of the professional associations in standard setting also helped the development of accountancy as a profession in the UK.<sup>150</sup>

As far as the period of the Imar Bank case in Turkey is considered, contrary to the UK standards, neither professional associations nor accountancy as a profession were highly developed. Instead, audit work used to be concerned primarily with the implementation of prescriptive legal requirements in terms of, for example tax compliance.<sup>151</sup> This audit work definition did not allow auditors to use freely their professional judgement in any case. Furthermore, as Gray suggested, secrecy (or confidentiality) in business relations also influence the accounting values.<sup>152</sup> According to Gray,<sup>153</sup> managers in less secretive societies (i.e. more transparent ones) tend to disclose information whereas they tend to be more confidential in secretive environments and share business information only to those who are closely linked to the management.<sup>154</sup>

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<sup>146</sup> See Chapter II, Section 2.2.

<sup>147</sup> Gray's accounting sub-culture values are professionalism, uniformity, conservatism, and secrecy. See Gray (n 31) p. 8.

<sup>148</sup> Ibid p. 9.

<sup>149</sup> Ibid p. 8.

<sup>150</sup> For industry self-regulation, see also Chapter III, Section 3.2.

<sup>151</sup> See also Chapter VI, Section 2.

<sup>152</sup> Gray (n 31) p. 11.

<sup>153</sup> Ibid p. 8.

<sup>154</sup> It was also found that managers with a tendency to be secretive would have less incentive to choose higher quality auditors because they would not want to share information with outsider investors. See Ole-Kristian Hope, Tony Kang, Wayne Thomas, Yong Keun Yoo, 'Culture and Auditor Choice: a test of the secrecy hypothesis' (2008) 27 *Journal of Accounting and Public Policy* 357, pp. 358-60.

In the Imar Bank case, as required by law, auditors checked the company's financial accounts whether they were prepared and presented in accordance to the law. Auditors however, did not critically question the accuracy of the financial accounts. Instead they completely relied on the information presented by the management who in fact designed the internal control system to ensure that the bank was run in accordance to the major shareholders' interests. The auditors' verification of the financial reports without critically questioning their accuracy may be related to lack of professionalism in the auditing society in Turkey at that time. Professionalism requires independence and expertise. However, in Turkey, auditors were involved as an organ within the companies during the time, thus not able to conduct an independent audit but worked as an employee of the management.<sup>155</sup> Auditors in the Imar Bank case also did not ask for more information from the management because of the likely influence of the cultural value of secrecy on auditors' work. The management's reluctance to disclose adequate financial information was not seen inappropriate by the auditors, as they perceived non-disclosure as normal.

Gray observes that professional judgement will find its acceptance in societies where there are few rules (instead of prescriptive detailed rules)<sup>156</sup> and individual decisions are more easily tolerated.<sup>157</sup> According to Gray's concept of accounting values defined by cultural values of professionalism and secrecy, accounting values in Turkey found consistent with high secrecy (low level of transparency and less incentive to disclose information) and low level of professionalism and less flexibility in rules.<sup>158</sup> As suggested, societal factors might explain differences in accounting values in different countries.<sup>159</sup> The accounting system of a country is shaped by its economic, historical and technological development as well as its legal system, capital market development and education.<sup>160</sup> The list is not exhaustive. It has shown that cultural values also have a say on the development of accounting profession in a country. Thus, even if the law is formally converged, cultural values

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<sup>155</sup> See Chapter VI, Section 3.1.

<sup>156</sup> See also Chapter III, Section 2.3, for a discussion on rules- versus principles-based standards in auditing.

<sup>157</sup> Gray (n 31) p. 9.

<sup>158</sup> In Gray's classification, Turkey is grouped under 'Near Eastern' countries. See *ibid* pp. 12-3.

<sup>159</sup> Gray's model for accounting values is based on Hofstede's definition on societal values: power distance, uncertainty avoidance, individualism, and masculinity. See *ibid* p. 8.

