Book Review of *Disruption in the Audit Market: The Future of the Big Four*, *Financial Failures & Scandals: From Enron to Carillion,* and *The Future of Auditing*

Abstract

This article provides a concise review of the three books, *Disruption in the Audit Market: The Future of the Big Four* (ISBN: 978-0367-220-66-2), *Financial Failures & Scandals: From Enron to Carillion* (ISBN 978-036-7220-73-0), by Prof. Krish Bhaskar and Prof. John Flower, together with Mr. Rod Sellers, and *The Future of Auditing* (ISBN: 978-0367-220-66-2) by Prof. David Hay.

Introduction

In this review, I discuss the books, *Disruption in the Audit Market: The Future of the Big Four*, *Financial Failures & Scandals: From Enron to Carillion*, by Prof. Krish Bhaskar and Prof. John Flower, together with Mr. Rod Sellers, and *The Future of Auditing*, by Prof. David Hay. The three books share a common theme, the future of auditing and financial reporting. The two books by Bhaskar, Flower, and Seller, which make up the series, *Disruptions in Financial Reporting and Auditing*, zero in on specific issues faced by the audit industry and regulators with a focus on the UK, and propose policy suggestions. *The Future of Auditing* focuses on the economics behind the value of auditing, the opportunities and challenges facing the profession, and the future of auditing research.

All of the authors are notable in their respective fields. Prof. Bhaskar, the principal author of the series, was founding Prof. of Accounting at the University of East Anglia, UK, and previously held positions at the London School of Economics and the University of Bristol. He has published over 50 books and many peer-reviewed papers. He has also worked extensively in the IT, consulting, investment banking, automotive and forecasting sectors. Prof. Flower was formerly Prof. of Accounting at the University of Bristol and Director of the Centre for Research in European Accounting, Brussels prior to his retirement. He has extensive research experience in financial reporting and has published scholarly critiques and many radical books. Mr. Sellers, OBE, FCA, who likes to be regarded as a contributor to the series, has extensive experience in senior financial and corporate roles in the industry. Prof. Hay is Prof. in Auditing at the University of Auckland, New Zealand. Prof. Hay's contribution and dedication to auditing research have been immense. In 2017, Prof. Hay and his co-authors won the "Notable Contribution to the Auditing Literature Award" presented by the Auditing Section of the American Accounting Association. He is the Editor-in-Chief of the *International Journal of Auditing* and serves on the editorial board of many research journals. Prof. Hay has also had extensive professional auditing experience.

In the following sections, I discuss in more detail what each book contains, and their contributions at the end.

Disruption in the Audit Market: The Future of the Big Four

This book provides a critical examination of the state and future of the Big Four in the UK. The authors believe that change is necessary to address the expectation gap and the perception of deterioration in audit quality due to a lack of auditor independence and competition in the market.

The first chapter gives a brief introduction of the book and the team behind the series. Chapter 2 provides an overview of the accounting and auditing profession. Topics discussed include the changes to auditing in the UK around audit partner rotation, and the restrictions around non-audit services. The chapter also provides descriptive information about the top audit firms in the UK. Chapter 3 discusses the structure of the audit market, the Big Four's non-consensual collective behavior, and the struggles faced by the Big Four and other mid-tier audit firms. The authors then review various industry and academic evidence on the definition of audit quality and the relation between audit firm size and audit quality. The following 'quality axiom' is presented: 'size is important and is linked with higher quality audits.'

Chapter 4 starts by presenting the following quality axiom: 'higher audit quality is linked to shorter length of audit tenure.' The authors acknowledge the mixed evidence in the literature regarding auditor tenure and audit quality. In reaching this axiom, they rely on a study by Singer and Zhang (2018), which examines audit firm tenure and the timeliness of misstatement discovery in the Netherlands published in *The Accounting Review*. The chapter then discusses the effect of the requirement to name the engagement partner briefly, and what various parties think of the auditors in general. Finally, a description of the audit tendering process, and evidence on the determinants of winning an audit tender is presented. The authors conclude that the rapport and working relationship between the auditor and the client is the most influential factor in auditor selection, whereas price was not a major influence. They raise concerns about auditor independence and the exercise of skepticism as a result of the tendering process.

