
A NEW CLIENTS' PARADIGM IN PROFESSIONAL AUDITING SERVICES FIRMS. CAN THE AUDITOR – AUDITEE RELATIONSHIP SURVIVE?

Șerban Toader¹

¹*Ecole des Ponts Business School, Paris, France*

E-mail: serbantoaders@outlook.com

Please cite this paper as:

Toader, Ș., 2020. A New Clients' Paradigm in Professional Auditing Services Firms. Can the Auditor – Auditee Relationship Survive? In: R. Pamfilie, V. Dinu, L. Tăchiciu, D. Pleșea, C. Vasiliu eds. *6th BASIQ International Conference on New Trends in Sustainable Business and Consumption*. Messina, Italy, 4-6 June 2020. Bucharest: ASE, pp. 1271-1278

Abstract

Professional auditing services firms are under intense external public pressure to enhance quality and independence. Independence is essential in ensuring public trust in the financial statements of their clients. At the same time, these firms also aim to maintain robust financial stability in terms of revenues and profitability. This teaching case presents the story of Alan, a competent Audit Director in an international professional auditing services firm. Alan contemplates the best approach to both maintain client relationships and ensure independence.

Keywords

International audit firms, independence, audit regulation, client importance, change management

JEL Classification

M42, K23

Introduction

On a mild Friday evening in January 2020, Alan, an audit director at a large international professional auditing services firm, was in the airport lounge again, on his way back from a regional audit conference. A useful place to meet people he mused to himself, especially as his Firm's brochures were on display and his photo was in them. However, travel is not as exciting as some think. Even though the airline he flew was his audit client, their customer service leaves room for improvement. The flight was delayed; there was no explanation, and the airline staff seemed more interested in their own problems than in caring about the passengers.

This made him think about his business. As an audit director, he was expected to do competent audits, develop people, maintain existing client relationships, win new clients, and meet financial targets such as revenues and profitability. More recently, it was the relationship with audit clients, which kept him awake at night. He worked with many of his clients for a long time and maintained a strong personal and professional relationship with key finance people.

Could it be that he was too close to them and may not be independent anymore? Ever since he joined his present employer, he worked hard to become a trusted advisor for his clients. He told his team the same thing. However, he knew the auditors must play according to different rules than a typical company. So, he asked himself, as an auditor, how far shall you go for a client and maintain your independence at the same time?

What is an independent external audit?

When he joined the Firm, he learned that auditors are part of the accounting profession, one of the oldest professions in the world (Retief, 2012). He read about and then experienced how the profession evolved in time. Following the Great Depression of the 1930s, the regulators in the United States requested that the financial statements of public companies shall be examined by external, independent accountants (also called auditors) to ensure transparency and increase trust in the capital markets (Niemeier, 2007). Mandatory audits of public interest entities are now required in developed and emerging economies alike. To ensure consistency and quality of the audit services amongst various auditors and countries, the profession and regulators have developed professional auditing standards such as International Standards of Auditing published by the International Federation of Accountants (IASSB, 2017).

In addition to the technical competence, the standards requested auditors to be independent of their clients in order not to influence or bias their audit opinion on the financial statements. If there are doubts regarding their independence, their audit opinion and the financial statements may not be trusted by investors and financial markets, confidence decline, and a market economy could not be ultimately functional. Auditors must comply with the professional Code of Ethics, which required them to be objectives and to demonstrate integrity in their personal and professional life (IFAC, 2006).

The large international professional auditing services firms are multi-disciplinary: audit, tax, advisory. Initially, they offered tax and advisory services to their audit clients, which subsequently raised questions about the independence of auditors. If clients are paying more for the non-audit services than for the audit services, how could the auditors be independent? The situation culminated in the early 2000s in the Andersen/Enron scandal, which ended with the shocking demise of Andersen, at the time, one of the Big 5 international accounting firms. Subsequent legislation in the U.S., such as Sarbanes – Oxley aimed to regulate better the auditors. All the remaining Big Four firms* separated their consulting business (except for Deloitte) and introduced stricter independence criteria.

The auditors seemed to have learned their lesson, and things went well for several years in the first decade of the 2000s. The firms increased their audit fees following Sarbanes Oxley, and the audit was the central pillar in terms of profitability and stability. In the meantime, the new requirements significantly restricted the firms' ability to provide non-audit services to audit clients. These were good years for auditors, remembered Alan.