<sup>160</sup> See *ibid* p. 7.

may still be effective on the business relations and practices, and thus might result in differences in practice.

The Imar Bank case was important in terms of illustrating a large scale of accounting fraud, audit and corporate governance failure. However, it happened more than a decade ago. Reforms, especially in the banking sector were enacted shortly after the case was revealed.<sup>161</sup> Moreover, since the last decade, there has been significant development on rules and regulations on auditing also since then auditing as a profession has developed with the adoption of international auditing standards.<sup>162</sup> Furthermore, the influence of national cultural factors is likely to be less relevant for international firms.<sup>163</sup> As Turkey keeps following an international route in audit regulation – including the adoption of international standards and EU law on auditing – and promoting the interaction between its capital markets and international markets, it is therefore suggested that the influence of national cultural values on auditing is likely to decrease.

At level 4, the degree of functional dissimilarities is high. At this level, the costs of harmonisation should be considered. With the enactment of new laws, the number of regulations on auditing has expanded gradually in Turkey. For the following reasons compliance costs are likely to be substantial: first, Turkey is not currently a member country of the EU. Its laws and rules may differ in certain areas. Moreover, currently, there is no cooperation with the European Council in terms of law making.<sup>164</sup> This may create a disadvantage for Turkey compared to the EU Member State countries, both in terms of law making and in the application processes. Second, an effective system of capital markets is necessary for the successful adoption of laws in the audit practice. Yet, the Turkish capital market is less developed and the economy is relatively fragile when compared with European countries. To reduce the negative effects of functional dissimilarities in convergence, it might be necessary to issue new laws in other areas as well. However, this is likely to increase compliance costs. Thus, functional dissimilarities can be seen to be a major impediment to convergence between EU and Turkish laws on auditing.

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<sup>161</sup> See Chapter VI, Section 1.2.2.

<sup>162</sup> For the recent audit reforms in Turkey, see Chapter VI, Section 4 in general.

<sup>163</sup> Hope *et al* (n 154) p. 358.

<sup>164</sup> European Council only gives explanatory information regarding the law in context during the negotiations. See also Chapter VI, Section 1.3.2 for the negotiation process.

## **CONCLUSION**

Financial markets become more integrated every day. This integration has increased the number of cross-listed firms and international (and multinational) investments between countries. On the one hand, investors rely on auditing and assurance services for their investments to achieve the most return on their investments. In addition, companies use auditing services to provide a true picture of their financial situation. On the other hand, countries try to provide a secure and attractive investment environment for investors in their capital markets. An effective audit market can contribute to the stability and efficient operations of financial markets.<sup>165</sup> As a result, the importance of external auditing has grown, not only for corporate governance in companies, but also in ensuring trust and confidence in financial markets.

The global need for auditing services has led to the creation of international professional standards in auditing.<sup>166</sup> Ultimately, countries that aspire to benefit from a comparability advantage and to attract foreign investment have adopted this uniformity,<sup>167</sup> not only in professional standards, but also in global form under the Big Four audit firms.<sup>168</sup> As this chapter has submitted, this kind of approximation is a kind of convergence through ‘congruence’.<sup>169</sup> In addition to this natural convergence, there is also convergence of form through the adoption of EU laws on auditing that can be seen as convergence through ‘pressure’.<sup>170</sup>

This chapter has submitted that a current globalised world makes it difficult, if not impossible, to categorise systems into legal families. As worldwide globalisation and market integration increases, the trend will be for a convergence of laws on auditing between EU and Turkish laws. In Turkey, the effects of globalisation (i.e. adoption of ISAs) and EU membership process (i.e. harmonisation with EU Directive 2006/43/EC) have had a direct impact on the laws on auditing and will continue to do

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<sup>165</sup> See Chapter I, Section 2.3.

<sup>166</sup> See Chapter III, Section 3.2.

<sup>167</sup> For the case of Turkey, see Chapter VI.

<sup>168</sup> See Chapter II, Section 2.4.

