

The Role, Compromise and Problems of the External Auditor in Corporate Governance*

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Abstract

This study reflects on the role, compromise and problems of the external auditor in the corporate governance with particular reference to the UK. The external auditor is an independent person or firm of auditors appointed by the shareholders to investigate the financial statements prepared by the management and report his findings to the shareholders. This study identifies the various instruments used by government and accountancy bodies to regulate the role of the auditor. The statutory role of the external auditors is to issue audit report of his opinion on true and fair view of the financial statements. The study indicates that the role of the external auditor is greatly facilitated by efficient and effective internal control system and with the cooperation of the audit committee. However, the study provides striking evidence that in the course of the audit role, some auditors compromise their professional integrity for economic gain. The big four firms provide a better picture of the professional compromise. Alongside this, it identifies corporate accounting scandal linked to the professional misconduct of the auditors. Furthermore, the problems frustrating the effective role of the auditor within the framework of the corporate governance were identified in the study as auditor's independence, morality, public expectation and audit market cartel. In conclusion, the study shows that the role of the external auditor is inevitable for good corporate governance. However, to have effective role of the auditor, it is recommended among others that the regulatory body should be directly involved in the appointment of auditors of large companies.

Keywords: Corporate governance, External auditor, Accounting scandal, Big four audit firms

1. Introduction

Within the framework of the corporate governance, management is responsible to prepare the annual financial statement detailing the operating results as well as the financial position of a company. The financial statements are presented to shareholders to account for the stewardship of the management. However, such financial statements may lack credibility and shareholders may hardly believe the information contain therein. In order to overcome the problem of credibility of financial statements, an auditor who is independent of the management is appointed to investigate the information in the financial statements and report his findings to the shareholders (Al-Thuneibal *et al.*, 2011; Millichamp, 2010).

In performing this role, the auditor fosters the trust of the public and encourages them to believe that the financial statements are true and fair (Sikka, 2009). However, following numerous cases of corporate scandal, some, which were linked to the negligence or involvement of the auditors, the public confidence in the financial statements has been eroded (Pflugrath *et al.*, 2007; Percy, 1997; Sikka, 2008a & 2009) and the role of auditors in eliminating agency conflict is being doubted. This paper examines the role of the external auditor in corporate governance and to achieve this objective the remaining parts of this paper are divided as follows: the second and third part discuss the place of audit in corporate governance and regulation of external auditing respectively. Part four examines the statutory role of the external auditors while fifth and sixth part focus on how auditor's role is supported by internal control system and audit committee respectively. Part seven is on the role of the big audit firms while high profile corporate accounting scandal is discussed in part eight. The problems of external auditors are addressed in part nine and this is followed by the conclusion and recommendations.

2. Corporate Governance and the Auditors

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Corporate governance is a system by which firms are directed and controlled (Cadbury, 1992). Larcker et al. (2007) describe it as set of mechanisms that influence management's decisions when corporate ownership is separated from control. Corporate governance mechanisms are economic and legal institutions, which provide assurance to the investors about the safety of their investment and of getting back returns on the investment (Shleifer and Vishny, 1999).

One of the mechanisms for providing assurance to the investors and other stakeholders is corporate auditing. The principal characteristics of ensuring effective corporate governance such as transparency, accountability and integrity are enhanced with conduct of audit into the affairs of a corporation.

Generally, internal and external auditors may conduct audit into the operation of a company. The internal auditors are the employees of a company who are appointed by the management to carry out audit of the day-to-day affair of the company as part of the internal control system.

The external auditor is highly regarded in the corporate governance framework because unlike the internal auditor, is appointed by the shareholders. The external auditor is an independent person or firm of auditors appointed according to statutory requirement to investigate the financial statements of an entity and express his opinion in form of report on the true and fair view of such financial statements. OCED (2007) describes external auditors as "auditors of an organisation which are not under the control of the organisation and may not report to objectives set by the organisation" (p 283).

3. Regulation of the Role of the External Auditor

External audit of corporate operations and financial statements in most countries has statutory backing. Corporate audit by external auditor is made compulsory by laws to address agency problem arising from the separation of ownership from corporate management (Coyle, 2010; Solomon, 2010). At the same, the audit is regulated to ensure quality of work and minimise abuse in the audit process (ICAEW, 2009).

