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Regulating audit quality: Restoring trust and legitimacy

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ABSTRACT

The global financial crisis, corporate failures and scandals in many countries raise significant questions audit quality. In the UK, the FRC took the unprecedented step of codifying audit quality in its 'Audit Quality Framework'. We analyze the extent to which audit firms, professional bodies, and investors considered the FRC proposals sufficient for addressing concerns about audit quality. Using impression management and legitimacy as a framework to analyze stakeholder responses we go beyond audit quality drivers identified by the FRC. In contrast to the drivers identified by the FRC, our focus on transparency, expertise, professionalism and commercialization of the audit shows that FRC, audit firms and professional bodies have mainly focused on issues which possibly do not pose a threat to the commercial interest of audit firms. Overall, our analysis shows that regulatory and professional bodies engaged in image management and the promotion of audit quality in an attempt to remedy tarnished image and augment their legitimacy and standing. In attempting to restore trust and legitimacy regulatory bodies, such as the FRC, have to reconcile complex often contradictory stakeholder demands.

1. Introduction

The global financial crisis, corporate failures and scandals in many countries raise significant questions about the effectiveness of financial reporting and auditing. Auditing firms, professional and regulatory bodies are often subject of criticism and face pressures to restore confidence in auditing. The crisis in confidence has spurred a move away from 'self-regulation' to greater emphasis on 'independent' regulation of auditing in the UK.[1] Marking a significant development in the regulation of auditing the FRC sought to codify audit quality and issued the 'Audit Quality Framework' (FRC, 2008). This coincides with various measures adopted in many countries aimed at restoring trust in auditing and governance. Hitherto, however, no audit regulatory body has tried to codify audit quality.

In this paper we examine stakeholder views on audit quality as represented in the responses to the FRC (2006) consultation. Examining the codification of audit quality in the UK in the aftermath of corporate scandals our paper focuses attention on the rhetoric and legitimation associated with the regulation of audit quality. Our analysis focuses on the extent to which respondents – audit firms, professional bodies, and investors – considered the FRC proposals sufficient for addressing concerns about audit quality. We used impression management and legitimacy as a framework to analyze stakeholder responses. The framework enabled us to go beyond the factors identified by the FRC. Our analysis shows that there are

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[1] For example the Auditing Practices Board, a body responsible for setting auditing standards, assumed greater responsibility and became an operating body of the UK Financial Reporting Council.

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underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and transparency of the audit process and of audit firms that have not received much regulatory attention. We find that in response to institutional pressures respondents aligned themselves with the audit quality rhetoric to legitimise themselves and protect their image. Our paper shows that audit firms and professional bodies advanced various points indicating the need for FRC to address additional issues in order to improve audit quality. To legitimise its existence, the auditing profession has a vested interest in convincing users that accountants can be trusted. In pursuit of that the auditing profession engaged in modes of impression management which at the institutional level enabled symbolic displays pertaining to diligent public service for the benefit of outsiders but which had limited practical implications for how audit work is actually performed. Our analysis further reveals that corporate malpractices continue to raise questions about audit quality and evoke varying response from auditors, regulators, and users of audit. Increasing demands are made on the profession to respond to the wishes of audit beneficiaries. Although the profession has apparently responded to some of the concerns it has failed to address the fundamental issues underlying the growing criticisms concerning audit quality.

Our paper contrast with existing research on audit quality which has paid limited attention to the regulation of audit quality and how interested parties, in particular audit firms and professional bodies, seek to influence that process. In the extant literature audit quality is mostly conceptualized in terms of output measures. Definitions employed usually embrace dimensions of auditor competence and independence (Watkins, Hillison, & Morecroft, 2004). Researchers often focus on outcomes that are associated with auditing. These include for instance the association between the existence of auditing in particular environments and improvements in the credibility of financial statements, often measured in terms of earnings quality (see for example, Abbott, Parker, & Peters, 2004; Van Tendeloo & Vanstraelen, 2008), the accuracy of the auditor's judgements and issuance of correct opinion on financial statements (Knechel & Vanstraelen, 2007); litigation against audit firms; enforcement actions by regulatory bodies, e.g. in the case of the US Securities and Exchange Commission (SEC) sanctions (Palmrose, 2000); and business failures often following a 'clean' report (see Francis & Krishnan, 2002). A limited body of research focuses on audit firm and team characteristics affecting audit quality (Beattie & Fearnley, 1995; Bierstaker & Wright, 2001; Carpenter, Dirsmith, & Gupta, 1994; Frantz, 1999). Most research on audit quality adopt archival method and tend to focus on differences in audit quality due to differences in audit firm characteristics, often using various measures of size and market concentration (see Moizer, 1997; Watkins et al., 2004). Notwithstanding the fact that Francis (2004) observes that we know more about audit quality than we might have originally suspected, it is important to recognise that audit quality is a nebulous concept. Given its socially constructed nature, it is almost impossible to reach a common understanding of what audit quality is and hence to measure improvements in practice. In most cases it is unobservable to those not involved in the audit process, the only observable outcome of the audit process being the audit report (Eilifsen & Willekens, 2007; Manson & Zaman, 2001).