<sup>169</sup> The term ‘convergence through congruence’ is borrowed from Siems. See Siems (n 9) pp. 250-96.

<sup>170</sup> For ‘convergence through pressure’, see *ibid* pp. 314-17.

so.<sup>171</sup> However, the approximation of laws in this form does not necessarily result in actual convergence, suggesting that differences may still persist.<sup>172</sup>

The main conclusions of this chapter are as follows: If external auditing does not play a central and critical role in concentrated ownership structures,<sup>173</sup> the enactment of audit reforms in Turkey can be read as the pressure of globalisation and worldwide integration of financial markets and the political and economic pressure of the EU membership process.<sup>174</sup> This means that Turkey has succeeded in reforming its company and capital markets law in compliance with the EU Directive 2006/43/EC.<sup>175</sup> Also, the positive effects of globalisation are likely to prompt the application of international auditing standards in businesses in Turkey. Nevertheless, despite harmonisation attempts, there are a number of impediments to the convergence of auditing between EU and Turkish laws. It is due to the institutional and legislative differences in the audit market in Turkey. As a result, actual convergence may not be easily achieved, although there seems to be convergence in form as a result of the adoption of EU *acquis*.

This chapter noted the appearance of an ineffective institutional framework in the auditing industry in Turkey as an impediment to auditing convergence in practice. In particular, it proposed that the multi-headed structure of the audit oversight mechanism in Turkey should be terminated. In order to achieve this, the independence and institutional capacity of the KGK needs to be strengthened in the field of auditing both in terms of supervision and rule making. In addition, the cooperation and coordination with the other regulatory bodies operate in the auditing field need further enhancement.

Actual convergence cannot be achieved by approximation of laws alone, but requires institutional transformation as well. Institutional modification would make the

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<sup>171</sup> For the critical analysis of the laws on auditing in Turkey, see Chapter VI in general.

<sup>172</sup> There is no common practice on auditor liability rules among Member States. See Chapter V.

<sup>173</sup> For the role of auditing in concentrated systems, see Chapter I, Section 3.

<sup>174</sup> For the EU membership process of Turkey as a motivation for the law reforms, see Chapter VI, Section 1.3.

<sup>175</sup> Heribert Hirte, 'The Corporate Governance of the Turkish Joint Stock Companies and Harmonization with European Union Acquis' Seminar für Handels-, Schifffahrts- und Wirtschaftsrecht, Universität Hamburg Sommersemester 2011 (von Talha Barut) p. 37. See also Commission Progress Report (n 74) p. 50.

adoption of imported law more successful.<sup>176</sup> There is a strong correlation between institutional structure in a country and the successful application of imported rules. In other words, the effectiveness of law is linked to the institutional set-up of economic institutions through, for example the enforcement force of these institutions. Without sufficient institutional set-up, the approximation of law alone is less likely to bring successful implementation. Institutions must operate efficiently for the law to be making sense to the society. This should be understood as institutions work to familiarise the imported rules not only to the society (for the application of laws) but also to courts and other regulators (for the enforcement of laws). Unless these conditions are met it is unlikely that the imported law serve its purpose. If the society could not establish a familiarity with the imported law there will be no implementation or the law will be implied in contradiction to its initial purpose.<sup>177</sup> This is the case in the application of private litigation practice in Turkey. Institutional modification might be necessary to familiarize the private litigation system for investors in Turkey. In order to operate the system of paying compensation in Turkey, the capacity of courts must be improved to meet the demand for private litigation. To create such demand, it is necessary that the users understand the true meaning of the law. This could be achieved through increasing the public awareness on the legal remedies available within the judicial system in Turkey.

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<sup>176</sup> Berkowitz *et al* (n 2003a) (n 79) pp. 180-1.

<sup>177</sup> See also Section 2.3 above pp. 238-9.