External audit is regulated in most countries through the mechanisms of self-regulation and external regulation. In UK, corporate audit and accountancy profession is regulated through government legislations, special agencies of the government and accountancy professional bodies (ICAEW, 2009).

Although there are a number of legislations that regulate corporate audit in UK such as the Companies (Audit, Inspection and Community Enterprises) Act 2004, Statutory Auditors and the Third Country Auditor Regulation 2007, the principal legislation is the Companies Act 2006. Sections 475 to 539 in part 16 of the Act contain provisions relating to audit.

Apart from the provisions on appointment (section 498-491), duties and rights (section 498-502) of the auditor etc., the Companies Act 2006 brought some changes into corporate auditing in UK over the Companies Act 1985. One important change having impact on auditor's report is section 504 which requires that the name of the senior statutory auditor must be stated in the report and personally signed by him which was not the case under Companies Act 1985. This suggests that greater responsibility is now demanded of the senior partner in audit work. However, the Act has not adequately addressed the age-long problem of auditors' independent such as provision of non-audit service by the auditors to the client.

In addition to legislations, UK government carries out oversight function on corporate audit and implement various legislations relating to the accountancy profession through its agencies. Financial Reporting Council (FRC) is one important agent of UK government in this regard. FRC discharges its responsibilities through six organs.¹ Out of these organs, Professional Oversight Board (POB) plays important oversight regulations on accountancy and audit (ICAEW, 2009). The roles of POB include:

- i. To exercise external and independent oversight power on the professional accountancy bodies and the way they regulate the professional conduct of their members.
- ii. To function as the statutory oversight of the supervision of the auditing profession and in this case, it is responsible for the recognition, supervision and de-recognition of the accountancy bodies that are responsible for supervising auditor's work.

- iii. To monitor the quality of auditing functions relating to listed public companies through its Audit Inspection Unit (ICAEW, 2009).

Apart from POB, the Auditing Practices Board (APB) is also regarded to have great impact on the auditor's role. It is the responsibility of APB to develop standards for auditing, assurance and ethical value of auditor as well as ensuring the effective application of the standards (ICAEW, 2009).

The self-regulation of audit is the responsibility of the professional accountancy bodies in UK. The major accountancy bodies exercising self-regulation on audit in UK include:

- i. The Association of Chartered Certified Accountants (ACCA)
- ii. The Institute of Chartered Accountants in England and Wales (ICAEW)
- iii. The Institute of Chartered Accountants in Ireland (ICAI)
- iv. The Institute of Chartered Accountants of Scotland (ICAS)²

The roles of these bodies are typically to set standards for entry and education requirement of their members and for engagement in public practice and professional conducts. They also deal with matters relating to professional misconduct of members. Similarly, International Federation of Accountants (IFAC) and International Accounting Standard Board (IASB) play influential role in auditing in UK. IFAC's International Standards on Auditing (ISAs) as well as IASB's International Financial Reporting Standards (IFRSs)/International Accounting Standards (IASs) guide the preparation of financial statements and auditing of companies in UK.

However, there has been outcry that external auditing is suffering from excessive regulation (Bernnan and McGrath, 2007). It is claimed that regulation of auditing profession has been "wrested from the hands" of the accounting bodies and taken over by the UK government (Marcus, 2006). Marcus (2006) argued that the situation which the profession is presently suggests that "new problem," "new scandal" and "new regulation". Added to this, the cost of complying with numerous regulations is becoming great. Critics have pointed out that implicit and explicit costs of the excessive regulations may be greater than the benefits accruing to the society (Bernnan and McGrath, 2007).

Nevertheless, the important question is: has heavy regulation of audit reduced corporate accounting scandal? Evidence shows that after the passage of Sarbanes Oxley (SOX) Act 2002 in US, there were several cases of corporate accounting scandal that followed, for instance, the scandal of AIG in 2004, Lehman Brothers in 2010. The recurring cases of accounting scandal in recent time are indication that regulation alone cannot solve the problem confronting corporate audit. Perhaps consideration should be given to morality.