In contrast to research examining the effects of audit quality on for example financial reporting, our focus on the regulation of audit quality contributes to the existing literature and recognises that audit quality has been a matter of concern and regulatory attention for some time. Over the years there have been numerous attempts to improve audit quality. In the US for instance prior to the Enron/WorldCom debacle the Panel on Audit Effectiveness (POB, 2000, 2) considered at length the nature and quality of the audit. It noted that:

> Several major instances of misstated earnings resulted in headlines reporting massive declines in market capitalization. If share prices decline when companies' results fail to meet expectations, they decline even more precipitously when the market learns that previously issued audited financial statements are unreliable. This frequently leads to restatements of those financial statements, suggesting that the financial reporting system may not, in fact, promote the most efficient allocation of capital.

The Panel on Audit Effectiveness further noted that restatements raised the question "Where were the auditors?" and in an effort to improve the quality of auditing made recommendations which included a call for auditors to perform some "forensic-type" procedures on every audit to enhance the prospects of detecting material financial statement fraud. The Panel called for auditing and quality control standards to be made more specific and definitive to help auditors enhance their professional judgement. In specified areas the Panel suggested audit firms should review, and where appropriate, enhance their audit methodologies, guidance, and training materials. A system of peer reviewers to "close the loop" by reviewing those materials and their implementation on audit engagements and then reporting their findings was also recommended. The Panel also urged audit firms to put more emphasis on the performance of high quality audits, communications from top management, performance evaluations, training, and compensation and promotion decisions.

In the UK the Institute of Chartered Accountants England and Wales (ICAEW) formed the 'Audit Quality Forum' in 2002 to promote auditing and contribute towards restoring confidence in auditing and governance. In its publication "Audit Quality" the ICAEW (2002) observed that auditors provide a quality service to shareholders if they provide audit reports that are independent, reliable and supported by adequate audit evidence. Six factors contributing to audit quality were identified: good leadership, experienced judgement, technical competence, ethical values and appropriate client relationships, proper working practices, and effective quality control and monitoring review process.

In a related consultation paper "Reporting on Audit Quality Monitoring", the UK Professional Oversight Board (POB, 2006) suggested measures to improve audit quality. These included extended public reporting on Audit Inspection Unit (AIU) findings, and sharing information on AIU findings with audit committees. The FRC recognised that audit quality is also affected by the choice available in the market for audit services.[2] Around this period in response to continued concerns about effectiveness of auditing the FRC also issued a discussion paper in an attempt to codify audit quality. Analysis of the responses to the discussion paper is the focus of this paper.

In the next section of the paper we first conceptualize regulatory and professional bodies' and audit firms' responses to concerns about audit quality as impression management whereby they attempt to restore trust in audit quality through engagement in the regulatory process, but without committing to actual substantive changes to how audit work is actually performed.

2. Restoring trust in audit quality

2.1. Conceptual framework

Significant commitment to institutionalise more independent standard setting and oversight processes in the name of strengthening audit quality is evident in the post-Enron period (Humphrey, Khalifa, Robson, & Sharma, 2007). The regulatory pursuit of audit quality marks a shift in the discourse associated with external auditing which had previously focused on notions of adding value (see Eilifsen, Knechel, & Wallage, 2001; Knechel, 2007; Manson & Zaman, 2001; Peecher, Schwartz, & Solomon, 2007; Power, 2007). The loss of public confidence in audit practice means that new representations of auditing are likely to become pivotal in creating and managing new and 'improved' impressions of the profession (Humphrey et al., 2007). In the promotion of audit quality and attempt to restore public confidence in the audit process, the concerns of, and initiatives taken by, regulatory agencies are likely to reflect efforts intended to maintain, defend or manage their individual domains (Baysinger, 1984; Cooper & Robson, 2006; Sikka, 2009; Wyatt, 2004; Zeff, 2003).

Impression management and legitimacy is of central importance when there is a debate relating to audit quality. Accounting regulatory bodies and accounting firms are image sensitive organizations that rely on creating and maintaining an impression of their activities to correspond with public expectations (Alvesson, 2001; Humphrey et al., 2007). In the process of defining and defending its jurisdiction the accountancy profession attaches considerable importance to its image and takes initiatives to defend and reinforce its "image" when questions were raised about audit quality. Humphrey et al. (2007) suggest that when audit quality becomes the espoused ideal of auditing practice, auditors are likely to align themselves with this image and rhetoric in response to institutional pressures.

