Singapore Management University
Institutional Knowledge at Singapore Management University

Research Collection Yong Pung How School Of Law | Yong Pung How School of Law

11-2019

Addressing the auditor independence puzzle: Regulatory models and proposal for reform

Aurelio GURREA-MARTINEZ
Singapore Management University, aureliogm@smu.edu.sg

Martin GELTER

Follow this and additional works at: https://ink.library.smu.edu.sg/sol_research

Part of the Business Organizations Law Commons

Citation

Aurelio GURREA-MARTINEZ and GELTER, Martin. Addressing the auditor independence puzzle: Regulatory models and proposal for reform. (2019).
Available at: https://ink.library.smu.edu.sg/sol_research/3707

This Blog Post is brought to you for free and open access by the Yong Pung How School of Law at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Research Collection Yong Pung How School Of Law by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email cherylds@smu.edu.sg.

Addressing the Auditor Independence Puzzle: Regulatory Models and Proposal for Reform

By Martin Gelter and Aurelio Gurrea-Martínez

November 27, 2019

Auditors play a major role in corporate governance and capital markets. They facilitate firms' access to financing by creating trust among public investors with efforts to prevent misbehavior and financial fraud by corporate insiders. In order to fulfill these goals, however, in addition to having the adequate knowledge and expertise, auditors should perform their functions in an independent manner. Unfortunately, auditors are subject to conflicts of interest by, for example, providing non-audit services or the mere fact of being hired and paid by the audited company. Therefore, even if auditors act independently, investors have reason to think otherwise. This lack of trust can undermine a firm's access to financing and the development of capital markets.

Regulators have attempted to solve auditor independence issues through a variety of mechanisms, including prohibitions and rotations. Likewise, politicians and scholars have recently suggested new proposals to deal with this problem, including breaking up audit firms and empowering public investors.
In a recent paper, to be published in the *Vanderbilt Journal of Transnational Law*, we argue that all of the regulatory responses suggested in the literature have flaws. In our view, they either do not effectively reduce the auditor's conflicts of interest or do so at a very high cost for the audit profession that may undermine the quality of the auditor's work. For this reason, our paper suggests new strategies to solve the auditor independence puzzle.
We argue that three primary problems undermine the independence and credibility of auditors. First, in companies with controlling shareholders, the controller has a strong influence on the nomination and supervision of auditors. The controller can dominate the shareholder meeting and appoint the majority of the board and, therefore, the audit committee. As a result, the ability (or at least credibility) of auditors to effectively monitor corporate insiders is undermined.

Second, our paper challenges the traditional gatekeeper and quasi-rent models used to explain why auditors may have incentives to conduct audits thoroughly and independently. We argue that both models do not sufficiently take into account the internal agency problems *within* an audit firm. While reputational benefits can be enjoyed by both audit partners and audit firms, most of the costs generated by an accounting scandal are borne exclusively by the audit firm, because audit partners can often move to positions elsewhere. For this and a number of other reasons, they do not have strong incentives to monitor their peers. Moreover, since misbehavior by audit firms does not seem to lead to strong market sanctions (audit firms are still hired even if they are punished for breaking the law, as many cases have shown), except in severe financial

scandals such as the one involving Enron, audit firms do not have strong incentives to implement internal policies to prevent misbehavior.

Finally, our paper discusses how the provision of non-audit services may undermine the independence and credibility of auditors. First, the provision of non-audit services may increase the economic dependency of auditors on their clients. Second, the possibility of providing future professional services may skew their work, at least in the minds of public investors. Finally, a variety of non-audit services, including certain types of tax and consultancy work, can create problems of "self-review", that is, a situation in which auditors may need to review their own work, due to the impact of certain professional services (e.g., valuation, tax) on the company´s financial statements. Moreover, as the auditor would act independently for the interest of public investors when acting as an auditor, but it would act in the exclusive interest of the client when acting as a consultant, the existence of these "two hats" may create more severe problems for the credibility and independence of auditors.

Our paper suggests several recommendations to enhance the independence of auditors. First, we argue that, in the context of controlled firms, auditors should be elected with a majority-of-the-minority vote. Second, while auditors in many jurisdictions are subject to certain temporal prohibitions to be hired by previous clients, we believe that the length of these temporal prohibitions should be extended. Moreover, regulators should also restrict the type of services potentially provided to the audit client. Third, policymakers must pay closer attention to the internal governance and compensation systems of audit firms. We argue that increased transparency of audit firms is essential to enhance the independence of auditors. Finally, recent empirical studies have shown that audit committees seem to fail to perform their monitoring functions. In our opinion, this is due to the influence of corporate insiders on the audit committee. For this reason, we propose to increase the power and presence of public investors in the audit committee.

This post comes to us from professors Martin Gelter at Fordham University School of Law and Aurelio Gurrea-Martínez at Singapore Management University School of Law. It is based on their recent article, "Addressing the Auditor Independence Puzzle: Regulatory Models and Proposal for Reform," available here.