4. The Role of the External Auditors

For the shareholders and other stakeholders to believe in the financial statements, it is imperative to appoint independent expert to audit the financial statements (Coyle, 2010), hence the role of external auditors in corporate governance. The role of the external auditors in sustaining good corporate governance is widely acknowledged. Cadbury (1992) declared that "the annual audit is one of the cornerstone of corporate governance...The audit provides an external and objective check on the way in which the financial statements have been prepared and presented..."(p.36). Through the role of external auditor, the shareholders monitor and control the management and this helps to enhance transparency in a company (Solomon, 2011).

Basically, the statutory role of the external auditors is to issue audit report of his opinion on financial statements. In UK, the functions and duties relating to this role are specified in details under sections 495-498 of the Companies Act 2006. Section 495 provides that external auditor must prepare report on all annual accounts during his tenure as the auditor and present to the shareholders. Such report is to:

- i. identify the annual accounts audited and the financial report framework used in the preparation of the financial statements.
- ii. describe the scope of the audit, auditing standards used in conducting the audit³

Furthermore, the auditor must state in his report whether in his opinion the audited annual accounts give a true and fair views pertaining the following:

- i. the statement of financial position (balance sheet) which provides information about the state of affairs of the company as at end of the accounting year.

ii. the statement of profit or loss and other comprehensive income (the income statement) which provides information about the operating performance of the company for the accounting year.
iii. For a group account, the information in consolidated statement of financial position (consolidated balance sheet) and consolidated statement of profit or loss and other comprehensive income (consolidated income statement) relating to state of affairs as at the end of the accounting period and the performance for the accounting period. Similarly, the auditor must state whether in his opinion the accounts have been properly prepared as prescribed in the relevant financial reporting framework and in line with requirements of Companies Act 2006 and ISA.⁴ In addition, the auditor must state the type of opinion he gives in the report of a company that is whether it is qualified or unqualified opinion or emphasis on matter which he wishes to draw attention of the shareholders⁵.

In respect of directors' report, the auditor must review the report and state in his report whether the information in the directors' report is consistent with his audit opinion. For the listed companies, auditor must report on the auditable part of the directors' remuneration report and state if it has been properly prepared as prescribed by the Companies Act 2006⁶.

In preparing the audit report, section 498 provides for the following duties to be carried out by the auditor:

- i. He must investigate the company to enable he forms opinion whether:
 - a) adequate accounting records have been maintained by the company and adequate returns for the purpose of his audit have been received from the branches of the company not visited by him.
 - b) individual accounts of the company are consistent with the accounting records and returns.
 - c) the auditable parts of the directors' remuneration report are consistent with the accounting records and returns in the case of the companies listed on the stock market,
- ii. The auditor must state in the report where in his opinion:
 - a) adequate accounting records have not been maintained by the company and adequate returns for the purpose of his audit have not been received from the branches of the company not visited by him.
 - b) individual accounts of the company are not in agreement with accounting records and returns.
 - c) In case of the listed companies, the auditable parts of the directors' remuneration report are not in agreement with the accounting records and returns⁷.
- iii. The auditor must state in his report where he fails to obtain all the information and explanations, which he considers are necessary for successful conduct of his audit.
- iv. The auditor must include in his report whether the provisions of section 412 of the Companies Act 2006 relating to directors' benefits disclosure are not complied with in the company's annual accounts. For the listed companies, he must state where the provisions of section 421 concerning the information on the auditable parts of the directors' remuneration report are not complied with in the report.⁸

The UK company law illustrates that enormous power are given to the auditors to detect and report any financial and operational misconduct of the management. To exercise such power in the best interest of the stakeholders, the auditors must be independent of the management and must carry out their statutory role without bias or favour. However, the greatest impediment to effective discharge of the role is bias, which is rooted from lack of professional independence of auditor. In many instances, evidence has suggested that auditors have compromised their professional independence for economic gain. In the case of Enron, the firm of Arthur Andersen was allegedly reported to have relied on Enron for large portion of its income (Coyle, 2010; Sikka, 2009).

Another issue surrounding the role of the auditors is the gap between public expectation and their assumed role particularly in detection of fraud (Cousins *et al.*, 1998; Shaikh and Talha, 2003). Stakeholders expect the auditors to detect and report material frauds while the auditors have always claimed that detection of fraud is incidental not primary role of auditors. Sikka *et al.* (1998) declared that this issue has remained controversial and has lower credibility and prestige of the auditors' work. Even then, studies show that some shareholders still have regard for audited financial statements because it contains some degree of credible information (Kothra, 2001).