To legitimise its existence, the auditing profession has a vested interest in convincing users that accountants can be trusted. In pursuit of that the auditing profession engages in modes of impression management (Neu, 1991) which at the institutional level produces symbolic displays pertaining to diligent public service for the benefit of outsiders but does not have any serious practical implications for the actual performance of auditors' work. Regulatory pronouncements and audit firms' engagement in the post-Enron debate relating to audit quality might be reflective of an underlying concern with protecting the profession. As regulatory and professional bodies engage in image management and the promotion of audit quality in an attempt to remedy their tarnished image and augment their legitimacy and standing, public interest is often stated in manifest terms in their pronouncements but the latent private interest is often unremarked upon (Parker, 1994). Also, concerns over potential damage to the profession and its members may often prevail over the protection of the public (Bedard, 2001; Preston, Cooper, Scarbrough, & Chilton, 1995; Sikka, 2009). The rhetorical expressions of the accounting profession relating to serving the public interest may reveal an ideology that is concerned with maintaining its own economic position (Baker, 2005) and form an integral element of a strategy in which the accounting profession seeks to secure and enhance the material and symbolic value of its labour (Willmott, Cooper, & Puxty, 1993; Zeff, 2003).

In examining the regulation of audit quality framework and the stakeholder responses, our analysis is informed by a framework within which the regulatory institutions sought (and still seek) to restore trust in audit through a process of legitimation and impression management. Our use of legitimacy and impression management as organizing concepts is consistent with for instance Matthew (2003: 350) who notes that:

> "Organizations seek to establish congruence between the social values associated with or implied by their activities and the norms of acceptable behaviour in the larger social system in which they are a part. In so far as these two value systems are congruent we can speak of organisational legitimacy. When an actual or potential disparity exists between the two value systems there will exist a threat to organisational legitimacy."

2.2. Methods and data

As a precursor to the publication of the Audit Quality Framework (FRC, 2008), the Financial Reporting Council, the regulatory body for financial reporting and auditing in the UK, issued a discussion paper "Promoting Audit Quality" (FRC, 2006). The discussion paper, which is the focus of our analysis in this paper, identified four main drivers of audit quality: the culture within an audit firm; the skills and personal qualities of audit partners and staff; the effectiveness of the audit process; the

[2] Initiatives aimed at improving corporate governance and auditing in the UK include 'Competition and Choice in the UK Audit Market' (Oxera Report, April 2006) and 'Choice in The UK Audit Market: Discussion Paper' (FRC, 2006).

Table 1
Summary issues and group response.

Audit quality issues (% considering FRC framework insufficient)	Groups		
	PB	AF	INV
Culture	56%	67%	62%
Staffing	0%	13%	14%
Process	56%	63%	48%
Reporting	44%	88%	67%
External	83%	81%	43%
Group average	48%	62%	47%
		52%	

Notes: PB, professional bodies; AF, audit firms and INV, investors.

reliability and usefulness of audit reporting. In the discussion paper the FRC also identified a number of factors affecting audit quality which it considered to be beyond the control of auditors: the approach taken by management; the contribution made by audit committees; the role of shareholders and commentators; the role of litigation as a driver of audit quality; the approach of regulators; the pressures caused by the accelerating reporting regime.

We view responses submitted to standard setting bodies as being part of a political process in which respondents engage in image management and rhetoric. Prior research which have relied on submissions have often attempted to quantify the responses for statistical analysis (see Weetman, Davie, & Collins, 1996). Whilst such an approach may seem scientific and objective it has its drawbacks (Manson & Zaman, 1999). For the purpose of this paper, we do not solely rely on quantitative coding but complement the initial coding of the responses with detailed textual analysis. We have thus sought to retain the richness of the views expressed and arguments advanced by respondents in support of their position in the comment letters. Accordingly, we base our examination on the actual text of the comment letters and where appropriate include representative quotations. Although our use of the written responses has its own limitations, it is consistent with prior research.[3]

The Financial Reporting Council received responses on its proposed Audit Quality Framework from accounting firms, professional bodies, investors, corporations, and other stakeholders. These responses serve as the base data for our analysis. Our approach facilitates analysis of differences in responses between groups and enables a better understanding of the features of audit which are important for each group. A few of the comment letters were short on answering all of the posed questions, but we only consider those who provided full feedback. The distribution of these respondents is: audit firms – 8; professional bodies – 3; investors – 7; companies – 1; and others. Our analysis reported in the next section focuses on the first three groups.

In the next section of the paper we provide an analysis of the views of various stakeholders concerning audit quality. We rely on the responses of stakeholders to the FRC Consultation on Promoting Audit Quality to gauge views and focus on the extent to which three groups – professional bodies, audit firms and investors – agreed with notions of audit quality as conceived by the FRC and considered its initiative and approach as indicated in its discussion paper to be sufficient. Thereafter, we go beyond issues identified in the FRC framework and explore underlying concerns that remain largely unaddressed. We show that FRC framework focused on audit quality issues which do not directly threaten the commercial interest of audit firms. We find that there are underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and transparency of the audit process as well as that of audit firms.

