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Vivien Beattie
University of Glasgow

Stella Fearnley
Bournemouth University

Tony Hines
University of Portsmouth

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Vivien Beattie,[a] Stella Fearnley[b] and Tony Hines[c]

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[a] Vivien Beattie (corresponding author)
Professor of Accounting
Dept. of Accounting and Finance, University of Glasgow
West Quadrangle, Main Building
University Avenue
Glasgow G12 8QQ
Tel. +44(0)141 330 6855
Email V.Beattie@accfin.gla.ac.uk

b Stella Fearnley
Professor of Accounting
Department of Accounting and Finance, Bournemouth University
Dorset House, Talbot Campus
Fern Barrow
Poole
Dorset BH12 5BB
Tel. +44(0)1202 965829
Email s.fearnley@bournemouth.ac.uk

[c.] Tony Hines
Principal Lecturer in Accounting
Portsmouth Business School, University of Portsmouth
Richmond Building
Portland Street
Portsmouth PO1 3DE
Tel. +44(0)23 92844156
Email Tony.hines@port.ac.uk

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ABSTRACT

In line with global changes, the UK regulatory regime for audit and corporate governance has changed significantly since the Enron scandal, with an increased role for audit committees and independent inspection of audit firms. UK listed company chief financial officers (CFOs), audit committee chairs (ACCs) and audit partners (APs) were surveyed in 2007 to obtain views on the impact of 36 economic and regulatory factors on audit quality. 498 usable responses were received, representing a response rate of 36%. All groups rated various audit committee interactions with auditors among the factors most enhancing audit quality. Exploratory factor analysis reduces the 36 factors to nine uncorrelated dimensions. In order of extraction, these are: economic risk; audit committee activities; risk of regulatory action; audit firm ethics; economic independence of auditor; audit partner rotation; risk of client loss; audit firm size; and, lastly, International Standards on Auditing (ISAs) and audit inspection. In addition to the activities of the audit committee, risk factors for the auditor (both economic and certain regulatory risks) are believed to most enhance audit quality. However, ISAs and the audit inspection regime, aspects of the 'standards-surveillance-compliance' regulatory system, are viewed as less effective. Respondents commented that aspects of the changed regime are largely process and compliance driven, with high costs for limited benefits, supporting psychological bias regulation theory that claims there is overconfidence that a useful regulatory intervention exists.

Keywords: audit quality, regulation, audit committees; audit inspection; ISAs.

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INTRODUCTION AND MOTIVATION FOR THE STUDY

The economic crisis is the latest event to raise interest globally in audit quality, the integrity of financial reporting and corporate governance. The scale of the problem has also raised expectations of further regulation in the banking sector which may well impact on reporting, auditing and governance outside this sector. National regulatory systems are increasingly interconnected with supranational private sector standard setting bodies, such as the International Accounting Standards Board (IASB), the International Federation of Accountants (IFAC) and governmental bodies such as the European Union (EU) (e.g., Cooper and Robson, 2006: 430).

However, interest in audit quality and in related changes in regulation and practice have been ongoing for many years. Reviewing trends in US audit regulation, Kinney (2005) observes that the 1980s heralded in a period of de-regulation (consistent with policy shifts to allow competition and market forces greater influence). Some writers argue that this period of regulatory capitalism was instrumental in the emergence of conceptions of the audit as a commodity driven by economic considerations of the auditee management and the need to deliver added value to the client company (Jeppesen, 1998; Windsor and Warming-Rasmussen, 2009). In the practice field, business risk auditing approaches emerged in the 1990s (Power, 2007).

The Enron scandal in 2002, however, prompted a global shift to re-regulation (Kinney, 2005). In the US, the Sarbanes Oxley Act (SOX) (2002) introduced major changes to the US audit, financial reporting and corporate governance regimes. Similar regulatory changes subsequently occurred in the UK and many other countries (Lennox, 2009). Scandal and regulatory change has brought attendant changes in the conceptualisation of practice. For example, Khalifa, Sharma, Humphrey and Robson (2007) present evidence that the dominant audit discourse shifted from one of 'business value' to one of 'audit quality'.

The loss of Enron's audit firm, Andersens, left only four major firms dominating the global audit market and led to an overall loss of confidence in audit quality which affected the remaining firms and created concerns about competition and choice for major companies using audit services in this market (e.g. General Accounting Office (GAO), 2003; US Treasury, 2007; FRC, 2007; EC, 2008). Generally, however, it was concluded that market-led solutions were to be encouraged in the first instance (GAO, 2008; FRC, 2008). SOX made significant changes to the US listed company auditing and governance regimes including: inspection of listed company audits by a new independent agency, the Public Company Accounting Oversight Board (PCAOB); independent setting of auditing standards; restriction of non-audit services; and a requirement for greater engagement with the auditors by the company audit committee.

Confidence in audit quality was not just a problem in the US. As Andersen was a global firm, audit clients and regulators in many other countries were affected. Ensuring that the remaining firms carried out high quality audits in the future was seen as paramount to making sure that no other firms failed. Thus many changes to the regulatory regime for auditors were also made in other jurisdictions including the UK and the EU. Following a government review (CGAA, 2003), major changes in the UK included the restructuring of the Financial Reporting Council (FRC) which took responsibility for setting auditing standards, setting ethical standards for auditors and conducting independent inspections of public interest audits. The review also included changes to the UK Combined Code for Corporate Governance requiring much closer engagement between the audit committee of a company and its auditors, thus creating a much more significant role for the audit committee chair (ACC) in the audit process (FRC, 2003). A further major change in the EU was the move to International Financial Reporting Standards (IFRS) in 2005 for the group accounts of all companies listed on EU markets. This change required the input of significant resources for all companies (Dunne, Fifield, Finningham, Fox, Hannah, Helliar, Power and Veneziani, 2008).

Given the enhanced role of the audit committee in the relationship between a company and its auditors, the audit committee chair (ACC) is now a key party in the audit process. There have been no studies in the UK or other jurisdictions which have

simultaneously sought the views of the three key preparer groups (i.e. chief financial officers (CFOs), ACCs and audit engagement partners (APs) on the impact of the post Enron regime on audit quality. The most recent UK study was carried out before the post-Enron changes were introduced (Duff, 2004).

Sadly, this avalanche of regulation has not prevented the meltdown in the banking sector that western economies have recently experienced. Some observers have questioned whether audit quality failures contributed to the crisis (e.g., Holmes and Sukhraj, 2008; Sikka, 2009). However, the UK Parliament Treasury Committee, as part of its Inquiry into the Banking Crisis, investigated the role of auditors (Treasury Committee, 2009) and concluded that they

> *'had received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in "tunnel vision", where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures'* (Paragraph 221).

The aim of the present study is to evaluate, from the preparer and auditor perspectives, the effectiveness of recent changes to the audit regulatory landscape. Specifically, the study: (a) identifies the extent to which CFOs, ACCs and APs of UK listed companies believe that key features of the 2007 regulatory environment (which has since changed little) enhance or undermine audit quality; (b) establishes whether the responses differ significantly depending on respondents beliefs regarding the value of audit to the company or client; and (c) identifies the changes to either the regulatory framework or the behaviour of auditors which the respondents believe would most improve audit quality. The research is carried out by means of a contemporaneous survey of all three groups. New regulatory factors are considered alongside pre-existing regulatory and economic factors in order that the relative effectiveness of new regulation can be assessed in context.

Given that this study was carried out in 2007 and concerns about the role of audit were expressed by the Treasury Committee based on the bank audits with 2007 year ends, the research findings are also considered in the context of the conclusions drawn by the Treasury Committee (2009) in relation to the regulatory framework.

The findings of this research should provide policy makers with valuable evidence to inform future policy in relation to the desirability of and attitudes to further changes to the UK and other regimes that may be considered in response to the economic crisis. In recent years, there has been a growing call for evidence-based policy making that assesses the effects of financial regulation, including the costs, benefits and particularly the unintended consequences (Buijink, 2006; Pawson, 2006; Mulherin, 2007; Schipper, 2009).

The paper is constructed as follows: Section two provides more detail about the 2007 UK regulatory framework and also includes an overview of the literature on regulation and audit quality. Section three describes the research methodology and research questions. Section four provides the results and section five summarises and concludes.