5. Internal Control System and the Auditors' Role

The assessment of internal control system is critical to effective discharge of the auditor's role in corporate governance. Such assessment would afford him the opportunity of understanding the client's control environment, which in turn will help him decide on the appropriate audit approach to adopt.

In UK, Internal Control Revised Guidance Combined Code (2005) which followed Turnbull Report of 1998 places the responsibility for maintaining sound internal control system on the board of directors while the responsibility of the management is the implementation of the system. Internal control system facilitates the role of the external auditor by ensuring that company maintains quality financial reporting.¹⁴

However, if the external auditor observes that the system is weak that suggests that it is less reliable. In this case, the auditor may have to do more substantive tests in his work. Auditor is expected to inform management about any weakness he observes in the system. Letter of Weakness does this in accordance with requirement of ISA 400.

Weakness in internal control system makes the work of auditor more difficulty. Empirically, Krishanan and Visvanathan (2007) show that companies with weak internal control system witnessed more auditor changes. The consequence of weak internal control was manifested in the case of Baring Bank in which the general manager (Leeson) to Singapore office engaged in an unauthorised speculative trading on the Nikkei, which resulted to loss of £827million in 1995 without the knowledge of the management at head office in London (Coyle, 2010).

6. Audit Committee and the Auditors' Role

Audit committee as an important mechanism of corporate governance also supports the external auditor in his role. In UK, it was the Cadbury Committee Report (1992) which first recommended that company should have audit committee (Solomon, 2010). The UK Corporate Governance Code (2010) provides that audit committee should be established with at least 3 members (2 in case of small company), of which 2 must be independent non-executive directors. The audit committee is critical to corporate accountability and its responsibility assists the external auditor in his role in corporate governance to be transparent. By monitoring the preparation of financial statements by the management, audit committee enhances the role of the external auditor.¹⁵

The increasing cases of corporate scandal in recent times have encouraged stakeholders to question the adequacy of oversight responsibility of the audit committee. In the case of Enron, it was reported that the failure of the audit committee contributed substantially to the collapse of the company (Solomon, 2010).

7. Corporate Auditors' Role and the Big Four

Many auditing firms operate in different parts of the world. In UK, there are 9,950 firms in 2004 but dropped to 7,843 in 2009 (Christodoulou, 2010; FRC, 2010a). However, the auditing market in UK and worldwide is dominated by four large firms commonly referred to as "the big four". These firms are PricewaterhouseCooper (PWC), Deloitte, Touché and Tohmatsu (DTT), Ernst and Young (EY) and Klynveld Peat Marwick Goerdeler (KPMG).

The big four operates in more than 140 counties and have more than 140,000 employees each with combined global income of \$103.61billion in 2011 (see Table 1). They have enormous resources with which they can influence politicians, regulators and public policy (Sikka, 2009). The firms have admitted to have entered into agreement to restrict competitions in auditing market in Italy in 2000 (Sikka, 2009) and this suggests that the big four is cartel. The issue in this context is how well these firms have been playing their role as auditors.

However, the big four have been linked to a number of corporate scandal and nefarious acts (Sikka, 2002, 2009). Sikka (2009) declared that the big four are willing to indulge in nefarious acts like price-fixing, bribery, corruption, money laundering, etc that affect the public in the name of competition. The behaviour of these firms was completely in variance with their code of conduct and professional ethic. Contrarily to its code of conduct, PWC⁹ was fined \$2.5million in 1999 for braking audit independence rule in respect of ownership of securities in a company, which it was the auditors. It was also fined \$5 million for violating the same rule in 2000 (Sikka, 2009).

The case of KPMG¹⁰ was not different. It was fined \$22million in 2005 in a case relating to Xerox for wilfully aiding and abetting the company in violation of US law on anti-fraud, reporting and internal control. Similarly, in 2006, US government brought a case against it for allegedly false claim of travelling reimbursement and it agreed to pay \$2.77million (Sikka, 2009).