3. Analysis – impression management

We now provide an analysis of the responses to the FRC discussion paper, *Promoting Audit Quality*. We first focus on the extent to which respondents considered the framework to be sufficient for addressing concerns about audit quality. In the subsequent sub-section we go beyond the factors identified by the FRC, and focus on underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and the transparency of the audit process as well as that of audit firms. These issues have received limited regulatory attention. We identified these four issues through an iterative analysis of the responses to the FRC discussion paper using the theoretical framework discussed earlier in the paper which focused our attention on the role of legitimation and impression management in the regulatory process.

3.1. An insufficient framework

As explained earlier, the FRC classified audit quality issues into five broad areas – audit firm culture; staffing and personnel; audit process; auditor reporting; and external factors outside the control of auditors. Table 1 below provides an overview summary of the three groups' views on the appropriateness of the FRC framework. It shows that overall all three groups considered the FRC framework to be insufficient in addressing concerns about audit quality. Compared to the professional

[3] See Weetman et al. (1996), Hodges and Mellett (2002), Georgiou (2004).

Table 2
Audit quality issues (% considering FRC framework insufficient).

	PB%	AF%	INV%
Culture within a firm			
Important factors of an audit firm's culture identified	33%	50%	14%
Pressures that could compromise audit firm culture identified	67%	88%	86%
Further steps needed to build confidence in audit firm culture	67%	63%	86%
Staffing			
Technical skills, personal qualities and experience are key drivers	0%	0%	0%
Issues affecting inadequately trained or skilled workforce identified	0%	25%	29%
Audit process			
All factors that determine if audit process is effective identified	0%	63%	43%
All threats to the effectiveness of audit process identified	100%	63%	43%
Steps needed to counter threats to effectiveness of audit process	67%	63%	57%
Audit reporting			
Factors affecting confidence in audit opinions identified	67%	88%	71%
Other reasons why users may not have confidence in audit opinion	67%	100%	57%
Further steps needed to reinforce confidence in audit opinion	0%	75%	71%
Other issues			
All external factors that may adversely affect audit quality identified	100%	88%	29%
Steps needed to reduce risk of external factors affecting audit process	67%	75%	57%

Notes: PB, professional bodies; AF, audit firms and INV, investors.

bodies and the investor groups, audit firms considered relatively more proposals to be insufficient.[4] The investor group was mostly concerned that the FRC proposals did not adequately address audit firm culture and auditor reporting issues. Overall, the FRC's framework was considered insufficient especially in relation to audit quality factors including the extent to which it addressed audit firm culture, audit process, and audit reporting.

The FRC (2006) identified a number of indicators of audit firm's culture which may enhance audit quality. These included leadership of firms emphasising the discharge of auditors' professional responsibilities; respect for the base principles of auditing and ethical standards; partner and staff development system that will promote personal characteristics important for quality audit; independence of financial considerations in decision making process to avoid any negative effect on audit quality; promotion of consultation on difficult issues and provision of sufficient resources to deal with matters as they arise; and development of information infrastructure to support the audit function. It also noted threats to quality oriented cultures including audit leadership having insufficient input to the firm's management decisions; over-emphasis on winning and retaining audits; over-emphasis on non-audit services; excessive cost cutting in times of economic downturn; and insufficient importance placed on technical training. Within each of the broad issues, the respondent groups identified a number of factors that needed further attention. In the following we first summarise and then discuss respondents' assessment of the FRC framework in respect of the specific issues affecting audit quality (Table 2).

Overall respondents recognise culture as an important audit quality issue. Most investors and professional bodies find the quality factors identified by FRC to be a sufficient account of cultural issues. However, relatively more audit firms identify other factors as important. Additional factors suggested by audit firms include: the extent of engagement partner involvement in the audit, the degree of cohesiveness internationally of the firm/network, the importance of audit work to the firm, the ownership and management structure of the firm, the extent to which the firm is willing to contribute to profession-wide initiatives (commitment to public interest), and the firms' experience with substantial public interest audits.

Another driver of audit quality examined in FRC (2006) relates to staffing – the skills and personal qualities of audit partners and staff. It notes that the training given to audit personnel needs to be appropriately coordinated with audit work; training at all levels needs to address a broad range of issues; managers and partners need to provide mentoring and 'on the job' training; and post-qualification training needs to focus appropriately on audit related issues. Additionally, the FRC also identified a number of threats to the skills of an audit team including: failure to develop the necessary personal characteristics through effective mentoring; failure to retain staff with the necessary experience and expertise; allocating capable staff on the basis of client prestige rather than audit risk; and insufficient or ineffective training.