Recent changes in the environment

Although the auditors were, in general, not considered responsible for the financial crisis of 2007 – 2009 and for the demise of financial institutions such as Lehman Brothers, the European Union regulators introduced a reform of the audit profession which came into effect on 17 June 2016 (The European Parliament and the European Council, 2014). The E.U. Audit Directive required the Public Interest Entities such as listed companies, banks, and insurance companies to periodically tender audit services and rotate auditors, prohibited many non-audit services, and introduced fee limitations for accepted non-audit services as well as stricter oversight by regulators of the audit firms.

* Big Four is the generic name by which the public refers to the largest international accounting firms, which include Deloitte, EY, KPMG and PwC.

While the firms remained multi-disciplinary (audit, tax, advisory), the audit services become highly regulated, high-cost service. They started to invest and develop their tax and consulting services offered to non-audit clients, which become more preeminent in the firms' market offering. And yet, a string of new scandals involving auditors hit the media again. The auditors were once again in the eye of the storm.

Changes in the Firm's independence approach

His thoughts were interrupted by his iPhone (again). A meeting request - marked urgent - from his new (acting) head of the audit function. Alan had a very good professional and personal relationship with the former head of function, Anne. In fact, some colleagues complained that Anne showed favoritism to Alan. Alan had brushed this off as small-minded, petty gossip. But now his circumstances have changed.

David, the new head of function, was very different; brusque, self-opinionated shoot first - ask questions later. Alan did not realize how much his world would also change when Anne announced she would be going early on maternity leave. Alan prided himself on being good with clients. On planning to advance his assignments. On delivering good service to his clients. Maybe he spent a little too long on some engagements, but he never got complaints from his clients. And they come back to him, year after year, for more work. What could be wrong with what he did?

Alan recalled his recent discussion with David. A colleague's assignment was behind schedule as the process of clearing risk management and independence procedures took longer than expected. The client was becoming impatient. He was not sure what he could do expedite the process, and the client was very important (according to David). So, Alan had re-arranged his schedule to help the colleague. Only to find his colleague gets praise, and David made remarks about Alan's being unfocused.

David wanted a meeting on Monday morning to discuss the implementation of the Firm's plans for stricter independence and risk management. The recent regulatory developments increased public interest in the audit profession, and the reaction of competitors put the Firm on a burning platform. The Firm's revised approach included a more thorough, periodic review of all relationships with audit clients, new client and engagement acceptance procedures, periodic rotation of the audit personnel, etc. Such discussions were not new for Alan, but it seemed that now the Firm was more committed than ever. Some of the changes made sense to Alan, but he knew that some clients would not be delighted by what they see an increase in the Firm's bureaucracy.

Alan knew that the meeting would also be about rotating out some of his audit clients. He was anxious about the prospect for two reasons. First - he had a long and strong relationship with them, and he would not like to see that such a relationship is weakened or, worse, lost. Second - those clients generated significant audit fees. If those clients and fees were moving to another colleague, how was he going to replace them? Managing a substantial volume of profitable fees was crucial if he wanted to become a partner. Was it fair that his successful, well-organized effort to keep and maintain relationship should be sacrificed to help those who were not as good as him in maintaining a relationship even if they performed a competent audit? Perhaps he will get new audit clients in exchange, but he had no connection with them. He will have to invest a lot of time and effort with people he did not know and may not like him.

But times are hard. Maybe things must be changed. Alan has had several years of promotions, salary and benefits increasing, work knocking at his door, cherry-picking the best clients. Getting the work done was what mattered. However, now more and more clients were asking quotes from competitors, organized audit tenders while the Audit Committees (and not the management) were the most influential on the auditor's selection. While Alan knew the

members of the Audit Committees of his clients, he had a much stronger relationship with the finance executive management.

Clients' initial reaction

Did he imagine it, or do the procedures to clear risk management and independence matters already seem to take longer? And more questions were asked by the internal risk management bureaucrats about the quality of financial reporting and relationships with clients! Colleagues from other functions were suddenly interested in meeting Alan's audit clients to "keep the client for life" to use the office buzz phrase. He knew that some secretly hoped that the client would change auditors and then have better opportunities to sell their tax or advisory services, which were prohibited before.