REGULATORY CHANGE IN THE UK AND LITERATURE REVIEW

Changes to the UK regulatory regime

UK-specific changes include the UK's own response to the Enron crisis (CGAA, 2003) and the 2006 Companies Act. The CGAA review resulted in the Accountancy Foundation (the oversight body established by the accountancy professional bodies in 2002) being replaced by a restructured FRC, with several new operating bodies. Originally set up in 1992, the FRC's remit was to set and enforce accounting standards (via the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP)) and to maintain the Combined Code for Corporate Governance. Its responsibilities were extended to include control of the Auditing Practices Board (APB), the Accountancy and Actuarial Discipline Board (AADB) and general oversight via the Professional Oversight Board (POB)).[1] The effect of this was to remove completely any responsibility for audit standard setting and oversight of the profession from the accountancy professional bodies.

The Financial Reporting Review Panel (FRRP), which is responsible for ensuring compliance with accounting requirements, added risk based pro-active monitoring of the financial statements of public interest entities to its existing model of reacting to

complaints and publicly available information. The FRRP now selects industry sectors and specific areas of financial information, combined with an assessment of company specific risk factors. Its remit was also extended to monitoring the requirements of the UK listing rules (FRC, 2005: 7).

In addition to its existing duties of setting auditing standards, the APB took responsibility for setting ethical standards for auditors. Two key provisions of the ethical standards, which reflect the European Commission's (EC) fundamental principles for auditor independence (European Commission, 2002), are: mandatory rotation of all partners on each listed company audit, with the audit engagement partner in the UK rotating every five years; and greater restrictions on the provision of non-audit services (APB, 2004a). The POB became responsible for the inspection of public interest audits and the publication of the results of the inspections. This work is carried out by the POB's Audit Inspection Unit (AIU, 2008).

Further regulatory developments have occurred that affect the auditing environment since these regulatory structures were put in place. International Standards on Auditing (ISAs) were adopted by the APB (adapted for the UK environment) (APB, 2004b) and became mandatory for all UK audits from December 2005 year ends onwards. In early 2009, the International Auditing and Assurance Standards Board (IAASB) completed its 5 year long project to 'clarify' ISAs.[2] The EU issued the revised 8th Statutory Audit Directive and ethical standards for auditors were amended to ensure that they would be consistent with changes in the law which were to arise from the implementation of this Directive in 2008 (APB, 2007).

In the area of accounting regulation, EU legislation mandated the use of IFRS by UK listed companies in their consolidated financial statements for December 2005 year ends, replacing UK GAAP (EU, 2002). This caused significant changes in accounting and hence auditing practice. In particular, IFRS do not clearly state the 'substance over form' principle of FRS 5 *Reporting the Substance of Transactions* (ASB, 1994). Decisions to extend the use of IFRS to other company accounts, was left to member states to decide. In the UK entities were permitted to choose either UK GAAP or IFRS.

The third audit-related regulatory sphere to experience significant change was corporate governance. A formal framework emerged from the UK financial scandals of the early 1990s in the form of the Cadbury Report (1992) which subsequently became the Combined Code (and is soon to become the UK Corporate Governance Code). The UK market regulator, the Financial Services Authority, requires listed companies to provide a 'comply or explain' statement in their annual report which sets out how the Combined Code has been applied by the company (FRC, 2006a).[3] Code provision C3.1 states that 'The board should establish an audit committee of at least three or in the case of smaller companies two, members, who shall all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.' The responsibilities of the audit committee include monitoring 'the integrity of the financial statements of the company…reviewing significant financial reporting judgments contained in them' (provision C3.2). The auditor's responsibilities in relation to communication with those charged with governance are contained in ISA (UK and Ireland) 260 (APB, 2004c). Timely communication with the relevant parties in the company is required about audit matters.

To summarise, UK re-regulation in the audit arena post-Enron has been significant. There are now more regulatory bodies (e.g. the FRC's AIU) and these bodies they have a more intrusive mandate (e.g. FRRP now takes a proactive rather than a reactive approach) (Kershaw, 2006: 389).

Regulation theory

The literature on regulation adopts different theoretical perspectives, with the principal espoused approach drawing on the economics discipline (regulatory economics and public policy economics). Evidence of market failure, often combined with regulatory impact analysis, is used to justify the need for regulation on social welfare grounds. Regulatory impact analysis, however, does not necessarily identify the unintended consequences (often undesirable) of regulatory intervention.

If the case for market intervention is made, the general form of regulation must be decided. The main alternative regulatory forms (self-regulation versus government regulation) represent the classic trade-off between independence and expertise[4]. The

regulatory economics literature argues that the potential efficiency gains from self-regulation are attributable to the producers' superior knowledge of the issues, their greater ability to adapt to changing institutional conditions and the lower transaction costs of the regulatory process. To be set against this is the risk of self-interested participation in the process (Grajzl and Murrell, 2007). In the government model, however, regulatory capture is also a danger (Dal Bo, 2006). Beyond the general form of regulation, specific choices must be made in relation to, for example, self-reporting versus traditional direct monitoring of violations and inspection regimes. However, despite the risk of capture, the aftermath of the Enron collapse and loss of confidence in the accountancy profession led to a further move away from professional self regulation to regulation by a government agency, the FRC.

In the financial arena, regulation encompasses the regulation of both rules (standards and guidelines) and the groups subject to the rules (e.g. share dealers, accountants and auditors). Hirschleifer (2008), a behavioural financial economist, proposes a psychological, rather than an economic, theory of financial regulation. He argues that 'certain beliefs about regulation are especially good at exploiting psychological biases to attract attention and support. This irrationality, especially of the proponents of regulation, pervades the political discourse of regulation and strengthens the case for *laissez-faire*. Several underlying social and psychological processes in financial regulation are identified. Salience and vividness effects (i.e. events that draw attention), the violation of fairness and reciprocity norms, scapegoating, the availability heuristic amplified by media attention are all illustrated by the Enron scandal and the subsequent enactment of SOX. There also exists inherent overconfidence that a useful regulatory solution exists. Hirschleifer recommends that regulatory inertia should be built into the system to counteract the detrimental effect of these biases at the societal level.

Accounting and auditing regulation involves, *prima facie*, the professional accountancy associations, standard-setting bodies and regulatory agencies. Additionally, however, the professional firms (especially the global Big Four) are an increasingly important 'node in the network of institutions through which regulatory and professional processes operate' (e.g., Cooper and Robson, 2006, p.417). Adopting a political science perspective, Cooper and Robson (2006) argue that regulation has

been used to restore trust, a view which resonates with Hischleifer's (2008) scapegoat bias. Humphrey, Loft and Woods (2009) explore the impact of the financial crisis on the international financial architecture of the last decade, which can be characterised as a 'standards-surveillance-compliance' system based on transparency (Wade, 2007). They conclude that, in the wake of the crisis, this system is being strengthened, rather than changed. This system of financial regulation, which emphasises calculable standards and outcomes, arguably mirrors the rise of new managerialism in the fields of education and the public sector.

Research into audit quality

Audit quality can be conceptualised as 'a theoretical continuum ranging from very low to very high' (Francis, 2004: 346.). DeAngelo's (1981: 186) seminal economic analysis defines audit quality as the 'market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach'. Subsequently, however, researchers have recognised that these two characteristics of competence and independence do not represent the whole spectrum of audit quality attributes, with the effectiveness of the regulatory framework, service quality and responsiveness also being important aspects (e.g. Warming-Rasmussen and Jensen, 1998; Duff, 2004).

Recently, the FRC (2006b) considered how to identify the drivers of audit quality and promote audit quality. Having identified the lack of a clear agreed definition of audit quality, the FRC cites a key definition provided by the AIU (FRC, 2006b: 19):

> *'Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgments. A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and the Board properly to discharge their responsibilities.'*

The FRC subsequently issued its Audit Quality Framework (FRC, 2008) which identified five 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 reliability and usefulness of audit reporting; and factors outside the control of auditors affecting audit quality.

As the audit process is unobservable, the appearance as well as the fact of the behaviour of auditors is essential to public confidence in the value of audit. DeAngelo (1981) refers to this as the 'market-assessed' probability of breach detection and reporting. Quantitative archival empirical research into audit quality has used various observable outcomes to proxy for audit quality, such as: audit opinions; auditor selection and change decisions; financial statement outcomes; and analysts' forecasts. Reviewing 25 years of empirical audit quality research, Francis (2004) concludes that the most significant development in audit quality research is grounded in the assumption that differences in audit quality exist and can be inferred by comparing different groups of auditors. The main basis of differentiation is between large and small auditors (typically the Big Four versus the non-Big Four). It is argued that large audit firms are less dependent on any single client and also that they have incentives to protect their brand name. Research has shown that there is demand for quality-differentiated audits and that the top tier audit firms are higher quality (have lower thresholds for issuing modified audit reports and more effectively curtail aggressive earnings management).