In 'Promoting Audit Quality' the FRC identified the following characteristics of reliable and useful audit reporting: an audit opinion that commands confidence; and good communication with audit committees. The form of the auditor's report

[4] Our insufficiency measure is a simple addition of responses to the individual issues raised by FRC The basis is a classification of the individual responses (18 respondents in total) to each of the 13 questions addressing "sufficiency issues", e.g. Question 1: "Are there other important factors of an audit firm's culture that are not referred to [in the FRC framework]"? The percentages shown in Table 1 reflect summarization across issues (3 for culture; 2 for staffing; 3 for process; 3 for reporting and 2 for external factors) and across groups (3 PB; 8 AF and 7 INV). For example, the 67 percent insufficiency measure for audit firms considering the culture reflects that 4 of 8 firms find that there are other important factors (Q1); 7 of 8 firms find that there are further pressures that could compromise the culture of audit firms (Q2) and 5 of 8 firms find that there are further steps that should be taken to build confidence in the culture of audit firms (Q3). That is 4 + 7 + 8 in relation to the possible 8 + 8 + 8 provides the insufficiency measure tallied as 67 percent.

is highly codified and standardised (see Manson & Zaman, 2001). Key elements are specified in law and auditing standards: A clean auditor's report operates as a signal rather than a source of new information; and confidence in the auditor's report is inextricably linked to confidence in the presumed quality of the audit process. The FRC notes that good communication with audit committees is likely to make a key contribution to a high quality outcome of the audit. This view is consistent with existing research on the effectiveness of audit committees (see Turley & Zaman, 2007; Zaman, Hudaib, & Haniffa, 2011). Benefits of communication with the audit committees include: encouraging a dialogue about the scope of audit; proving a forum to discuss the key risks identified and judgements made in reaching the audit opinion; discussing qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting. The FRC notes a number of threats to confidence in audit reporting. It states that some users and commentators have concerns about: whether the scope of the meaning of "true and fair view" was restricted following the introduction of IFRS (a matter addressed by the UK Companies Act 2006); whether auditors are properly fulfilling their legal responsibilities to consider the adequacy of a company's accounting records; and whether auditor's reports should be more informative about key audit issues.

None of the respondent groups considered the audit opinion element of the FRC framework on audit quality sufficient. Compared to the investors the audit firms find more reasons why users may not have confidence in the audit opinion, i.e., compared to 57% of the investors, all audit firms found the FRC framework insufficient in this regard. It is natural that investors have less insight into the particulars of the audit process (cf. Carcello, Hermanson, & McGrath, 1992). This is also reflected at the more overall level when comparing the respondent groups' insufficiency assessments of the FRC (2006) features in this area. Most investors find that the factors and threats in this area have been sufficiently covered. Compared to investors, the audit firms are less happy with the framework in terms of identified factors and threats. In contrast, it is noticeable that the professional bodies find that the audit process issues are sufficiently covered, i.e., they do not think the FRC has omitted any factors. One of the professional bodies challenges the FRC's preconceptions relating to audit quality:

> The premise that seems to be implicit in the (current) initiative is that audit quality is lacking. (PB3, 2007, 3)[5]

3.2. *Audit quality – issues unaddressed*

The previous section showed that the FRC's approach to audit quality received somewhat mixed response from the respondents. The responses of various groups raise questions about the appropriateness of the audit quality framework.[6] Although the FRC has responded to some of the concerns, the audit quality framework does not directly address fundamental issues underlying the growing criticism concerning audit quality. The use of impression management and legitimacy as a framework to analyze stakeholder responses enables us to go beyond the factors identified by the FRC which do not directly threaten the commercial interest of audit firms, and focus on underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and the transparency of the audit process as well as that of audit firms. The remainder of this section focuses on these issues.

3.2.1. *Auditor expertise*

Underlying concerns about audit quality is a central issue relating to the expertise of individuals involved in the audit process. The essence of all professions lies in the expertise of its members. The auditing profession is characterised by its appeal to a unique knowledge-set (Bedard, 1989). Such claims to expertise however are punctured by unexpected collapses, frauds and failures raising suspicion that auditors lack expertise (Sikka, 2009). In the Audit Quality Framework the competence of auditors is emphasised, however it does not address how lack of expertise might have contributed to failures such as represented by the banking crisis.[7]

Our analysis of responses to the FRC (2006) shows that all the respondent groups agreed with the FRC that technical skills, personal qualities and practical experience of audit personnel are key drivers of audit quality. They also thought that the FRC had sufficiently identified issues affecting inadequately trained or skilled workforce to a large extent. Whilst the respondents provide few additional comments on staffing issues, a number of concerns are raised regarding this matter. Respondents identify the competences of existing audit staff and the importance of recruitment of new well-qualified staff. An investor observed that:

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[5] For the purpose of citing quotations we have adopted the format of referencing where (for instance in INV2, 2008, 1) the letters refer to the type of respondent (INV: investor, AF: audit firm) and the number to the respondent number in our coding, and the last number to the page of the comment letter from which the quote has been taken.