Alan's flight was finally called. As he walked to the plane, he thought about his colleagues and worried that they were not clients conscious at all. Last week he had had dinner with Peter, an old college friend who was a senior finance manager with one of the Firm's audit clients. Peter was always positive about the Firm in his conversations with Alan. But as the drinks had flowed, Peter had let slip that he had made three phone calls in the past two days to Claire, one of Alan's colleagues, and then sent an email to check why it was taking so much time to finalize the independence procedures. But Claire still had not called back. This made Alan upset. He understood Claire was busy, but why couldn't she just have taken five minutes to call Peter and explain about the new risk management and independence procedures? Alan also knew that as part of the audit rotation legislation, his competitors from another firm had been talking to Peter about their audit capabilities and efficient risk management procedures. If Claire did not return Peter's calls, this would not help the Firm's efforts to maintain and protect the audit relationship.

Thoughts about the Monday meeting

What will Monday's meeting achieve, Alan wondered? Maybe it was time for a grassroots review of what we do and how we do it, Alan mused. From time to time, this was necessary. And the public and media seemed more and more interested in the profession. Alan decides one point he will raise is the need to be in the market; to be visible to clients and targets; to show them that the Firm is strong and successful and keen to win work, that auditors are not a bunch of people scarred by their own shadow. Clients have their problems; they do not care about ours. They just want help, results, the job done.

Alan and his family had been on a weekend break last month with Paul, another college friend, who worked for a rival company. As Alan's and Paul's families had relaxed together by the pool, Paul and Alan compared how their two companies were weathering the recent regulatory inspections. Last year was rough, Paul had said. Nobody knew if they would pass independence regulatory tests. But while there had been comments from the regulator, Paul had survived, and he now felt more secure about his future. His Firm was now much more focused on quality and independence, Paul had said. They have communicated professionally with their clients; reputation has improved and has not lost significant revenue. Alan had wondered at the time how long his Firm could go on putting off making similar tough decisions.

Alan recalled the conversation he had with Gary, the Ethics and Independence Partner, last week. Gary had emphasized that the regulatory outlook continued to be very difficult. "These are tough times, and not taking decisions is even tougher" he remembered him saying. There was no getting around the fact that the Firm needed to enhance its independence procedures. Competitors had already taken tough measures much earlier, and they seem to be more out of the radar of media. If Alan's Firm did not take steps now, it could lose its reputation and find it more and more difficult to maintain a good professional relationship with the regulators and with the other stakeholders. Alan wondered, though, whether enough of his colleagues

understand the position, or whether some are still in denial. Some were saying that media and regulatory interest come and go, like a pendulum, so there was no need to do anything. But it was clear to Alan that this was too optimistic.

So, David has asked for Alan's opinion before the meeting about how to effectively implement the new measures to enhance risk management and independence requirements but also retaining good clients. He then saw there was an attachment – an Excel spreadsheet containing his client's portfolio, with information about the duration of the Firm's audit mandate and a blank column marked "Proposed plan." Much work for the weekend, Alan thought.

From multi-disciplinary to audit only focus.

In the lounge, Alan met a colleague from the Advisory department, who was on his way to a client's pitch. He could not stop noticing his colleague's enthusiasm, which resembled his own not too long time again. They both were trained to consider success means strong client relationships, but it seems now they will take different paths.

As his plane soared into the night sky, Alan read the meeting request more carefully and saw that the Senior Partner of the Firm would also be there. This improved Alan's mood as he knew the SP was a fair and sensible person. Alan considered all the potential options and wondered if a direct discussion, all cards on the table, would be appropriate for the meeting. Finally, the food arrived. The friendly stewardess gave him an extra bottle of red wine. Alan started to feel better about the world. After all, he had got through bad times before, so why not this time again?

Teaching Objectives

The first proposed learning theme of this case is the Auditors' independence, followed by regulatory intervention and public expectations influence on strategic choices, which potentially leads to a more fundamental topic, Dealing with change and uncertainty. The participants will engage in an open and active conversation, lead and moderated by the instructor. The interactive character of the discussion will stimulate the participants to obtain a more comprehensive understanding of the proposed learning themes. They will use their critical judgment abilities to get a better theoretical and practical knowledge through both self-reflection while reading the case and the recommended additional literature and through the interaction with their colleagues and the instructor.

The participants, who identify themselves with Alan, will evaluate the situation and think critically about potential solutions and unintended consequences. While the case is specific to an industry and profession, it aims to put another brick in the bigger wall of knowledge of participants and to relate it to the adjacent space: the management of change.

Assignment Questions

1. Why ensuring independence, both in fact and in appearance, is important for building public trust?
2. What shall the audit firms do to keep independence and not lose business?
3. How could Alan support his firm in implementing the new independence requirements effectively?