## CHAPTER VIII: CONCLUSIONS

*“In the world of audit, the status quo is not an option”*.<sup>1</sup>

In today’s financial markets, there is an increased demand for financial auditing. This demand has assigned external auditing and auditors an important role in financial markets, and external auditing has become an important pillar of financial markets. An increased demand for, and expanded role of, auditing in financial markets have emerged in re-regulation of auditing rules. As a result, audit regulation has regularly been subject to modifications and reforms not only in the EU but also in Turkey. As long as there is a demand for auditing in financial markets, it is likely that modifications and reforms will also be needed in the future. This thesis explored to what extent these reforms lead to convergence and identified the forces for and obstacles of convergence between the EU and Turkish laws on auditing.

This chapter provides a general conclusion to the thesis. It starts with a review of the thesis from Section 1. The second section presents the main conclusion of the thesis. Finally, the third section concludes with some suggestions and recommendations for further research.

### 1. REVIEW OF THE THESIS

This thesis started by exploring the role of auditing in different corporate governance systems. It was submitted that, in dispersed systems, external auditing functions as a monitoring mechanism to reduce agency costs. External auditing also has a governance function in concentrated systems. In such systems, agency problem exists as an exploitation of minority shareholders: thus, external auditing is used to reduce the information asymmetry between controlling shareholders and minority shareholders through the use of high quality audits to give assurance to investors that the scope for controlling shareholders’ opportunistic behaviours is limited. Also as submitted, in addition to its governance function, external auditing plays an

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<sup>1</sup> Jonathan Faull, General for Internal Market and Services, European Commission, 10 February 2011.

important role in ensuring trust and confidence in financial markets. An increasing number of cross-listings and international investments have resulted in a greater demand for auditing. As a result, external auditing has become an indispensable element in financial markets.

The second chapter explored the role of auditors and submitted that external auditing today has moved beyond its traditional monitoring governance function to a wider business approach. Under the new form of external auditing, auditors have become more dependent on advisory services, with their independence likely to be jeopardized under this framework. In addition, the users of audit reports expect auditors not only to check on accounts, but also to provide assurances regarding the financial stability of the company. However, a statutory auditor's duty is not to provide comfort regarding the financial health of the company. The wrong perception regarding the role of auditors has resulted in an expectations gap. This issue has long been debated since Enron until now, and reached a peak during the global financial crisis, where it remains. The Big Four audit firms serve as a good example in the audit market as they provide audit services around the world under a global network and their role was heavily debated during and after the global financial crisis. This chapter explored their role in the crisis in terms of reporting going concern accuracy and audit quality. The discussions in this chapter contributed to the debate by identifying structural (i.e. appointment and remuneration of auditors by the audit client) and functional (i.e. auditor independence; expectations gap) problems with auditing. The main conclusion of Chapter II was that the expectations gap is derived from the ill-defined role of auditors and the public's wrong perceptions regarding that role. The global financial crisis represents a good example on this issue. As this chapter submitted, although there were certain audit failures, a general conclusion regarding the failure of auditors in the global financial crisis to issue going concern opinions would not be justified.

For this purpose of thesis, an examination of the pillars of audit regulation was necessary to provide a legal perspective. In this respect, Chapter III contributed to existing external auditing literature by providing an analysis of audit regulations and laws. This chapter made a number of contributions to the understanding of audit regulation. To begin with, the justifications and motivations of regulation are implied

in audit regulation. This chapter submitted that audit regulation is needed in order to deal with the expectations gap, the aftermaths of audit failures, information asymmetries, and the risk of distortion of competition in the market. On the one hand, the state is mainly involved in audit regulation through the regulation of financial markets law, company law, and competition law. On the other hand, private regulators also set principles for the audit profession where political influences (i.e. IMF, World Bank, European Commission) and/or commercial aspirations (i.e. through lobbying by the Big Four) are likely to be involved at this stage. This chapter presented that the current audit regulation does not have a traditional form of industry self-regulation since state and private actors influence audit regulation at national, regional, and international levels. It is likely that the different regulatory motives of state and private regulators might hinder the primary public interest role of audit regulation.