[6] But we acknowledge that in its consultation paper the FRC did note other possible threats to an effective audit process. According to the FRC they include: Increased use of computerized audit methodologies may distance auditors from the company being audited, reduce flexibility and result in time spent coping with the technology at the expense of evidence gathering. The FRC noted that over-prescriptive auditing standards, regulation and audit methodologies can have adverse impacts such as insufficient emphasis on tailoring audit procedures to specific circumstances; inhibiting the exercise of judgement; forcing a focus on producing documentation at the expense of performing audit procedures properly, and encouraging "client capture" where the relationship with the client is so close that objectivity is impaired.

[7] As Sikka (2009) notes auditors might argue that the financial crisis unfolded suddenly and thus they were ill-prepared to make judgements about the likely financial distress. However, there has been a long history of banking failures which have raised issues about earnings management, income shifting and failures of auditing technologies. This suggests that auditors' claims of expertise might be more of myth than reality.

> An issue not directly addressed in the [FRC] paper is the fact that most 'client facing' audit work is undertaken by unqualified staff with less than three years experience. (INV3, 2007, 3).

Threats suggested by professional bodies include demands on engagement teams, that is, increased complexity leads to increasing demands on personal auditor skills and quality as well as to the possibility of insufficient understanding of users' needs. They also warn of the potential risk of domineering chief executive or client. In turn, several of the audit firms are concerned about professionalism of their counterparts. They point to negative impact on audit quality when company's personnel provide inaccurate information; do not make documents or information available on time; and seek to manage messages to the company's board. They also observe that a threat to audit quality arises when an audit committee lacks leadership.

One audit firm expressed concern that audit committees are not adequately aware of IFRS rules. Audit firms are also concerned about the increased pressures on the audit process, that is, more resources are necessary to ensure that there is audit expertise at many levels. For instance there is a threat to audit quality if insufficient partner and manager time is committed at the planning stage (to reflect preferred risk-based audit approach). Audit firms also see a role for the regulators in countering threats to the effectiveness of the audit process.

> It is the role of the regulator to publicise examples of good and bad behaviour and to publicise when auditors identified fraud, and to raise awareness of new regulation to stakeholders. (AF4, 2007, 11)

3.2.2. Professionalism

Audit quality is affected not only by the audit process but also by the professionalism of the auditors as well as that of the preparers of financial statements. The professionalism of auditors is an important dimension of audit quality, and auditors attempt to distinguish their expert labour by appealing to claims of professionalism. However, audit firms are also profit making entities like their auditees, and their success is measured by increase in fees and profits. The increasing focus on the provision of consultancy services and in particular the blurring of the distinction between audit and consultancy potentially further undermines the professionalism of audit firms and audit quality. In enumerating that the four drivers of audit quality are the culture within an audit firm; the skills and personal qualities of audit partners and staff; the effectiveness of the audit process; and the reliability and usefulness of audit reporting, the FRC audit quality framework does not give due weight to the threats to auditors' professionalism. A particular threat to audit professionalism results from the fact that employees of major audit firms are inculcated into prioritising interest of audit clients and that employees know that their career progression depends on this (Grey, 1998).

In their response to the FRC consultation, audit firms noted additional factors needing the FRC's consideration. However, whilst focusing on issues of professionalism they tend to identify issues that do not pose a direct threat to the commercial interest of the audit firms. Common concerns voiced by audit firms include: influence of increased regulation of both financial reporting and auditing; overregulation, preoccupation with audit documentation rather than judgement issues and an 'unfortunate' move towards a rule based approach. Audit firms emphasise the need for regulation to be principles based so that "standards encourage thinking auditors". Professional bodies are also supportive of this view. One body identifies a major threat in over-prescription and reliance on standards and regulation rather than considering whether the appropriate approach is being taken for each individual audit. Whilst professional bodies warn of the threat of dominant clients, many audit firms seem more preoccupied with the engagement partner rotation rule. They argued that the UK five-year rotation rule is less favourable in terms of audit quality than the EU 8th Directive seven-year rule. Commenting on the effect of the UK rotation rule, an audit firm argued that:

> It will make it difficult to develop younger partners for highly specialised clients and harder for smaller firms to comply. (AF2, 2007, 6)

3.2.3. Commercialization

Another fundamental issue affecting audit quality relates to the commercial nature of auditing. Whilst the FRC focused on what it terms as the four main drivers of audit quality: i.e. the culture within an audit firm; the skills and personal qualities of audit partners and staff; the effectiveness of the audit process; the reliability and usefulness of audit reporting, we find that commercialization is also an important factor affecting audit quality. Neither the FRC nor the professional bodies attach much weight to how the profit motive of audit firms might undermine audit quality and contribute to failures.