Other archival approaches to researching audit quality have examined, *inter alia*: audit firm and audit partner rotation; the impact of corporate governance characteristics; and the impact of audit firm review and inspection. Each of these is briefly considered.

Long audit firm tenure is believed by some to lead to overly 'cosy' relationships between the auditor and the client company management and a loss of independence. Mandatory audit firm rotation has been called for called for to remedy this situation. Others argue that auditors' independence incentives are sufficient and that the inevitable learning curve of incoming auditors could lead to lower quality audits in the early years. A less radical intervention is to require audit *partner* rotation. A five year rotation period was introduced in many jurisdictions post-Enron (e.g. SEC, 2003). The evidence is mixed - studies set in Australia have shown that audit quality improves upon audit partner rotation (e.g. Fargher, Lee and Mande, 2008), whereas recent German evidence shows no association between mandatory audit engagement partner rotation and audit quality, but does find that audit quality declines upon the rotation of the audit review partner (Watrin, Lindscheid and Pott, 2009). In the UK, the APB recently proposed that the rotation period specified in the Ethical Standards for Auditors be increased from five to

seven years (APB, 2009a), although the arguments for both periods were described as 'finely balanced'. The revised ethical standard allows this extended period for the audit engagement partner of listed companies *only if* the audit committee determine that it is necessary to safeguard audit quality, with disclosure to the shareholders (APB, 2009b, §16-17). The period for engagement quality control reviewers and key partners is seven years (§19).

Agrawal and Chadha (2005) analyse a US dataset of audit committee and other corporate governance characteristics in relation to earnings misstatements. They find that the independence of the audit committees did not influence the frequency of restatements, although the presence of an independent director with financial expertise did reduce the frequency of restatements.

In many countries, systems of audit firm review and inspection have changed significantly in recent years. From 1988 until 2002, audit firms operating in the US with SEC clients were subject to mandatory peer review every three years, with the results of this review being publicly disclosed.[5] Hilary and Lennox (2005) find that audit firms gained clients following receipt of a clean opinion and lost clients following receipt of an adverse opinion, suggesting that the process credibly signaled audit quality, a conclusion confirmed by Casterella, Jensen and Knechel (2009). Following SOX, this model was replaced by independent inspections carried out by the PCAOB. Lennox and Pittman (2010) find that audit firms' market shares are not sensitive to these reports. They conclude that this may be because the inspectors are not seen to possess adequate technical knowledge and/or because the PCAOB reports are less informative that the peer review reports (as they do not disclose quality control problems). DeFond (2010) points out that this conclusion must be tempered by consideration of several related issues: (i) a lack of information value does not necessarily mean that the inspections are ineffective; (ii) the new regime may be effective in providing ex ante incentives for audit quality to improve, by applying stricter standards and/or imposing more severe penalties; (iii) the quality of financial reporting may have improved post SOX. By contrast, in the Dutch setting, Van de Poel, Opijnen, Maijoor and Vanstraelen (2009) conclude that independent inspections are effective in detecting audit quality.

The advantage of these indirect, archival approaches is that real-world data are used; however, the causal connection between the variables of interest is not always clear-cut. Research designs that employ direct methods, rather than indirect methods, include experimental and survey studies. In an experiment using Danish auditors, Windsor and Warming-Rasmussen (2009) find that the majority of auditors were not consistently independent in the context of client economic factors (client financial condition, size of fees and whether audit is tendered), indicating that IFAC's code of ethics appeal to 'independence of mind' is not effective**.**

There have been relatively few surveys of attitudes and beliefs regarding audit quality and what the key dimensions are. An advantage of this research approach is that the relative importance of a range of factors can be assessed. Carcello, Hermanson and McGrath (1992) survey preparers, auditors and users in the US and find that important factors are: knowledge of the client; industry expertise; responsiveness; and compliance with auditing standards. Post-SOX, 82% of 253 US audit committee members surveyed believe that audit quality has improved (Center for Audit Quality, 2008). The reasons for improvement were identified as being: increased audit committee oversight; requirements regarding internal controls; better communication with audit committees; CEO/CFO sign-off on financial statements; increased emphasis on quality of auditors; more rigorous audits; and audit committee oversight of auditors. Interview evidence from US company directors indicates that new regulation on the management-external auditor-audit committee relationship has improved audit quality, although there are suggestions that this benefit has involved costly compliance (Cohen, Hayes, Krishnamoorthy, Monroe and Wright, 2009). In Australia, interviews with key stakeholders reveal that the introduction of legally enforceable Australian Auditing Standards has not increased perceived audit quality (Hecimovic, Martinov-Bennie and Roebuck, 2009).

In the UK, Beattie, Fearnley and Brandt (1998, 1999) find that the factors that audit partners, finance directors and financial journalists most believed to enhance auditor independence in the pre Enron environment were: existence of an audit committee; risk of referral to the FRRP ; and risk to the audit firm of loss of Registered Auditor Status. Duff (2004) distinguishes between technical quality and service quality in a survey carried out in 2001-2 before the post Enron changes were implemented. It is found that

technical quality is characterised by status, independence and knowledge, while service quality is characterised by responsiveness, non-audit services and understanding of the client. In a UK investor survey about independence threats, Dart (2009) finds economic dependence in general and non-audit service provision in particular to be the most serious threats. The post Enron changes in the UK have significantly limited the opportunities for non-audit services provision, although economic dependence is still considered to be a threat.

To date, however, there have been no studies undertaken in the changed UK environment which have sought the views on audit quality of CFOs, audit partners, and, importantly, audit committee chairs. The present study seeks to fill this lacuna.

RESEARCH QUESTIONS AND METHODOLOGY

Research questions

Many regulatory changes impacting on the audit process have been implemented in the past few years. The focus of this study is to elicit the views of three key participant groups in the audit / financial reporting process, CFOs, ACCs and APs, on the features of the economic and regulatory environment which influenced audit quality in 2007, just before the current financial crisis emerged. We are particularly interested in the perceived effectiveness of the new (post-SOX) regulatory factors compared to pre-existing regulatory factors and continuing economic factors such as economic dependence. Our first detailed research question, which serves to contextualise the responses given, is:

Research question 1: To what extent do CFOs, ACCs and APs of UK listed companies companies believe the audit service is valuable to their company / client?

Research question 2: To what extent do CFOs, ACCs and APs of UK listed companies believe key factors in the 2007 UK regulatory framework and audit environment enhance or undermine audit quality?

Within the results of the combined sample there may be some contrasting respondent perceptions. Hence:

Research question 3: Do responses differ significantly by:

a) respondent group;

b) the extent to which respondents value audit?

To obtain a fuller understanding of where the 2007 framework might be considered deficient, we seek the views of respondents regarding possible improvements. Hence:

Research question 4: What changes to the regulatory framework, or to the behaviour of auditors, do respondents believe would most improve audit quality?

In 2009, the UK Treasury Committee, in its Inquiry into the Banking Crisis, questioned the usefulness of audit and suggested that the 'big picture was lost in a sea of detail and regulatory disclosures' (Treasury Committee, 2009, paragraph 221). Hence:

Research question 5: To what extent do the findings of this study support the views of the Treasury Committee about audit being 'lost in a sea of detail and regulatory disclosures' and indicate a possible unintended consequence of the changed regulatory regime?

Methods

The sample was taken from officially listed UK domestic companies, excluding AIM companies and investment trusts.[6] A target sample size of 500 for each group was initially set, including the top 250 qualifying companies by market capitalisation (as at 5th February 2007) and a systematic sample (every nth company ranked by market capitalisation) of 250 from the remaining qualifying companies.[7] To eliminate multiple selections of audit committee chairs, the final sample of ACCs was reduced to 446.[8]

AP respondents (i.e. those acting as engagement partner for qualifying companies) were identified by the 11 largest UK firms. This information was not publicly available. 439

audit partners were identified for survey, which is close to the UK population of listed company audit partners. For company specific questions audit partners were asked to respond in respect of their largest listed company client, referred to as 'Client X.'.