One of the main themes of this thesis is convergence. Chapter III submitted that audit regulation follows an international route (e.g. the adoption of ISAs). In this context, this thesis further examined EU laws on auditing in terms of convergence, in Chapter IV. In addition, this chapter critically analysed the EU's existing laws and law proposals in terms of preliminary issues on auditing. At the EU level, external auditing is regulated by Directive 2006/43/EC. Although Directive 2006/43/EC has set a benchmark for statutory audit practices in the EU, there were problems in the current structure of the EU audit market. Thus, the European Commission aims to re-regulate external auditing to change the *status quo* in the EU audit market. This chapter explored EU audit policy and laws and identified how corporate scandals, financial crises, and the single market objective of the EU have had shaped this policy and laws. The main contribution of this chapter is the critical analysis of the EU's law proposals on statutory auditing: the proposal for a Directive amending Directive 2006/43/EC<sup>2</sup> and the proposal for a Regulation on the statutory audit of PIEs.<sup>3</sup> This chapter showed that Directive 2006/43/EC has helped little in the harmonisation of auditing rules in the EU, as Member States implemented the

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<sup>2</sup> European Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts Brussels, 30.11.2011 COM(2011) 778 final (Draft Directive).

<sup>3</sup> European Commission Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities Brussels, 30.11.2011 COM(2011) 779 final (Draft Regulation).

Directive differently. This chapter also supplements Chapter II by providing a legal perspective on the preliminary issues in auditing, namely the expectations gap, auditor independence, and high concentration. In this respect, the reform proposals of the EU were critically evaluated in light of these issues in the EU audit market. It is submitted that, although the European Commission has proposed some radical proposals in the draft Regulation (e.g. prohibiting the provision of certain type of non-audit services and requirement of mandatory rotation of audit firms), it can be expected that Regulation is likely to increase the harmonisation level in the EU. Yet, it remains to be seen what the EU proposal will bring to the audit market and how it will change the current structure.

As external auditing becomes an important element in financial markets, the number of users of audit reports has increased. One of the questions that arise at this point is to what extent auditors should be liable to the users of the audited reports for the misleading and false information in the audited accounts. Chapter V explored the elements and conditions of auditor liability under international auditing standards (ISAs), EU law, and UK law separately. This chapter showed that ISAs do not impose any liability on auditors. Nor has the EU established a common auditor liability regime for Member States. However, to provide an example on the role of auditors and their legal responsibility in financial markets, this chapter explored the UK auditor liability regime under both common law and statute. As UK common law established, auditors owe a duty of care to the company based on contractual relationship; therefore, auditors can be held liable if they breach their contractual duty. Chapter V submitted that the scope of auditor liability rules has expanded in line with the changing role of auditors. However, the question of ‘to what extent should the scope of auditors’ liability be extended?’ still raises concerns. Increased liability rules may be necessary for the efficient function of markets to ensure trust and confidence wherein investors can be compensated for damages caused by auditors’ misconduct. However, under the current audit market structure, where there are only a few large audit firms, a major liability claim might have serious consequences. It is likely that the concentration level will increase as a result of a successful major liability claim. Also, because audit reports are publicly available, an unlimited liability regime would place auditors liable to the public at large. Due to these concerns, UK law established that auditors could be held liable to third parties

in terms of untrue or misleading statements in or omissions from prospectuses unless they disprove their negligence over that misleading information.<sup>4</sup> The discussions in this chapter are important to understand the duties and liability of auditors in financial markets. The analyses in this chapter also complement discussions in previous chapters, especially Chapters I and II.

This thesis so far had explored the concept of external auditing, including its role, function, and regulation, and the liability rules that the law imposes on auditors. Chapter IV and Chapter V explored EU laws on auditing with a limited scope in terms of convergence. To broaden the scope of the convergence discussion, the findings of this thesis were analysed further in Chapter VII in terms of convergence. Moreover, in order to enlarge discussions, Turkish laws on auditing as detailed in Chapter VI were added to the discussions in Chapter VII as well.