Recommended Solutions and Answers

The first question, about the importance of independence, is more straightforward. The participants could find comprehensive responses in both academic literature and professional practice materials published by the professional accounting associations or by the professional auditing services firms. The participants shall become aware of the overall context of doing business and not only focus on key performance indicators such as profit or revenue. If

professional auditing services firms do not perform their business in an adequate ethical context, with integrity and building trust, there could be some short-term gains but no long-term business.

There is no ideal response to the question about independence without losing business. The participants shall review proposed models vehiculated by regulators, academics, and the auditing industry. For instance, the firms could separate the audit business from the rest of the company. They were already required in the early 2000s to separate their consulting business. The participants could discuss whether the separation of consulting enhanced or not audit independence. Other suggestions may include increasing or maintaining audit fees but with more investment in technology to keep costs under control. More ambitious proposals could be that the firms redesign their audit services or create alliances with tech giants such as Microsoft or Google to develop a different, more technologically advanced audits. The participants shall critically discuss the intended or unintended consequences of their suggestions.

The third question is about Alan. He is at an essential time in his career and could use the situation to self-reflect in a meaningful way. What would help him to advance his career-long and short term? Perhaps he shall enhance his risk management and independence abilities. He shall cultivate the relationship with existing clients to ensure a smooth transition to another colleague. Other suggestions may include a focus on winning new audit business and speeding up the process to get acquainted with his new audit clients.

Target Audience

This teaching case may be useful for several audiences. It has obvious relevance for professionals working in the audit industry who could resonate with Alan and his situation. The case could be included in an executive education program offered by professional auditing and accounting associations. It could also be tailored to the context of an individual audit firm and included in an internal training program such as an annual update training course.

The themes covered by the case could present relevance for other categories of stakeholders interested in understanding better the audit profession. Potential participants may include finance and accounting executives who have a day to day interaction with external auditors or non-executive members of Boards or Audit Committees of public interest entities who are required to communicate with auditors and be responsible for the relationship. Other participants may be regulators of financial institutions or public entities whose role is to oversee the stability of financial or capital markets and auditors' regulators who could better understand the context they supervise.

In a broader academic sense, the case could be addressed to students in undergraduate accounting programs, and Master programs students specialized either in finance/accounting or business administration in general. However, the teaching approach shall be different. If used for undergraduate students, the case should focus more on understanding basic concepts such as independence. For the more advanced students, the case could be extended to all the proposed themes.

Teaching Plan and Discussion Management

The case study will be provided to the participants one week in advance so that they have the necessary time to read and reflect and prepare their initial thoughts. As the role of the instructor is crucial, he must obtain a profound understanding of the case and related literature and prepare well in advance of the discussion. As part of his preparation, one suggestion is to discuss the case and the teaching plan with a professional practice or academic colleague, familiar with the topic, and incorporate their initial feedback.

The logistical arrangements must be dealt with before the class discussion. Preferably, the class set up shall be arranged in a way to stimulate active discussion and not to allow some people to hide or withdraw from the conversation. Perhaps a technician may be needed to provide technical support for aspects such as the proper functioning of a computer, PowerPoint, Wi-Fi, projector, A.C. Once the participants enter the class and take their seats, the instructor shall announce the rules requiring active participation and discourage any potential distraction.

The proposed duration of the case discussion is of 90 to 120 minutes based on the below sequencing. The main instrument to be used by the instructor will be asking open-ended questions. He must be alert to intervene to either reenergize the discussion, if the case, and summarize the issues discussed before moving to the next topic.

Related References and Reading Materials

The instructor must be familiar with the theoretical and practical themes covered by the case. He may share the suggested bibliography and references with the participants before or after the discussion.

Understanding the context

The instructor may refer to several recent articles in the media which reflect that the professional auditing services firms are under intense regulatory and general public pressure to enhance the quality of audit services and independence (Marriage, June 5, 2019), (Pooley, May 16, 2019), (Giles, April 18, 2019), (Trentmann, June 30, 2019) etc.

Auditor Independence and Public Trust

Professional auditing services firms are essential in ensuring the confidence of the financial markets and the proper functioning of a market economy. Through their audit, they provide the trust in the financial statements of their clients by a large variety of stakeholders (Niemeier, 2007). Independence of audit firms from their clients is considered an essential aspect in meeting public demand (Harris, 2016), (ICAEW, 2019), (Allen, 2018). Several accounting scandals raised questions about auditors' independence and audit quality (Duska, Duska and Kurry, 2018). Causes for Unethical Behavior in business have been well documented (Wedell-Wedellsborg, April 2019). High-level representatives of the audit industry recognize that their approach to delight the clients generated unintended consequences (Smith, August 14, 2019). On the other side, recent academic research shows that if auditors are too strict with the clients, they get penalized (Cowle and Rowe, 2019).