The research instrument used a combination of closed-form and open questions. CFOs and ACCs were asked to value audit on a five point scale (from *not at all* to *very valuable*); APs were asked how their client valued audit. This data is used as a basis for further analysis.

The main part of the survey sought respondents' views on factors affecting audit quality. The definition of audit quality in the survey instrument was taken from the UK Financial Reporting Council's definition in their 2006 consultation:

> *'Obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements. It involves appropriate and complete reporting by the auditors which enables the Audit Committee and the Board properly to discharge its responsibilities.'* (FRC, 2006b: 19)

A total of 36 factors were listed, grouped into:

a. Economic and general regulatory factors;
b. Standards set by the Auditing Practices Board;
c. Activities of the audit committee.

The factors are listed in Table 1.

[Table 1 about here]

Respondents were asked to evaluate the impact of each factor on audit quality on a scale of 1 to 7, where 1 = serious undermines; 2 = moderately undermines; 3 = slightly undermines; 4 = no effect; 5 = slightly enhances; 6 = moderately enhances; 7 = greatly enhances. Finally, an open question invited respondents to give their opinion on the changes to the regulatory framework, or to the behaviour of auditors which would most improve audit quality.

A draft questionnaire was pretested with several finance directors, audit committee chairs and audit partners involved with listed companies. Questionnaires to CFOs and ACCs were sent direct by the researchers in June 2007. The AP surveys were distributed

at the same time by the firms. All responses were returned direct to the researchers. Two reminder letters were sent and the audit firms followed up at the same time.

Response rates and tests for bias

For the CFO sample of 500, 149 usable responses were received, representing a response rate of 30%; for the ACC sample of 446, 130 usable responses were received, representing a response rate of 29%; and for the AP sample of 439, 219 usable responses were received, representing a response rate of 50%. These rates compare very favourably with the rates typically obtained in recent years from senior executives (for example, Daugherty and Tervo (2008) obtain a response rate of 5.5% from a survey of CFOs, ACCs and CEOs of the S&P 500).

To test for response bias, responders and non-responders in the CFO and ACC groups were compared on the basis of several background characteristics. Table 2 provides an analysis of the respondents by Stock Exchange group, US listing, audit firm type and broad industry sector. It is apparent that the characteristics of the respondent groups are broadly comparable. There is no significant difference in the proportion of US listings across the 3 groups (χ^2 = 2.800; p = 0.247), or the proportion of non-Big 4 affiliated respondents (χ^2 = 2.157; p = 0.340), or the proportion of respondents affiliated to financial sector companies versus non-financial sector companies (χ^2 = 3.830; p = 0.147)[9]. There are, however, differences in the distribution across Stock Exchange groups (χ^2 = 16.823; p = 0.010). In particular, there are a higher proportion of Fledgling respondents among the CFO sample, and more FTSE 250 respondents among the ACC sample.

[Table 2 about here]

The validity of questionnaires can also be affected by the suitability of individual respondents, who should be both knowledgeable and involved in the relevant practices, usually at a senior level. CFO respondents, based on job title, were CFO/Group CFO (74%), financial controller (9%), (group) chief accountant (3%), deputy CFO (1%) and other/non stated (13%).[10] We therefore conclude that the risk of uninformed respondent bias in this sample is minimal.

FINDINGS

Research question 1: Value placed on audit by respondents or their clients

Table 3 shows the results of the question asking respondents to indicate how valuable audit is to them or, in the case of APs to their client X. The combined sample results show that 65.3% in total consider audit to be *valuable* or *very valuable.* CFOs are the most sceptical group with 15.9% classifying it as of *little value* or lower and only 11.7% rating it as *very valuable*. The most surprising finding is that ACCs are actually more positive about audit value than APs believe their clients to be; 63.6% of ACCs chose the top two categories compared with 57.3% of APs and 45.5% of CFOs.

[Table 3 about here]

Research question 2: Perceptions of the impact of factors affecting audit quality-combined groups

Table 4 shows the rank (out of 36), mean, median and standard deviation for each factor listed on the research instrument for the combined sample of CFOs, ACCs and APs. To facilitate interpretation, the factors are classified as pre-existing (relative to SOX) regulatory factors (RP), new regulatory factors (RN) or ongoing economic factors (E). Based on the median response, the majority of factors are rated as having either no effect on (10 factors) or slightly enhancing (22 factors) audit quality, with only four scores outside 4 and 5 (three moderately enhancing and one slightly undermining). It is interesting to note that three of the top five issues considered to most enhance audit quality are about aspects of audit committee activity. This appears to be a strong affirmation for the changes in corporate governance codes (FRC, 2005) which have given audit committees a central role in managing the relationship between the company and the auditor. It also confirms the US evidence of the influence of audit committees (Center for Audit Quality, 2008; Cohen *et al.*, 2009).

[Table 4 about here]

The two other factors included in the top five are *those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client* (mean 5.50) and *big four audit firm* (mean 5.48). The former finding supports Dart (2009) regarding the threat of auditor lack of

independence. The latter finding may have been affected by the high proportion big four APs and clients of big four firms included in the sample and responding to the questionnaire (see Table 2, panel (c)). Similarly *not big four audit firm* as an undermining factor may have been subject to the same influence. However these findings do support the empirical evidence that a large firm auditor is a quality signal (Francis, 2004).

Mandatory audit partner rotation (factors ranked 29 and 34) are perceived to have no significant impact on audit quality, consistent with Dutch evidence (Watrin *et al.*, 2009) and counter to Fargher *et al.*'s (2008) Australian results. Clearly the audit inspection regime and ISAs (factors ranked 23 and 30) are viewed as being minimally effective, consistent with recent evidence from other jurisdictions (Lennox and Pittman, 2010; Hecimovic *et al.*, 2009).

Only three factors have a mean evaluation score below 4 (i.e. issues which respondents believe undermine audit quality), with a further factor where the mean score is not significantly different from 4. Two of these, *management time and costs incurred in changing auditors* and *budget pressures imposed by audit firm on staff* (for which there was a high level of consensus) are economic factors which have not been fundamentally affected by the regulatory developments of the last 10 years.

To test whether these factors are correlated and to reveal the key underlying dimensions, an exploratory factor analysis was undertaken in STATA using the principal factors method with varimax rotation (STATA, 2007). Based on the eigenvalue ≥ 1 criterion (Kim and Mueller, 1978: 49), seven dimensions were extracted; however, a distinct 'elbow' existed at nine dimensions, hence nine were retained. Table 5 sets out these nine dimensions, in order of extraction, together with a subjective label based on each dimension's main constituent factors. The constituent factors with loadings of more than |0.50| are also shown along with the loadings.

[Table 5 about here]

Of these nine dimensions, the first three (economic risk; audit committee activities; and risk of regulatory action) explain a large proportion of the observed variation in

responses. Economic risk and regulatory risk emerge as distinct dimensions. Also, in relation to the audit committee, the second most enhancing factor (recent and relevant financial experience) is a unique dimension in its own right, uncorrelated with the other audit committee factors, indicating that the unobservable latent audit committee variables are two-dimensional. Dimension 3, risk of regulatory action, covers three (out of four) recent changes which have increased the risk of regulatory action, two relating to the FRRP, and one to the AADB. These issues were identified by (Beattie *et al.*, 1998, 1999).

Research question 3: Perceptions of the impact of factors affecting audit quality - between group comparison

Table 6 addresses research question 3(a) by summarising the 20 out of 36 factors where a significant difference in response existed between the groups (using the ANOVA test of difference at the 5% level). It is evident that APs are more likely to give a different response from the both other two groups; CFOs and ACCs are more likely to have a shared perspective.

[Tables 6 about here]

For 11 of the issues, APs have a significantly higher score than at least one of the other groups (compared with 6 issues for CFOs and 8 for ACCs) indicating a higher level of optimism regarding the number of factors promoting audit quality. The majority of issues that APs rank higher are economic issues included in the research instrument, e.g. *risk of damage to audit partner's reputation.* The results of *big four audit firm* show that APs are significantly more likely than their clients to rate this as an enhancing issue.

The four items rated significantly lower by APs than both the other two groups are all issues which are the subject of ethical standards. One of the issues that produced a large divergence of views between respondent groups was *audit engagement partner or independent review partner not to act for more than five continuous years.* Unsurprisingly, APs scored this lower and, with a mean of 3.65, actually believed that it undermined audit quality, while the other two groups evaluated it as a slight to moderate enhancement. Other issues which imply some measure of constraint or control over the activities of auditors were significantly less highly rated by APs. For example, *AC has*

procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards had a mean score of 5.13 by ACCs versus 4.73 by APs.