Similarly, EY¹¹ had acted in a number of instances against its code of conduct. EY was fined \$1.7million in 2004 for breaching SEC's independence rule by entering business relationship with PeopleSoft, the company that it served as auditor. Furthermore, in 2006, it paid fine of \$4.5million on allegedly false claim of various travelling reimbursements with US government (Sikka, 2008b, 2009).

DTT¹² was also reported to have acted in similar manner. It was fined \$50million to settle charges resulting from the failure of Adelphia Communication during its audit engagement with the company.

The alleged involvement of the big four in nefarious acts is a proof that these firms are not operating by good example and these acts have great impact on the reputation of the accountancy profession. This is so because these firms control large part of the global audit market and any negative acts by them will attract great attention and publicity worldwide.

8. Corporate Accounting Scandal

The frequency of corporate accounting scandal in the last past decade is alarming and has caused the public to question the role of the auditors in corporate governance. The numerous cases of corporate scandal have created crisis of confidence in the accountancy profession (Dewing and Russell, 2004). Though not every case of corporate scandal and failure can be attributed to auditing failure or auditor's negligence, some high profile cases as Enron, WorldCom, Parmalat, AIG, Xerox, Adelphia, Lehman Brother etc (see Table 2) were substantially linked to audit failure (Coyle, 2010, Sikka, 2007, 2008a, 2008b, 2009; Solomon, 2010).

Enron accounting scandal was a popular one. Enron was established in 1985 as US based energy company and it was prosperous in its early life that its stock rose by about 311% in 1990s (Coyle, 2010; Healy and Palepu, 2003). Though the sign of distress in the company started emerging in 1997 when it wrote off \$537million to settle a contract dispute with another company, it became obvious that Enron was in serious problem when in November, 2001 it restated its account of 1997 – 2000 to correct accounting abnormality. The restatement brought down its reported earnings for this period by \$591million and increased the debt by \$658million (Healy and Palepu, 2003). Consequently, the credit rating agents downgraded the company and it filed for bankruptcy in December 2001. Arthur Andersen that was the auditor of Enron was accused of negligence in its duty and was criticised of compromising its professional position for financial gain and this led to the winding up of the firm.

Similarly, accounting scandal in Parmalat, an Italian company was also attributed to failure in auditor's role. The company was one of the largest dairy companies in the world operating in 30 countries (Celani, 2004; Solomon, 2010). However, following the default in the payment of debt of €150million in November 2003, a big hole was discovered in the company's account. About 38% of the total asset of the company was reported to be held in non-existent account with €3.9million operated by its subsidiary (Bailat) in Bank of America (Analyzr, 2012; Solomon, 2010). The auditor first verified about the account in December 2002 and received a reply on a forged letter of the Bank of America stationary in March 2003, which confirmed the existence of the account. This was a case of fraud. The auditor was Grant Thornton International from 1990 to 1999 and was replaced by DTT. None of these firms uncovered the big hole in the account. This is an indication of complete brake down in the internal control, which the auditors should have detected, and act accordingly.

WorldCom was another high profile accounting scandal resulting from audit failure. WorldCom was US based telecommunication company, which grew rapidly through aggressive acquisition (Meyer, 2007). In 2002, the internal auditors of the company uncovered \$3.8billion fraud perpetrated by inflating the revenue and treating revenue expenses as capital expenses (Tran, 2002). This resulted into \$3.3billion not properly accounted for between 1999 and first quarter of 2002. Arthur Andersen that was the auditor of the company issued a clean health report on the company during the period and did not uncover the fraud.

In every scandal, the auditors have always put up a defence that it is clients' responsibility to detect and prevent fraud, error and other irregularities in their organisations (ISA 240, Goodwin and Seow, 2002; Gray and Manson, 2000; Sikka and Willmott, 1995). The auditors are still holding to the principle, which views audit as watchdog not

bloodhounds and not expected to detect fraud as enunciated in the case of Kingston Cotton Mill Company¹³ in 1896. Unfortunately, times have changed and public expectation of the role of the auditors has equally changed.

9. The Problems Frustrating Effective Role of External Auditor

9.1 Auditor Independence

The faith of the stakeholders in the auditor's report is rooted in the fact that auditor is free from the influence of management that is independence of management. Independence of the auditor is central to audit. The report of auditor who is not seen to be independent may be regarded as unreliable and lacking credibility.