When we extend our analysis beyond the four drivers identified by the FRC, we find that respondents to the Audit Quality Framework consultation identified additional pressures on audit quality. It is noticeable that the pressures identified by audit firms and the professional bodies are distinct from the pressures identified by investors. Concerns about appropriate (too low) audit fees and the ability to attract and hold on to well-qualified staff are shared by the audit firms and the professional bodies. They also argue that over-regulation forms a strong pressure against the culture of the audit firms. One of the professional bodies directly remarks that over-emphasis on compliance with rules will be at the expense of addressing other important aspects of quality. One audit firm links these elements by suggesting that:

> The interaction between more onerous auditing requirements and increasing fee pressure has the potential to impede the quality of audit work. (AF8, 2007, 1)

The investor group identifies pressures related to weak leadership, poor execution of training, inadequate communication, poor staff morale, lack of clear responsibility and accountability. Over concentration on non-audit services as well as commercial objectives of the firms/pressure on employees to maximise revenues are also identified as pressures. One investor sees this as a systemic flaw:

> The confidentiality agreements between audit firms and clients serve to compromise the culture of firms, who can be confident that cultural and other shortcomings will remain private. (INV7, 2007, 3)

Both professional bodies and audit firms disagreed with the sufficiency of the FRC framework. Additional factors suggested by professional bodies include: need broader view of audit quality rather than just focusing on "market quality", the quality of the clients' staff and of the information produced, pressure caused by need to make quick announcement of profits, and the increasing complexity of financial reporting standards. As further steps the professional bodies suggest that the audit process needs to be seen as part of the broader corporate governance and financial reporting framework. One body emphasises the need to:

> Periodically reassess the expectations of stakeholders and to identify any gap between expectations and professional practice. (PB1, 2007, 8)

Factors needing further consideration suggested by the audit firms include: litigation and liability issues; the move to more value based financial reporting; increasing globalisation, use of IT and use of remote shared service centres. One audit firm warned that:

> Standard setters can adversely affect audit quality if they move away from principles based approach. (AF7, 2007, 16)

3.2.4. Transparency

The four drivers of audit quality, i.e. the culture within an audit firm; the skills and personal qualities of audit partners and staff; the effectiveness of the audit process; the reliability and usefulness of audit reporting, identified by the FRC does not recognise adequately the lack of transparency of both the audit process as well as that of the audit firms. Over the decades there have been significant regulatory initiatives, particularly through codes of corporate governance, aimed at improving the transparency of companies. Yet, there has been relatively little advancement in making the audit process or the governance of audit firms more transparent. Audit firms are not equally subject to disclosure requirements applicable to equivalent companies or public sector bodies. The distinction between interests of investors and audit firms is clear when comparing the suggestions between these groups for improving audit quality. Whilst investors focus on "more transparency" with a number of specific suggestions for the profession, audit firms support steps to raise awareness of the culture issues among stakeholders and to create better understanding of good and bad audit practices. The latter is reminiscent of the expectation gap era. Further, the investors request access to information on a much more detailed level regarding the culture and policies of the audit firms, e.g. one investor suggests general access to the terms of audit engagements.

The investors expressed concern about audit firms' ability to apply and adapt the audit process to a changing business environment, about harmonisation of international auditing standards with national audit standards, and too much concentration of audits around 31 December.[8] Investors wanted specific steps that would provide improved accountability to and face-to-face dialogue with institutional investors and relevant information such as:

> Re-assurance that greater attention is being paid to ensuring commonality within global networks of the firm's standards. (INV6, 2007, 3)

Both professional bodies and audit firms opine that an additional factor needing FRC's attention is the reputation of the audit firms and individual partners. Some audit firms were less concerned about the wording of the audit opinion:

> We do not believe that the confidence in audit opinions is influenced significantly by the form of the report or the wording of it. The key is the quality and reputation of the audit firm providing the opinion backed up by the overall reputation of the audit profession. (AF5, 2007, 7)

Audit firms suggest that confidence would be found in the existence of an opinion and not in the form of wording. They argue that the audit opinion should be simple and they reiterate that length and legalistic wording does not aid understanding. This concern is also shared by an investor:

[8] In relation to the latter, one investor suggests research on how the concentration of audits around December year-ends impacts on the effectiveness of the audit process.