This thesis took Turkey as a case study because of Turkey's candidate EU membership status. The EU membership status of Turkey calls for a discussion on the ability of Turkey's to adopt EU laws. The results of this discussion were also used for the convergence analysis in Chapter VII. In Chapter VI, analyses of Turkey were based on socio-political and economic factors. The socio-political perspective considered Turkey's EU membership aims as a motivation for the law reforms. As the other motivation for the law reforms, the economic perspective considered Turkey's objective to become an active player in international financial markets - with an increased legal environment and strengthened governance structure of firms. Chapter VI showed that Turkey has achieved reform in its commercial law and capital markets laws, in order to become a member of the EU and to be an active player in the international financial markets. This chapter submitted that, through these law reforms, Turkish laws on auditing have become closer to EU law, especially in the areas of public oversight and the professional requirements for auditors to perform audits of PIEs. The findings of this chapter are further examined in terms of convergence with EU laws in Chapter VII.

Chapter VII examined the need, methods, and feasibility of convergence of auditing between the EU and Turkish laws. The findings of the previous chapters were applied to the question about the feasibility of convergence. Therefore, this chapter

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<sup>4</sup> See FSMA, s. 90. See also Chapter V, Section 3.2.2.

provided a general conclusion on the findings of the thesis in terms of convergence. This chapter contributed to the convergence debate. The main conclusions of this chapter are as follows: On the one hand, through the adoption of ISAs and the implementation of Directive 2006/43/EC, laws on auditing might become more similar between the EU and Turkish laws. However, differences may still persist. This is due to legislative and institutional differences. Hence, this approximation can only lead to formal convergence. On the other hand, through the effects of globalisation and the integration of markets, the trend will follow a convergence of laws on auditing. Actual convergence is more likely under this kind of convergence.

## **2. THESIS CONCLUSION AND MAIN FINDINGS**

This thesis made a number of contributions. To start with, it contributed to existing corporate governance literature in discussing the role of auditors in corporate governance (in a narrow context) and in financial markets (in a broader context).<sup>5</sup> This thesis also submitted a relatively comprehensive analysis on audit regulation. This is because audit regulation was examined from a number of perspectives, including the need of audit regulation, the current regulatory structure of auditing, and state and private actors that have play a role in audit regulation.<sup>6</sup> Thereof, this thesis contributed to the auditing regulation literature by providing a law perspective. A further contribution of this research is the comparative analysis of Turkish laws and EU laws on auditing.<sup>7</sup> The findings of this comparative analysis contributed to convergence debates in providing a discussion on the convergence of auditing between EU and Turkish laws.

The aim of this thesis was to examine auditing and shed fresh light on its regulation in the EU and in Turkey by questioning the possibility and feasibility of convergence. The result was a number of conclusions that are submitted across different chapters. The main conclusions of this thesis are as follows. The role of auditing in corporate governance and in financial markets has a growing importance. Greater attention received by auditing at international and EU levels, following the recent global financial crisis, can be seen as evidence. This thesis explained that there

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<sup>5</sup> See Chapters I and II.

<sup>6</sup> See Chapter III.

<sup>7</sup> See Chapter VII.

is a wrong perception amongst the public regarding the role of auditors, which results in an expectations gap. This expectations gap is widened during a time of crisis. This thesis submitted that a general conclusion on auditors' failure during the financial crisis would not be justified. However, as shown, there are structural and functional problems in auditing today. Times of crisis give opportunities to lawmakers to issue new laws. In this respect, this thesis submitted that audit regulation is motivated to change in the aftermath of audit failures. As this thesis established, audit regulation is also needed in dealing with the expectations gap, information asymmetries and the risk of distortion of competition in the market.