Auditor's independence may be threatened by factors such as deriving significant financial interest from a client, provision of non-audit services to a client, having close relationship with a client and intimidation (IFAC, 2010). In recent times, it was reported that the greatest threat to the auditor's independence is the provision of non-audit services to clients (Coyle, 2010; Goodwin and Seow, 2002; Sikka, 2009; Colbert, 2002; Ojo, 2006). Auditors may compromise their independence because they derived substantially part of their income from non-audit services (Fearnley *et al.*, 2002). Evidence has shown that the large firms derived great part of their income from non-audit services (see Table 3). The problem with provision of non-audit services is that it divides the focus of the auditor and creates unnecessary compromise.

Another area of independence, which no much is talk about, is appointment of external auditor, which in theory is done by the shareholders from recommendation of the directors. In reality, the management does the appointment and auditor may do anything to favour his employer (Solomon, 2010).

9.2 Ethical Value and Morality

The conducts of audit require someone with strong ethical value and it is for this reason that accountancy bodies issue ethical code to their members. The ethical code is made up values and principles, which guide auditors in their professional conduct (Calota, 2008). The fundamental principles of the ethical code are integrity, objectivity, professional competence and due care, confidentiality and professional behaviour (IFAC, 2010). The first problem with the ethical code issued by profession bodies is implementation. Auditors do not follow the tenet of the code in their professional conduct. For instance, in 2002, PWC violated the code regarding audit independence. Similarly, EY breached the code in 2004 by entering into unethical relationship with its client in US (Sikka, 2009).

The second problem with the code is that it focuses only on ethical or unethical action of the auditors not whether the action is right or wrong (Talha and Shalka, 2003). The code is based on ethical theory of deontology, which is rule oriented and concerns about the action, rather than consequence of an action that is why auditor who observed that something is wrong in a company would not disclose it because principle of confidentiality forbids him from disclosing information of his client to third party (Talha and Shalka, 2003). This suggests that the code hinders the principle of utilitarianism (Cooley, 2003), that is doing what is right and acceptable to majority.

9.3 Public Expectation Gap

Public expectation gap pertaining auditor's role is a serious concern to the accountancy profession worldwide (Salehi *et al.*, 2009; Sikka *et al.*, 1998; Ojo, 2006). Though the gap has always been there, it became wider following the alleged role of some auditors in corporate scandal in recent times.

The main issue in the gap is that the public views the role of auditor to include detection and prevention of fraud while auditors maintain that it is incidental role. However, under this controversy, the role theory provides better explanation of what responsibility is all about. This theory posits that human behaviour is guided by expectation of both the individual and other people (Solomon *et al.*, 1985). This suggests that the auditors' role should be guided by expectation of the public since it is a social position they are occupying for the interest of the public.

Citing the work of Davidson (1975), Adeyemi and Uadiale (2011) argued that unless auditors' role conforms to expectation, audit profession might risk social action of enforcement or penalty for nonconformity. Sikka *et al.*

(1998) contended that the greater the gap between public expectation and auditors' role, the lower is the credibility, respect and reliability accord the auditor's work.

9.4 Cartel in Audit Market

The big four firms dominate the global audit market. In the US market, these firms between 2002 and 2006 audited 98% of large companies (Ronen, 2010) and in UK market, the 97% of companies listed in FTSE were audited by them in 2010 (FRC, 2010a). The concentration of the global and UK audit market in the four firms has implication for the accountancy profession. First, such concentration may not allow for quality audit because the resources of these firms are limited. The study of Francis *et al.* (2011) indicated that concentration of audit market in the big four is detrimental to audit quality.

Furthermore, the concentration will cause disincentive to setting up audit firm and existing firms will be leaving the market. This will lead to short of human capital in the market in the long run. In UK, House of Lord's Economic Affairs Committee on "Auditors: Market Concentration and Their Role" noted the problem that small audit firms opportunity to grow is limited by the big four (Chamber, 2011).