The ACCs predictably tended to give higher scores to the factors describing various aspects of the audit committee's influence on audit quality, with four of the seven issues included in the research instrument producing scores significantly higher than both or one other respondent group.

Factor analysis was undertaken for each individual respondent group. Inspection of the detailed results reveals several interesting points of difference (due to space constraints, only a summary is presented in Table 7). The APs appear to have a simpler factor structure compared to the ACCs and CFOs – for APs, fewer dimensions explain an equivalent amount of variation in the data. For the APs, economic risk and risk of regulatory action combine to form a single top dimension. For this group only, risk of investigation by the FRRP for the company emerges as a separate dimension. The CFOs split audit committee factors into two separate dimensions; one concerning approvals and recommendations in relation to the auditor (dimension 3) and the other concerning audit quality more directly (dimension 9). In contrast to the other groups, they include the audit inspection factor in with the audit firm ethics dimension. For ACCs the factor 'risk of damage to audit committee members' personal reputation' is grouped in with the risk of regulatory action dimension.

[Table 7 about here]

Significant differences in the perceptions of respondents who regard audit as more valuable compared with those who regard audit as less valuable (see Table 3 – addressing research question 3(b)) exist for twenty-three audit quality factors for the combined sample[12]. Predictably, 22 of these factors are positive (i.e. those who value audit more highly tend to believe that more of the factors have a positive impact on audit quality). The only issue rated more highly by those with a lower opinion of the value of audit was *audit engagement partner or independent review partner not to act for more than five continuous years* is (mean difference -0.29, not significant in any individual respondent group). The CFOs' evaluation of audit was most likely to impact on their

rating of individual factors affecting audit quality, since 15 significant differences were identified, all positive, compared with 12 for APs and just 5 for ACCs.

Research question 4: Changes to the regulatory framework or to the behaviour of auditors which would most improve audit quality

In an open question respondents were asked '*In your opinion what changes to the regulatory framework, or to the behaviour of auditors, would most improve audit quality?*' A total of 158 comments were received from APs (72.1% of respondents who completed the section of the questionnaire), 78 from CFOs (52.3%) and 27 from ACCs (46.9%). A thematic frequency analysis of the comments is shown in Table 8.

[Table 8 about here]

Perhaps predictably, only 2.7% of those who took the trouble to comment considered the current framework to be satisfactory. Another group, who may have had misgivings about the existing framework, believed that a period of stability was desirable:

> '*The best change would be for the regulatory framework to stand still for a period of time to allow companies to catch up!'* (CFO 177)

The most popular form of improvement across all three respondent groups was that prescriptive regulation was excessive and that judgement should again have a central role in the regulatory framework:

> *'The regulatory framework, whilst needing to be robust, must not stifle the ability of auditors to exercise individual judgment to ensure sensible outcomes to audit issues. The fear is that the framework is becoming too rules based to do this.'* (CFO 389)

> *'No more international box ticking.'* (ACC 99)

> '*Greater freedom to exercise professional judgment - provided of course that it is fully documented. We need to move further away from prescriptive checklists which actually impair quality as they discourage intellectual challenge. The UK environment is far better than US in this respect.'* (AP 88)

The approach of the AIU, in particular, was questioned by APs:

> '*Changing the focus of the AIU from compliance with detail of auditing standards to matters of audit judgment – its effect is defensive auditing rather than enhanced audit quality.'* (AP 372)

The next most significant issue overall and among APs and CFOs was auditor rotation. The APs were very focused on the impact of the rules on engagement partners:

> *'5 yr partner rotation is too short and increases risk of audit failure. This is because too high a proportion of tenure is during 'learning' phase. 7 years was an appropriate balance.'* (AP299)

While CFOs also picked up on this point, they were often concerned with broader continuity:

> '*Continuity of audit staff at management levels.'* (CFO 396)
>
> '*Enforced rotation of Engagement Partner after 5 years detracts from quality.'* (CFO 250)

Possible improvements in the way that audit committees function, particularly their role with respect to setting audit fees, was a point raised by a substantial number of APs, but no other respondents. There was some variability in the precise points raised but the following are representative and suggest that not all audit committees are competent or supportive of the audit process: this has been brought out by in the US by Agrawal and Chadha (2005).

> *'Further focus on the quality and independence of the audit committee – personal experience possibly biases view but have found myself fighting the board and audit committee chair on some key issues of principle. A supportive chair would have made the experience far less stressful.'* (AP 504)
>
> '*Audit committees being fully prepared to pay the appropriate rate for a thorough audit.*' (AP 474)
>
> *'Role of non-execs is key. AC chair needs to have real relevant experience say as audit partner of another firm.'* (AP 523).

Comments about auditor behaviour were most common from ACCs and tended to suggest that excessive regulation would not improve standards of behaviour:

> *'Quality is achieved by having people of integrity in the company and in the audit team.'* (ACC 382)

The issue of competition and choice among audit firms was picked up by a few respondents, especially CFOs:

> *'A means of injecting real competitive tension to the process. Even if I wanted to, I couldn't just change auditors – there are too many repercussions.'* (CFO 278)

Other issues raised included limitation of liability, the need to simplify auditing and accounting standards, strengthening peer review of audit working papers, transparency within audit firms and loosening regulation on non-audit services.

Research Question 5: The extent to which the findings of this study support the views of the Treasury Committee about audit being 'lost in a sea of detail and regulatory disclosures' and indicate a possible unintended consequence of the changed regulatory regime

The most frequently suggested change appearing in Table 8 (117 in total) was a move away from rules and box-ticking. This provides some evidence that audit (and accounting) have moved more towards a complex process-driven activity and away from reliance on the judgement and integrity of the individual auditors. The low impact attributed to the activities of the AIU also reflects a lack of support for the auditing standards and the inspection regime which may also be driving audit down a stricter compliance route. Thus, both the quantitative and the qualitative evidence from the present study supports the analysis of Humphrey *et al.* (2009) regarding the transparency-based standards-surveillance-compliance regime, which would inevitably add to complexity.

SUMMARY AND CONCLUSIONS

This study has investigated the perceptions of 36 economic and regulatory audit quality factors held by 149 CFOs and 130 ACCs from UK listed companies and from 219 APs responsible for the audit of at least one UK listed company. The results indicate that most factors are perceived, on average, to have moderately or slightly enhanced audit quality. The recent regulatory changes which have given audit committees a more central role in the audit process are among the most highly rated factors, consistent with recent US findings (Center for Audit Quality, 2008; Cohen *et al.*, 2009), although it should be noted that audit committees were regarded as very important in the Beattie *et al.* (1998) UK study. None of the three issues considered to undermine audit quality is directly linked to the regulatory reforms. However the Big Four / non-Big Four factor may have been influenced by the high proportion of Big Four APs and clients in the survey.

Exploratory factor analysis reduced the original set of 36 factors to nine uncorrelated dimensions: economic risk; audit committee activities; risk of regulatory action; audit firm ethics; economic independence of auditor; audit partner rotation; risk of client loss; audit firm size; and, lastly, International Standards on Auditing (ISAs) and audit inspection. Of these nine dimensions, the first three (economic risk; audit committee activities; and risk of regulatory action) explain a large proportion of the observed variation in responses. Interestingly, economic risk and regulatory risk are distinct dimensions. Also, in relation to the audit committee, the second most enhancing factor (recent and relevant financial experience) is a unique dimension, uncorrelated with the other audit committee factors, indicating that the unobservable latent audit committee variables are two-dimensional.

The declared attitudes and beliefs of different respondent groups were compared, revealing different perspectives. APs were more likely to have a different and generally more positive perspective than the other respondent groups and they ranked a number of the economic factors as significantly more enhancing than the other groups. Conversely, some ethical standards (obviously a constraint on their activities) were ranked by APs as undermining audit quality. Unsurprisingly, ACCs were particularly enthusiastic about the regulatory reforms involving the audit committee. Comparison of the factor structure of the three groups revealed further significant points of difference. For the APs, economic risk and risk to auditors of regulatory action combined to form a single dimension, with the risk of investigation by the FRRP for the company being a separate dimension. The CFOs split audit committee activities into two distinct dimensions; one concerning approvals and recommendations in relation to the auditor and the other concerning audit quality monitoring more directly.