The regulation of auditor liability is a sensitive issue. To be sure, increased liability rules are necessary for the protection of investors from false and misleading information. This thesis expressed that, on the one hand, increased liability rules might encourage auditors to provide quality audits, and therefore mitigate information asymmetries in the market. On the other hand, due to the current market structure, the scope of liability cannot be determined without taking into account a risk of the disappearance of one of the large audit firms after a major liability claim. Nevertheless, this must not suggest that auditors should not be held liable for their negligent acts. Instead, regulators should act in the best interests of investor protection for the efficiency of financial markets and should take action to provide the most appropriate market conditions where auditors are not allowed to escape liability just because of concerns for litigation risk and effects on concentration.

One of the main messages of this thesis was that auditing, both in terms of its profession and regulation, follows an international route. For instance, the Big Four audit firms contribute to the internationalisation of auditing through their global networks. Similarly, ISAs are adopted in more than a hundred jurisdictions in the world. At the EU level, EU Directive 2006/43/EC has set a benchmark for statutory audit practices and rules between Member States. These attempts may suggest that there is an approximation in the laws of auditing. However, as shown, there is diverse implementation of EU laws. The form of the laws of EU Member States shows similarity after the transposition of Directive 2006/43/EC whereas the implementation of the Directive is diverse amongst Member States. This thesis has submitted that this is due to ineffective harmonisation methods used by the European

Commission. In conclusion, despite the drivers of convergence, such as the integrating of financial markets and harmonisation attempts of the EU, the actual convergence of auditing in the EU has not yet been achieved.

Similar results were found for Turkey. The globalisation and integration of financial markets and EU candidate membership has motivated Turkey to harmonise its laws on auditing with EU law. As a result, Turkey has succeeded in harmonising its law on auditing with the EU *acquis*. It has been found that the form of the law shows similarities, but that implementation of the rules may differ due to functional dissimilarities and legislative differences in Turkey. This thesis has submitted that the EU membership process and internationalisation of the economy is likely has led to formal convergence between EU and Turkish laws on auditing, yet, this is not likely to result in actual convergence. For more effective implementation of the laws in practice, modifications can be made, especially at institutional level, e.g. increasing the capacity of the commercial courts and giving a more active role to the KGK, the Turkish public oversight board in the audit sector.

### 3. FURTHER RESEARCH

At the time of writing, the EU proposals on the Directive<sup>8</sup> and the Regulation<sup>9</sup> for statutory audits of PIEs are in the process of discussion in the EU Parliament and Council, and a date of adoption has not been set. This thesis critically discussed the draft versions of these law reforms.<sup>10</sup> Therefore, the analyses in this thesis could not be applied to changes made (if there will be any) by these proposals.

With regards reforms, it will take years until they have been implemented in the EU.<sup>11</sup> More time is required in order to discover and evaluate their effects on the laws of EU Member States and also on the audit market structure. For instance, the EU proposes an audit supervision mechanism under ESMA;<sup>12</sup> time will tell what

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<sup>8</sup> Draft Directive (n 2).

<sup>9</sup> Draft Regulation (n 3).

<sup>10</sup> See Chapter IV, for a critical discussion on EU law proposals.

<sup>11</sup> The reforms are published in the Official Journal on 27 May 2014 and shall apply from 17 June 2016. With respect to Regulation No. 537/2014 there are some transitional provisions in terms of audit firm rotation.

<sup>12</sup> See *ibid*.

further reflections will be - e.g., whether EU-wide audit supervision is favourable to the EU audit market or not.

The financial markets are subject to constant changes and developments (e.g. political and economic). There are possible effects of these changes and developments on the application of laws (also on the creation of new laws). Further studies may consider such effects on the application of EU laws by Member States as well as the effects on Turkey's adoption. For instance, future studies can examine current financially distressed Member States (e.g. Greece, Portugal, and Spain) and also candidate countries, which are smaller and at a lower economic level than current countries in the EU (e.g. Serbia, Iceland) and how their political and economic situations effect the implementation of EU law. In this respect, empirical research could be conducted to improve the understanding of the primary differences and similarities of Member States as well as between Member States and other candidate countries in terms of the implementation of the laws.

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