Disclaimer

Alan and his circumstances are fictional, and any resemblances to real persons or events are purely coincidental. Serban Toader has developed this teaching case as part of his Executive DBA Program at Ecole des Ponts Business School. It aims to represent a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation.

References

- Allen, C.R., 2018. A new take on ethics and independence. *Journal of Accountancy*, [online] Available at: <<https://www.journalofaccountancy.com/issues/2018/dec/accounting-code-of-ethics-and-independence.html>> [Accessed 8 April 2020].
- Cowle, E.N. and Rowe, S.P., 2019. *Don't Make Me Look Bad: How the Audit Market Penalizes Auditors for Doing Their Job*. [SSRN Scholarly Paper] Rochester, NY: Social Science Research Network. Available at: <<https://papers.ssrn.com/abstract=3228321>> [Accessed 21 May 2020].
- Duska, R.F., Duska, B.S. and Kurry, K.W., 2018. *Accounting Ethics* (3rd ed.): John Willey and Sons.

- Giles, C., 2019. Regulator calls for law change to end Big Four dominance of U.K. auditing. *Financial Times*. April 18, 2019 [online] Available at: <<https://www.ft.com/content/4219750e-612a-11e9-a27a-fdd51850994c>> [Accessed 1 April 2020].
- Harris, S.B., 2016. *Auditor Independence and the Role of the PCAOB in Investor Protection*, [online] Available at: <<https://pcaobus.org/News/Speech/Pages/Harris-speech-ICGN-06-28-2016.aspx>> [Accessed 12 March 2020].
- ICAEW, 2019. *Auditor independence*, [online] Available at: <<https://www.icaew.com/technical/ethics/auditor-independence>> [Accessed 8 March 2020].
- IAASB, 2017. *INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD FACT SHEET*. [pdf] Available at: <<https://www.ifac.org/system/files/uploads/IAASB/International-Auditing-and-Assurance-Standards-Board-Fact-Sheet.pdf>> [Accessed 10 March 2020].
- IFAC, 2006. *CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS*. [pdf] Available at: <<https://www.ifac.org/system/files/publications/files/ifac-code-of-ethics-for.pdf>> [Accessed 12 February 2020].
- Marriage, M., 2019. PwC to split audit practice and hire 500 experienced staff. *Financial Times*. June 5, [online] Available at: <<https://www.ft.com/content/47f89a82-86e0-11e9-97ea-05ac2431f453>> [Accessed 10 March 2020].
- Niemeier, C.D., 2007. Independent Oversight of the Auditing Profession: Lessons from U.S. History. [pdf] Available at: <https://pcaobus.org/News/Speech/Documents/2007-11-08_CDN_IDW_Speech.pdf> [Accessed 4 April 2020].
- Pooley, C.R., 2019. KPMG to reform UK governance in response to audit market review. *Financial Times*. May 16, 2019, [online] Available at: <<https://www.ft.com/content/2c796142-77bd-11e9-be7d-6d846537acab>> [Accessed 10 March 2020].
- Retief, E., 2012. The roots of accounting - the second oldest profession in the world : roots of accounting. *Professional Accountant*, 2012(4), pp.8-11.
- Smith, C., 2019. 'Delighting' clients undermine accounting industry's moral courage - KPMG SA chair, [online] Fin24. Available at: <<https://www.fin24.com/Companies/Financial-Services/delighting-clients-undermine-accounting-industrys-moral-courage-kpmg-sa-chair-20190814>> [Accessed 21 April 2020].
- The European Parliament and The European Council, 2014. DIRECTIVE 2014/56/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. *Official Journal of the European Union*, L 158/196. [pdf] Available at: <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056>> [Accessed 17 February 2020].
- Trentmann, N., 2019. U.K. Audit Regulator Steps Up Enforcement Efforts. *Wall Street Journal*. [online] 30 Jul. Available at: <<https://www.wsj.com/articles/u-k-audit-regulator-steps-up-enforcement-efforts-11564527662>> [Accessed 21 May 2020].
- Wedell-Wedellsborg, M., 2019. The Psychology Behind Unethical Behavior. *Harvard Business Review*. [online] 12 Apr. Available at: <<https://hbr.org/2019/04/the-psychology-behind-unethical-behavior>> [Accessed 21 May 2020].