The majority of respondents believe audit to be either valuable or very valuable. It is surprising that APs feel that their own service is not always highly valued by their clients and ACCs think more of audit than APs believe their clients do. This result suggests that audit may still be viewed as a commodity or may, as the Treasury Committee suggests, be ‘lost in a sea of detail and regulatory disclosures’. CFOs were the most sceptical group about the value of audit but only a small minority rated audit as *of little value* or worse. As might be expected, respondents who value audit have a more positive view on impact of individual factors on audit quality.

The nature of recent regulation was heavily criticised in comments about possible future changes to the regulatory framework and auditor behaviour. As not all respondents made comments, the set of comments may not be representative of the whole group, however, some important themes emerged. Recent regulatory change was considered to be rife with rules and box ticking. The five year mandatory requirement for audit partner rotation was heavily criticised by many as being too short, especially by APs; and the AIU was criticised for its process / documentation focus. Respondents' widespread concern that these aspects of the changed regime are largely process and compliance driven, with high costs for limited benefits, indicates there may be overconfidence that a useful regulatory intervention exists, supporting Hirchleifer's (2008) psychological bias theory of regulation. This evidence also supports the concerns of the Treasury Committee (2009).

The results should be of direct interest to policy makers in assessing the impact of the range of recent changes that have been introduced into the UK auditing framework and in considering possible future developments, thus supporting evidence-based policy-making. The enhanced role of audit committees especially seems to be welcomed, particularly where best practice is followed and the extension of the period of audit partner rotation from five to seven years (APB, 2009b) is supported. The trend of recent regulation away from an emphasis on professional judgment and further towards Wade's (2007) 'standards-surveillance-compliance' regulatory system is questioned by some respondents. Findings suggest that, from an effectiveness perspective, the changes to the corporate governance and FRRP regimes have been more effective than the audit inspection regime. However it must be borne in mind that it is mainly the auditors who are affected by the AIU, whereas the governance and FRRP regimes affect finance directors, audit committees and auditors.

The emerging evidence of an unintended consequence of the changed regime causing audit to become overly process driven is of considerable concern. There is some evidence that the pursuit of a higher level of compliance in audit performance, which is a good thing, has also resulted in a devaluation of what is a vital contribution to the integrity of financial reporting.

The present study has a number of the limitations normally associated with a questionnaire approach, notably noise and potential response bias. However these risks are mitigated by the seniority of the respondents (minimising the risk of uninformed respondent bias) and the relatively high response rate obtained. While the present study focuses on the views of three preparer groups, future research could usefully investigate the views of user groups particularly in relation to the audit inspection regime which is perceived by preparers as of less value than might have been expected.

ENDNOTES

[1] The AADB was previously called the Accounting Investigation and Discipline Board; the POB was previously called the Professional Oversight Board for Accountancy.

[2] The IAASB is the international auditing standard-setting board. It is an independent board of the International Federation of Accountants (IFAC), the global organisation for the accountancy profession.

[3] The Code is subject to regular review, and an updated version was issued in June 2008.

[4] Government regulation may be direct or may be delegated to a government agency.

[5] Review results took the form of a clean report (no significant internal control weaknesses), modified report (significant but not serious internal control weaknesses) or adverse report (serious or very serious weaknesses).

[6] AIM companies are excluded because they are not yet required to adopt IFRS; investment trusts are excluded because, as they do not trade, their accounting, auditing and governance is very different.

[7] For a variety of reasons, several companies in the initial sample were reselected (e.g. company had delisted, merged or demerged, or moved domicile since their last annual report; company reported under US GAAP). A replacement was sought from the same industry group and with the closest market capitalisation).

[8] The initial company sample resulted in 58 companies (33 involving the top 250) where the audit committee chair had been selected more than once (in three cases, four times). The 27 cases involving non-top 250 companies were reselected, but this often produced new duplications.

[9] A χ^2 test of association between respondent group and the six broad industry sectors was, however, significant ($\chi^2 = 26.795$; $p = 0.003$). Comparison of the expected frequencies with the actual frequencies revealed that the AP group contained markedly more respondents affiliated to industrial companies and markedly less affiliated to consumer companies than the other two groups.

[10] ACC respondents were all audit committee chairs, with the exception of two who were Deputy Chairs; included AP respondents were all listed company audit engagement partners (4 responses were eliminated as they did not fall within the criteria set for the following reasons: client reported under US GAAP only, client not yet on IFRS (AIM company), AP audited investment trusts only; and client was a public sector organisation).

[11] Seven factors from Table 4 do not feature in Table 5, due to their 'uniqueness'. These factors are: management time and costs incurred in changing auditors; budget pressures imposed by audit firm on staff; competition among audit firms; disclosure of non-audit fees paid to auditor with detailed breakdown; audit firm to establish policies and procedures to ensure that partner and staff are not rewarded/promoted for selling non-audit services to their audit clients; audit firm to establish monitoring procedures to ensure compliance with its policies; and one audit committee member has 'recent and relevant financial experience'. STATA reports each variable's 'uniqueness', with values greater than 0.6 indicating that the variable is not well-explained by the extracted factor (STATA, 2007: 290). The first four factors just listed meet this cut-off, while the remaining three are close to it. The first four of these factors emerge as lesser dimensions (dimensions 12, 13, 15 and 10, respectively) in their own right. Audit firm non-audit services policies seems to be two-dimensional, loading moderately highly on dimension 4 (audit firm ethics) and dimension 10 (non-audit service fee disclosure). Audit firm policy compliance procedures loads moderately on three dimensions (audit firm ethics; economic independence of audit firm; and economic risk). Finally, 'recent and relevant financial experience' of one audit committee member loads moderately on dimension 2 (audit committee activities) but also on a lesser and unique dimension 11.

[12] For this analysis, a dichotomous variable was created based on the responses in Table 3 - respondents who considered audit to be of no, little or moderate values were combined into one group, while those who considered audit to be valuable or very valuable were combined to form the other group.

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Table 1: List of Factors Affecting Audit Quality

Economic and general regulatory factors affecting audit quality

(a)	Management time and costs incurred in changing auditors
(b)	Big four audit firm
(c)	Not Big four audit firm
(d)	Competition among audit firms
(e)	Partners' desire not to lose status by losing key client
(f)	Client important to firm's overall portfolio
(g)	Budget pressures imposed by audit firm on staff
(h)	Client assessed as high audit risk
(i)	Risk of litigation against audit firm
(j)	Risk of damage to auditors firm's reputation from public scandals
(k)	Risk of damage to audit partner's personal reputation
(l)	Risk of damage to audit committee members' personal reputation
(m)	Risk of investigation by the Financial Reporting Review Panel:
i.	for company
ii.	for auditor
(n)	Risk to audit firm of disciplinary action by FRC Accountancy and Actuarial Discipline Board (AADB)
(o)	Risk to audit firm of loss of Registered Auditor status
(p)	Disclosure of non-audit fees paid to auditor with detailed breakdown
(q)	Introduction of International Standards of Auditing (ISAs) for December 2005 year ends
(r)	Audit Inspection Unit (AIU) carrying out independent inspections of public interest audits and publishing reports

Influence on audit quality of standards set by the Auditing Practices Board

(a)	Partner independent of the audit to review all aspects of the audit engagement
(b)	Audit firm to take responsibility for a control environment that places compliance with ethical standards above commercial considerations
(c)	Audit firm to designate ethics partner to ensure compliance with ethical standards
(d)	Audit firm to establish policies and procedures to ensure that partner and staff are not rewarded/promoted for selling non-audit services to their audit clients
(e)	Audit engagement partner or independent review partner not to act for more than five continuous years
(f)	Other audit partners or other staff in senior positions not to act for more than seven years
(g)	Those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client
(h)	Total fees from listed client not normally to exceed 10% annual fee income of firm
(i)	Total fees from listed client not to exceed 10% of the base on which the client's engagement partner's profit share is calculated
(j)	Audit firm to establish monitoring procedures to ensure compliance with its policies

Influence of activities of the audit committee on audit quality

(a)	Audit committee:
i.	is composed of independent non-executive directors
ii.	is primarily responsible for recommending the appointment, re-appointment and removal of auditors to the board
iii.	approves the terms of engagement and the remuneration of the external auditor
iv.	ensures an adequate audit can be carried out for the fee
v.	has procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards
(b)	One audit committee member has 'recent and relevant financial experience'
(c)	Auditor required to communicate with the audit committee on all key issues associated with the audit, and with ethical standards