10. Conclusion and Recommendations

Theoretically, it is widely acknowledged that the role of the external auditor is inevitable for good corporate governance. There is no doubt that the role of the external auditor has brought about improvement in accountability and transparency in corporate governance thereby reducing agency problems. The faith of the shareholders and other stakeholders in the financial statements has been enhanced by the role of the auditor.

However, the striking findings emanating from this study is that some auditors are compromising their professional integrity, objectivity and independence for economic gains. Such behaviour has affected public confidence in the credibility of auditor's report.

Furthermore, the study provides important evidence to indicate that the problems of auditor's independence, morality, public expectation and audit market cartel are frustrating the role of the auditor. In the light of the findings of this study, it is recommended that:

1. In UK, to over the problem of auditor's independence, FRC should be empowered by law to be involved in the appointment of external auditors of large corporations. Furthermore, the Council through APB should issue specific guidelines that keep non-audit service substantially low.
2. The accountancy bodies in UK should review their professional ethical code to emphasize more on action that is right that is morality.
3. Since there is great change in public expectation of auditor's role, auditor would have to adjust to the expectation of the public by paying more attentions on material misstatement in financial statements. Furthermore, auditors should not indulge in nefarious acts that may tarnish their image before the public.
4. The Competition Commission must save the UK audit market from dominance of the large firms through their aggressive takeover strategy. The small firms constitute the majority and should have access to the market.

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Note

1. The organs of FRC are Accounting Standards Board (ASB), Auditing Practices Board (APB), Financial Reporting Reviewing Panel (FRRP), Professional Oversight Board (POB), Accountancy, Actuarial and Discipline Board (AADB) and Board for Actuarial Standards (BAS).
2. Other professional bodies in UK whose members are not auditors are Chartered Institute of Public Finance and Accountancy (CIPFA) and Chartered Institute of Management Accountants (CIMA).
3. Companies Act 2006 section 495(2)
4. Ibid Section 495(3)
5. Ibid Section 495(4)
6. Ibid Section 496
7. Ibid Section 498(1)
8. Ibid Section 498(2)
9. PWC's code states that the firm will act "professionally, doing business with integrity, upholding our client's reputation as well as own"(PWC, 2011, p2).
10. KPMG's code provides that "acting lawfully and ethically, and encouraging this behaviour...maintaining independence and objectivity, and avoiding conflicts of interest" (KPMG, 2010, p24).
11. The code of EY states that "no client or external relationship is more important than the ethics, integrity and reputation" (EY, 2008).
12. DTT's code provides that "we act honesty and integrity, we operate within the letter and the spirit of applicable laws" (DTT, 2005, p.2).
- 13 Kingston Cotton Mill Co Ltd 1896, FN 2, 1Ch 331.
14. The internal control system supports the role of the external auditors by ensuring company's operation is carried in more efficient and effective manner. It also safeguards the assets of a company from unauthorised usage, loss and fraud and ensuring that a company maintained quality internal and external financial reporting through proper maintenance of records and generation of credible, relevant and timely information (Coyle, 2010).
15. The auditor committee assists the external auditor in his role by monitoring the preparation of financial statement by the directors and reviewing significant judgments made in the financial statements. It recommends the appointment and removal of the external auditor to board and monitors his independence; objectivity and effectiveness of the audit process.

Table 1: The Big Four Audit Firms

Firm	Year of Statistics	Revenue	Employees	Countries Operating	Head Office
PricewaterhouseCooper	2011	29.2	169,000	158	UK
Deloitte, Touché & Tohmatsu	2011	28.8	182,000	150	US
Ernst and Young	2011	22.9	152,000	140	UK
KPMG	2012	22.7	145,000	140	Netherland

Source: Big 4. (2011) *The 2011 big four firms performance analysis*.