> Qualifications about an audit opinion should relate to genuine uncertainties or challenges of judgement and not to a reduction of scope of what the audit purports to be or to whom and for what purposes it is addressed. (INV2, 2007, 4)

An audit firm had difficulty in seeing auditor communication as being part of audit quality and suggests that:

> Much of the concern raised is actually about disclosures in the financial statements rather than audit quality as such. (AF4, 2007, 11)

It is noticeable that the nature of the factors suggested by investors is different. Factors suggested by investors address both the form and a wish for more informative audit reports. Suggestions include that signatures of actual people instead of audit firm signatures could provide a positive signal. They also note that improved "emphasis of matter paragraph" has the potential to enhance the quality of audit. One investor thought more information was needed to provide insight into the way the opinion is formed. Specifically in the case of audit opinions on consolidated financial statements, information was considered necessary about the proportion of the group results which are not audited by the group auditor. One investor even suggests that:

> More discursive audit opinions should encourage shareholders and investors to read the audit opinion. (INV7, 2007, 6)

Audit firms also see a role for audit committees in closing the expectation gap between auditors and users. One firm suggests enhancing direct disclosure between audit committee and shareholders or making formal communication between auditor and audit committee more available.

4. Concluding remarks

Corporate malpractices provided a fresh impetus to the debate concerning audit quality. Coinciding with various measures adopted in many countries aimed at restoring trust in auditing and governance, the Financial Reporting Council's attempt to develop an 'Audit Quality Framework' (FRC, 2008) marked a significant development in the UK. No other regulatory body has tried, or felt the need, to codify audit quality. In the context of existing academic research on audit quality, this paper focused on the response of three groups – professional accounting bodies, audit firms and investors – to the FRC's (2006) discussion paper *Promoting Audit Quality*. We have found that overall all three groups generally supported the FRC's approach, but they considered the FRC's response insufficient. We found that respondent groups advanced various points indicating the need for FRC to address additional issues in order to improve audit quality. To legitimise its existence the auditing profession has a vested interest in convincing users that accountants can be trusted. Regulatory pronouncements and audit firms' engagement in the post-Enron debate relating to audit quality show an evident concern with protecting the profession. In contrast to investors, responses to the FRC audit quality initiative from audit firms and professional bodies display concern with protecting the interests of the professional accounting body corporate and its individual members. In expressing their position audit firms, however, were concerned with preventing too much prescription and emphasised the importance of recognising the role of professional judgements in audit quality. Whilst generally appearing supportive of the FRC proposals, audit firms were, however, keen to emphasise the role of other parties, in particular that of audit committees in promoting audit quality.

The focus of our analysis in this paper went beyond the issues identified by the FRC which do not directly threaten the commercial interest of audit firms. We focused on underlying concerns centering on issues related to the expertise and professionalism of auditors, commercialization of audit, and the transparency of the audit process as well as that of audit firms that have not received much regulatory attention. Whilst the FRC and audit firms focused on technical issues relating to the audit, these four issues remained largely unaddressed in the FRC's Audit Quality Framework. Our analysis thus shows that audit quality is not just a mere technical phenomenon, but is also part of the rhetoric employed by regulators, professional bodies and audit firms in the aftermath of corporate failures and resulting lack of trust in auditing. In contrast to the drivers identified by the FRC, our focus on transparency, expertise, professionalism and commercialization shows that FRC, audit firms and professional bodies have mainly focused on issues which possibly do not pose a threat to the commercial interest of audit firms. Interestingly, the notion of audit quality, in particular the drivers identified by the FRC is not based on any systematic analysis of audit failures.[9] In attempting to restore trust and legitimacy regulatory bodies, such as the UK Financial Reporting Council, have to reconcile complex often contradictory stakeholder demands. Overall, our analysis shows that regulatory and professional bodies engaged in image management and the promotion of audit quality in an attempt to remedy its tarnished image and augment its legitimacy and standing. Also, concerns over potential damage to the profession and its members often tended to dominate the responses.

Our paper has a number of limitations. The analysis in our paper has been limited to responses to the FRC's discussion paper and does not extend to examining other related initiatives taken in the UK nor to tracing (any) changes in regulators, professional bodies' or audit firms position on audit quality issues over a period. Such an examination is worthy of future

[9] An analysis, for instance, based on the UK Department of Trade and Industry inspectors' reports into past corporate failures, or the US reports relating to Enron, WorldCom and Lehman or the lawsuits against auditors might have revealed very different concerns and meaning of 'audit quality'.

research as it has the potential to extend and provide complementary insights into the issues examined in our paper. Additionally, reliance on response letters does not provide evidence of audit quality in practice. Further empirical research is needed on how external regulatory initiatives permeate into audit firms and affect audit practice. Similarly, given the increasing emphasis on audit committees as a monitor of audit quality research examining their effect on the actual conduct of audit in different institutional and regulatory settings can make a valuable contribution to the literature on audit quality. In undertaking such empirical investigation, researchers should also examine the conditions affecting loose/de-coupling between regulatory pronouncements about audit quality and the actual performance of audit.

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