Table 2: Analysis of Respondent Groups by Stock Exchange Group, US Listing, Audit Firm Type and Industry Sector

Panel (a): Stock Exchange Group

Stock Exchange Group	**Chief Financial Officer (CFO) sample**		**Audit Committee Chair (ACC) sample**		**Audit Partner (AP) sample**	
	No.	*%*	No.	*%*	No.	*%*
FTSE 100	44	*29.7*	31	*24.2*	52	*24.1*
FTSE 250	48	*32.4*	57	*44.5*	85	*39.3*
FTSE Small-Cap	43	*29.1*	37	*28.9*	75	*34.7*
Fledgling	13	*8.8*	3	*2.3*	4	*1.9*
Missing	1	-	2	-	3	-
Total	149	*100.0*	130	*100.0*	219	*100.0*

Panel (b): US Listing

	Chief Financial Officer (CFO) sample		**Audit Committee Chair (ACC) sample**		**Audit Partner (AP) sample**	
	No.	*%*	No.	*%*	No.	*%*
US listing	18	*12.1*	8	*6.2*	23	*10.5*

Panel (c): Audit Firm Type

Audit firm type	**Chief Financial Officer (CFO) sample**		**Audit Committee Chair (ACC) sample**		**Audit Partner (AP) sample**	
	No.	*%*	No.	*%*	No.	*%*
Big four	131	*88.5*	118	*91.5*	188	*86.2*
Non-big four	17	*11.5*	11	*8.5*	30	*13.8*
Missing	1	-	1	-	1	-
Total	149	*100.0*	130	*100.0*	219	*100.0*

Panel (d): Industry Sector

Industry sector[b]	**Chief Financial Officer (CFO) sample**		**Audit Committee Chair (ACC) sample**		**Audit Partner (AP) sample**	
	No.	*%*	No.	*%*	No.	*%*
Financials	30	*20.3*	28	*21.7*	31	*14.2*
Consumer goods	25	*16.9*	21	*16.3*	18	*8.3*
Services	56	*37.8*	40	*31.0*	66	*30.3*
Industrials	23	*15.5*	27	*20.9*	52	*23.9*
Resources	9	*6.1*	10	*7.8*	40	*18.3*
Utilities	5	*3.4*	3	*2.3*	11	*5.0*
Missing	1	-	1	-	1	-
Total	149	*100.0*	130	*100.0*	219	*100.0*

Notes to table:

a) Percentages are based on non-missing values.

b) The 10 Level 3 Datastream economic groups were combined to form 6 groups as follows: cyclical and non-cyclical consumer goods are combined; cyclical and non-cyclical services are combined; general industrials and IT are combined; and resources and basic industries are combined.

Table 3: How Valuable is Audit to your Company/Client X?

Response	CFO		ACC		AP		Combined	
	No.	***%***	**No.**	***%***	**No.**	***%***	**No.**	***%***
Not at all	2	*1.4*	0	*0.0*	0	*0.0*	2	*0.4*
Of little value	21	*14.5*	9	*7.6*	6	*2.8*	36	*7.5*
Moderately valuable	56	*38.6*	34	*28.8*	87	*39.9*	177	*36.8*
Valuable	49	*33.8*	48	*40.7*	97	*44.5*	194	*40.3*
Very valuable	17	*11.7*	27	*22.9*	28	*12.8*	72	*15.0*
Sub-total	*145*	*100.0*	*118*	*100.0*	*218*	*100.0*	*481*	*100.0*
Missing	4		12		1			
Total	**149**		**130**		**219**		**498**	

Table 4: Perceptions of the Impact of Factors Affecting Audit Quality – Combined Sample

Id	Category	Factor[a]	Rank	Mean[b,c]	Median	Std dev[d]
1	RN	Auditor required to communicate with the audit committee on all key issues associated with the audit, and with ethical standards	1	5.63	6	0.89
2	RN	One audit committee member has 'recent and relevant financial experience'	2	5.59	6	0.88
3	RN (scope widened)	Those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client	3	5.50	5	1.16
4	E	Big four audit firm	4	5.48	6	1.18
5	RP	AC is composed of independent non-executive directors	5	5.41	5	0.88
6	RN	Audit firm to establish monitoring procedures to ensure compliance with its policies	6	5.32	5	0.91
7	RN	Partner independent of the audit to review all aspects of the audit engagement	7	5.26	5	**0.84**
8	E	Client assessed as high audit risk	8	5.18	5	1.06
9	E	Risk of damage to audit partner's personal reputation	9=	5.15	5	1.23
10	RP	Risk to audit firm of loss of Registered Auditor status	9=	5.15	5	*1.37*
11	RN (proactive)	Risk of investigation by the Financial Reporting Review Panel for auditor	11	5.10	5	1.11
12	RP	Total fees from listed client not normally to exceed 10% annual fee income of firm	12	5.07	5	1.13
13	RN	AC ensures an adequate audit can be carried out for the fee	13	5.04	5	0.94
14	E	Risk of damage to audit firm's reputation from public scandals	14	5.02	5	*1.31*
15	RN	AC is primarily responsible for recommending the appointment, re-appointment and removal of auditors to the board	15	5.01	5	0.93
16	RN (new body)	Risk to audit firm of disciplinary action by FRC Accountancy and Actuarial Discipline Board (AADB)	16	4.99	5	1.09
17	RN	Audit firm to take responsibility for a control environment that places compliance with ethical standards above commercial considerations	17	4.90	5	1.01
18	E	Risk of damage to audit committee members' personal reputation	18	4.89	5	1.01
19	RN	AC has procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards	19	4.88	5	0.83
20	RN (proactive)	Risk of investigation by the Financial Reporting Review Panel for company	20	4.84	5	0.93
21	RN	Total fees from listed client not to exceed 10% of the base on which the client's engagement partner's profit share is calculated	21	4.83	5	1.02
22	RN	AC approves the terms of engagement and the remuneration of the external auditor	22	4.81	5	0.87

23	RN	Audit Inspection Unit (AIU) carrying out independent inspections of public interest audits and publishing reports	23	4.80	5	1.04
24	E	Risk of litigation against audit firm	24	4.76	5	*1.29*
25	RN	Audit firm to designate ethics partner to ensure compliance with ethical standards	25	4.63	5	**0.85**
26	RN	Audit firm to establish policies and procedures to ensure that partner and staff are not rewarded/promoted for selling non-audit services to their audit clients	26	4.62	4	0.86
27	E	Competition among audit firms	27	4.54	4	1.19
28	E	Client important to firm's overall portfolio	28	4.28	4	1.14
29	RN	Other audit partners or other staff in senior positions not to act for more than seven years	29	4.26	4	1.18
30	RN	Introduction of International Standards on Auditing (ISAs) for December 2005 year ends	30	4.21	4	1.05
31	E	Partner's desire not to lose status by losing key client	31=	4.12	4	1.15
32	RN (extended)	Disclosure of non-audit fees paid to auditor with detailed breakdown	31=	4.12	4	**0.65**
33	RN	Audit engagement partner or independent review partner not to act for more than five continuous years	33	4.08	4	*1.44*
34	E	Management time and costs incurred in changing auditors	34	3.68	4	0.96
35	E	Budget pressures imposed by audit firm on staff	35	3.45	4	**0.78**
36	E	Not Big four audit firm	36	3.27	3	1.06

Notes to table:

a). Factors are shown in decreasing rank order.

b) Response scale is: 1. Seriously undermines, 2. Moderately undermines, 3. Slightly undermines, 4. No effect, 5. Slightly enhances, 6. Moderately enhances, 7. Greatly enhances.

c). Factor group means which are NOT significantly different from 4 (no effect) at the 5% level (two-tailed) are shown with a grey background to cell.

d). High consensus (std. dev. ≤ 0.85) shown in bold; low consensus (std. dev. ≥ 1.25) shown in italics.