Table 2: List of Corporate Accounting Scandal from 2000 -2011

Company	Auditor	Country	Alledged Scandal
2000			
Micro Strategy	PWC	US	Improper revenue recognition
Unify Corporation	DTT	US	
Computer Associate	KPMG	US	Prematured revenue recognition
Lernout and Hauspie	KPMG	Belgium	Improper accounting treatments
Xerox	KPMG	US	Falsified financial results for 5 years
2001			
One Tel	EY	Australia	
Enron	AA	US	Falsified financial results to boost profit & hid debt
2002			
Adelphia Communications	DTT	US	Overstated profit by inflating capital expenses & hiding debt.
CMS Energy	AA	US	Round-trip trades to artificially boost trading volume
Tyco	PWC	Bermuda	Improper accounting practices
Reliant Energy	DTT	US	Round-trip trades to artificially boost trading volume
Worldcom	AA	US	Overstating cash flow by classifying operating expenses as capital expenses.
AOL Time Warner	EY	US	Inflated sales by booking barter deals to keep revenue growth up.
Duke Energy	DTT	US	Involved in round-trip trades to boost trading volumes and revenue.
El Paso Corporation	DTT	US	Engaged in round-trip trades to boost trading volumes and revenue.
Global Crossing	AA	Bermuda	Engaged in swaps with other carriers to inflate revenue and shredded accounting documents.
Homestore.com	PWC	US	Inflated sales by booking barter transactions .
Mirant	KPMG	US	Overstated balance sheet items.
Peregrine Systems	KPMG	US	Overstated sales by improperly recognizing revenue.
Nicor Energy	AA	US	Improper accounting practice which boosted revenue and underestimated expenses.
Kmart	PWC	US	Misleading accounting practices intended to deceesive investors.
Halliburton	AA	US	Improper treatment of construction cost overruns.
Dynegy	AA	US	Involved round-trip trades to boost trading volume and cash flow.
Merck	PWC	US	Recorded of uncollected co-payment.
Qwest Communications	AA/ KPMG	US	Inflated revenue through swaps and improper
Bristol-Myers Squibb	PWC	US	Improper revenue recognition and understated reserve for sale return etc.
Sumbeam	AA	US	Inflated revenue by forcing wholesalers to accept inventory.
Imclone Systems	KPMG	US	
Freddie Mac	PWC	US	Understated earnings
2003			
Parmalat	TG	Italy	Falsified documents relating to bank account
Nortel	DTT	Canada	Improper distribution of bonus
Royal Abold	DTT	Neitherland	Inflated allowances.

2004			
AIG Brand Chiquita	PWC EY	US	Improper accounting practice Made illegal payment
2008			
Bernard L. Madoff Investment Security LLC	FH	US	Operated fraudulent investment scheme which paid abnormal high return (Ponzi scheme)
Anglo Irish Bank	EY	Ireland	Covered up loan
2009			
Satyam Computer Service	PWC	India	Falsified accounting records
2010			
Lehman Brothers	EY	US	Manipulated accounting to deceive investors
2011			
Olympus Corporation	EY	Japan	Deferred posting of losses on investment securities

Sources: Derived from

Forbes (2002) *The corporate scandal sheet*.

Golden, A.M. (2009) Madoff's investment scandal.

Russell, J. (2011) Olympus reveals details of accounting scandal

Sharp, A (2010) Lehman Bro.' "Repo 105" account scandal – accounting gimmicks or outright fraud.

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Table 3: Big Four Firms' Audit and Non-Audit Fees from 2009-2011

Auditor	Year	Audit Fees		Non-Audit Fees		Total Revenue
		\$'billion	Percent	\$'billion	Percent	\$'billion
PricewaterhouseCooper	2011	14.14	48.39	15.08	51.61	29.22
	2010	13.27	49.94	13.30	50.06	26.57
	2009	13.10	50.00	13.10	50.00	26.20
Deloitte, Touché & Tohmatsu	2011	12.30	42.71	16.50	57.29	28.80
	2010	11.70	43.98	14.90	56.02	26.60
	2009	11.90	45.59	14.20	54.41	26.10
Ernst and Young	2011	10.56	46.15	12.32	53.85	22.88
	2010	10.06	47.32	11.20	52.68	21.26
	2009	10.10	47.09	11.35	52.91	21.45
KPMG	2011	10.48	46.15	12.23	53.85	22.71
	2010	9.91	48.04	10.72	51.96	20.63
	2009	9.90	49.25	10.20	50.75	20.10

Sources: Derived from

PricewaterhouseCooper (2011) *Annual report*.

Ernst and Young (2011) *Annual review*.

Deloitte, Touché and Tohmatsu. (2011) *Financial statements*.

KPMG (2011) *International Annual Review*.

Big 4. (2011) *The 2011 big four firms performance analysis*.