Chapter 5 is about disputes in auditing. It begins by discussing the mixed evidence on the association between competition (as measured by the number of firms competing) and audit quality. The authors suggest that their evaluation, accompanied by the opinions of various interested parties, favors the conclusion that 'greater competition leads to better audit quality', which is the quality axiom they reach. However, the authors do not discuss the theoretical arguments for the positive relationship between competition and audit quality. Given the lack of consensus in theoretical and empirical evidence, I think this remains a contentious question. The majority of the chapter then presents criticisms and opinions regarding the role of the FRC, citing the Kingman review and various financial journalists. The authors welcome the decision to replace the FRC with Audit Reporting and Governance Authority (ARGA), which will have more regulatory power to sanction and correct misconduct by auditors and companies.

Audit disruption from new digital technology is examined in chapter 6. The authors provide an in-depth discussion of the latest technological developments related to accounting and auditing, how they may affect accounting and auditing, and the issues to be considered in light of the new technologies. The authors present qualitative evidence that new technology-enabled analytic tools are effective at improving audit quality by increasing the accuracy of accounting estimates and the ability to identify real anomalies. My thought after reading this chapter is that for audit quality to improve, it will become more important for regulators to address auditor's incentives to report misstatements rather than their ability to discover them.

Chapters 7 to 9 are concerned with the dominance of the Big Four and evaluate the potential solutions to tackle the choice problem. Chapter 7 considers the survival of the Big Four under the status quo, and explores the options for breaking up the Big Four and their attendant difficulties. The authors do not see splitting up the Big Four to create more choice as a workable solution as it may have far-reaching consequences internationally. The authors also comment on the proposal of developing the mid-tier auditors and provide their suggestions. Chapter 8 offers further discussions on the options of splitting up, and considers additional options, such as the Big Four lending resources and expertise to mid-tier audit firms, and joint audit. The authors are negative about the initiative of the Big Four lending resources to mid-tier audit firms because they suggest it conflicts with the axiom about audit firm size and audit quality. However, if greater capabilities and competency is one channel that explains why audit quality is higher for larger audit firms, transferring the knowledge and expertise will likely improve audit quality of the mid-tier audit firms. It appears that the concepts of perceived and actual audit quality are muddled up in the discussions. In chapter 9, more radical solutions are explored.

In the final chapter, the authors provide a summary of findings and discuss their recommendations regarding the insufficient choice issue and the audit quality issue in more detail. The authors suggest a number of proposals that will likely improve audit quality as supported by theory and evidence, such as imposing litigation liability against auditors in the UK. The authors also note the challenges in implementing the suggested changes.

Financial Failures & Scandals: From Enron to Carillion

The central theme of this book is financial failures: how they happened, why they happened, what are their impact, and what we can learn from them, with a focus on the UK. The book is broken down into nine chapters, accompanied by additional online resources.

In chapter 2, the authors point out some developing trends in financial reporting, including the focus on non-financial information and forward-looking information, which are typically not independently assured and could be susceptible to misdirection. The chapter then describes the role of the financial reporting regulators in the UK, and comments on the review of the FRC by Sir John Kingman (2018). Chapter 3 provides a discussion of the differences between creative accounting, aggressive accounting and fraud, the typical methods of achieving them, and the motivation for such behavior.

Chapter 4 covers the earlier financial scandals, including the case of Lehman Brothers, Waste Management, WorldCom, Enron, Kanebo, the Gol, Connaught, and MG Rover. The authors suggest these failures are often to do with a lack of independence from the management by the audit partners and audit committee, and having excessively powerful executives with opportunistic incentives. In chapter 5, three more recent cases are discussed in detail: the Tesco scandal, the collapse of HBOS, and the acquisition of Autonomy by HP. The authors suggest that reform is necessary to strengthen the competency and independence of the audit committee, reduce the influence that management has over the appointment and remuneration of the external auditors, and impose tougher regulatory sanctions against those responsible. It is interesting to note that the recognition of commercial income, which led to the overstatement of profits at Tesco, was reported as an area of focus (critical/key audit matter, hereafter CAM) by Tesco's auditor. But its audit committee dismissed this concern in the audit committee report and in effect sided with the management.