Table 5: Factor Analysis of Audit Quality Factors – Combined Sample

Dimension No.	Descriptive label	Principal constituent audit quality factors	Dimension loadings	Table 4 ranking
1	Economic risk	Risk of damage to audit firm's reputation from public scandals	0.87	14
		Risk of damage to audit partner's personal reputation	0.82	9=
		Risk of litigation against audit firm	0.78	24
		Client assessed as high audit risk	0.63	8
		Risk of damage to audit committee members' personal reputation	0.53	18
2	Audit committee activities	AC approves the terms of engagement and the remuneration of the external auditor	0.81	22
		AC is primarily responsible for recommending the appointment, re-appointment and removal of auditors to the board	0.78	15
		AC ensures an adequate audit can be carried out for the fee	0.69	13
		AC has procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards	0.66	19
		AC is composed of independent non-executive directors	0.60	5
		Auditor required to communicate with the audit committee on all key issues associated with the audit, and with ethical standards	0.51	1
3	Risk of regulatory action	Risk of investigation by the Financial Reporting Review Panel for auditor	0.74	11
		Risk to audit firm of disciplinary action by FRC Accounting Investigation and Discipline Board (AADB)	0.71	16
		Risk of investigation by the Financial Reporting Review Panel for company	0.64	20
		Risk to audit firm of loss of Registered Auditor status	0.60	9=
4	Audit firm ethics	Audit firm to take responsibility for a control environment that places compliance with ethical standards above commercial considerations	0.76	17
		Audit firm to designate ethics partner to ensure compliance with ethical standards	0.72	25
		Partner independent of the audit to review all aspects of the audit engagement	0.51	7
5	Economic independence of auditor	Total fees from listed client not normally to exceed 10% annual fee income of firm	0.78	12
		Total fees from listed client not to exceed 10% of the base on which the client's engagement partner's profit share is calculated	0.76	21
		Those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client	0.52	3
6	Audit partner rotation	Audit engagement partner or independent review partner not to act for more than five continuous years	0.84	33
		Other audit partners or other staff in senior positions not to act for more than seven years	0.84	29
7	Risk of client loss	Client important to firm's overall portfolio	0.74	28
		Partner's desire not to lose status by losing key client	0.73	31=
8	Audit firm size	Not Big four audit firm	-0.65	36
		Big four audit firm	0.62	4
9	Audit inspection and ISAs	Audit Inspection Unit (AIU) carrying out independent inspections of public interest audits and publishing reports	0.57	23
		Introduction of International Standards of Auditing (ISAs) for December 2005 year ends	0.53	30

Table 6: Summary of Specific Audit Quality Factors for which there are Significant Differences between Respondent Groups

Id	Factor
	APs consider factor enhances audit quality significantly more than either CFOs or ACCs
8	Client assessed as high audit risk
9	Risk of damage to audit partner's personal reputation
14	Risk of damage to audit firm's reputation from public scandals
24	Risk of litigation against audit firm
28	Client important to firm's overall portfolio
4	Big four audit firm
	APs consider factor enhances audit quality significantly less than either CFOs or ACCs
21	Total fees from listed client not to exceed 10% of the base on which the client's engagement partner's profit share is calculated
26	Audit firm to establish policies and procedures to ensure that partner and staff are not rewarded/promoted for selling non-audit services to their audit clients
29	Other audit partners or other staff in senior positions not to act for more than seven years
33	Audit engagement partner or independent review partner not to act for more than five continuous years
	ACCs consider factor enhances audit quality significantly more than either CFOs or APs
13	AC ensures an adequate audit can be carried out for the fee
15	AC is primarily responsible for recommending the appointment, re-appointment and removal of auditors to the board
22	AC approves the terms of engagement and the remuneration of the external auditor
	APs consider factor enhances audit quality significantly more than CFOs
17	Audit firm to take responsibility for a control environment that places compliance with ethical standards above commercial considerations
18	Risk of damage to audit committee members' personal reputation
	APs consider factor enhances audit quality significantly more than ACCs
3	Those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client
11	Risk of investigation by the Financial Reporting Review Panel for auditor
	APs consider factor enhances audit quality significantly less than CFOs
32	Disclosure of non-audit fees paid to auditor with detailed breakdown
	APs consider factor enhances audit quality significantly less than ACCs
19	AC has procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards
	ACCs consider factor enhances audit quality significantly less than either CFOs or APs
10	Risk to audit firm of loss of Registered Auditor status

Table 7: Factor Analysis of Audit Quality Factors – by Respondent Group

Dimension No.	Descriptive label	Principal constituent audit quality factors for combined sample	Dimension no.		
			CFO	ACC	AP
1	Economic risk	Risk of damage to audit firm's reputation from public scandals	1	3	1
		Risk of damage to audit partner's personal reputation	1	3	1
		Risk of litigation against audit firm	1	3	1
		Client assessed as high audit risk		3	1
		Risk of damage to audit committee members' personal reputation	1	2	1
2	Audit committee activities	AC approves the terms of engagement and the remuneration of the external auditor	6	1	2
		AC is primarily responsible for recommending the appointment, re-appointment and removal of auditors to the board	6	1	2
		AC ensures an adequate audit can be carried out for the fee	[6&9]	1	2
		AC has procedures to ensure auditors' independence and objectivity and their compliance with Auditing Practices Board ethical standards	9	1	2
		AC is composed of independent non-executive directors	[6]	1	2
		Auditor required to communicate with the audit committee on all key issues associated with the audit, and with ethical standards	6	1	2
3	Risk of regulatory action	Risk of investigation by the Financial Reporting Review Panel for auditor	2	2	1
		Risk to audit firm of disciplinary action by FRC Accountancy and Actuarial Discipline Board (AADB)	2	2	1
		Risk of investigation by the Financial Reporting Review Panel for company	2	2	9
		Risk to audit firm of loss of Registered Auditor status	2	2	1
4	Audit firm ethics	Audit firm to take responsibility for a control environment that places compliance with ethical standards above commercial considerations	3	4	3
		Audit firm to designate ethics partner to ensure compliance with ethical standards	3	4	3
		Partner independent of the audit to review all aspects of the audit engagement	3	[4&1]	3
5	Economic independence of auditor	Total fees from listed client not normally to exceed 10% annual fee income of firm	5	5	5
		Total fees from listed client not to exceed 10% of the base on which the client's engagement partner's profit share is calculated	5	5	5
		Those in a position to influence the outcome of an audit not to have direct or indirect financial interest in the client or business relationships with the client	[5]&10	[5]	[5]
6	Audit partner rotation	Audit engagement partner or independent review partner not to act for more than five continuous years	4	7	4
		Other audit partners or other staff in senior positions not to act for more than seven years	4	7	4
7	Risk of client loss	Client important to firm's overall portfolio	7	9	6
		Partner's desire not to lose status by losing key client	7	12	6
8	Audit firm size	Not Big four audit firm	8	6	8
		Big four audit firm	8	6	8
9	Audit inspection and ISAs	Audit Inspection Unit (AIU) carrying out independent inspections of public interest audits and publishing reports	3	8	7
		Introduction of International Standards on Auditing (ISAs) for December 2005 year ends	[2]	8	7

Note to table: Square brackets indicate that the factor almost meets the |0.50| threshold.

Table 8: Analysis of Comments in Response to 'In your opinion what changes to the regulatory framework, or to the behaviour of auditors, would most improve audit quality?'

Response	CFO		ACC		AP		Combined	
	No.	***%***	**No.**	***%***	**No.**	***%***	**No.**	***%***
Move away from rules and box-ticking	36	*46.1*	21	*34.4*	60	*38.0*	117	*39.3*
Ease 5 year rotation rule	15	*19.2*	6	*9.8*	41	*25.9*	62	*20.9*
Competence of audit committees and fee pressure from the client	0	*0*	0	*0*	29	*18.4*	29	*9.8*
Integrity more important than regulation	5	*6.4*	10	*16.4*	9	*5.7*	24	*8.1*
Other improvements to audit quality	10	*12.8*	8	*13.1*	4	*2.5*	22	*7.4*
Period of stability in regulation needed	1	*1.3*	8	*13.1*	7	*4.4*	16	*5.4*
Improve competition and choice	7	*9.0*	2	*3.3*	4	*2.5*	13	*4.4*
Framework satisfactory	2	*2.6*	4	*6.6*	2	*1.3*	8	*2.7*
Ease complexity in accounting / auditing	2	*2.6*	2	*3.3*	2	*1.3*	6	*2.0*
Sub-total	*78*	*100.0*	*61*	*100.0*	*158*	*100.0*	*297*	*100.0*
Missing	71		69		61		201	
Total	**149**		**130**		**219**		**498**	