The Carillion case is discussed in depth in chapters 6 and 7. Chapter 6 provides the timeline of events leading to its collapse, and analyzes the causes of its failure. Chapter 7 details the various parties to blame. The chapters contain a large selection of quotes from the Select Committee report on Carillion published by the House of Commons (2018). In analyzing the culprits of the Carillion failure, the authors point out that 'there is a constant danger of an audit committee accepting the management's viewpoint on contentious matters.' The recognition of contract revenue was one of the three CAMs reported by Carillion's external auditor in their audit report in 2016, three months before the announcement of its collapse. In regards to the three CAMs disclosed in the audit report, the authors make the following comment (page 86) – 'Since Carillion did not collapse due to problems with the leasing agreement or with goodwill, presumably KPMG made the right decision in these two cases. But they were wrong about revenue recognition. We think being right two times out of three was not good enough.' This, to me, highlights the problem of the expectation gap. I think the auditor was right in their decision to communicate contract revenue recognition as CAM, given the significant judgments and risks involved. The authors suggest that it would be more beneficial if auditors were required to express an opinion on each CAM, which is currently not mandated by the standards. The chapter ends by discussing the regulatory and social impact of the Carillion scandal. Chapter 8 is a short chapter exploring two relatively recent cases of financial failures (Steinhoff and Conviviality), and the causes of their problems.

In the final chapter, the authors conclude by suggesting that the system is broken, and radical reform is needed. In particular, they point out the need for harsher penalties for directors, greater transparency about auditors' discussion with the audit committee, and to expand the scope of audits to address the wider social interest that auditors serve.

The Future of Auditing

While the two volumes in the *Disruption in the Audit Market* series focus on the problems and challenges facing the audit industry, the *Future of Auditing* emphasizes the value of auditing and highlights opportunities for the auditing profession and researchers. The book is divided into four concise chapters. In chapter 1, the author provides a succinct overview, and briefly discusses how financial statement auditing offers economic benefits for the audited companies and the broader economy. The main section of the book is structured around three topics – the value of auditing (chapter 2), the future of auditing (chapter 3), and opportunities for auditing research (chapter 3).

Chapter 2 begins with a simple explanation of the benefits of third-party assurance using an analogy between buying a used car and investing in a company. It then explains that auditing of financial statements is more complex because of the various stakeholders involved and the ambiguity of financial information. The chapter is structured into five parts. Part A explains the value of auditing via several theoretical lenses, including the agency view, the signaling explanation, the management control and governance perspective, the confirmation theory, and a few others. The empirical evidence in support of each explanation is then discussed in part B.

These sections provide explanations and evidence for the voluntary demand for auditing. Part C of the chapter considers the regulation of auditing, and discusses the reasons for requiring mandatory audits for certain types of entity. Two sets of views are presented. The first relates to the economic theory of regulation, and suggests auditing is a public good that benefits many stakeholders and the economic development of a country. The alternative is the public choice explanation, which suggests regulators impose legislation as an attempt to shift blame in the event of audit-related controversies. The author notes that the trend of a continuous increase in audit regulation following audit failures over the last decades offers some support to the latter perspective. In part D of the chapter, the author discusses settings in which auditing is valuable but are less explored by researchers, such as audits in less developed countries, audits of private entities, and public sector audits. The chapter concludes with a discussion on the historical evidence on the value of auditing.

Chapter 3 sheds light on several megatrends that will likely affect the future of auditing. The trends and changes happening in the world (discussed in Part A), including the increase in longevity of the population, improved equality of income, climate change, globalization, advancement in technology, and unconventional political developments will likely affect the demand for and the nature of auditing in the future. Part B discusses the trends in accounting and auditing. There is a need for auditors to adapt to the changing environment and provide more relevant information. New forms of auditing, such as assurance of internal control, environmental auditing, privacy auditing, and combined assurance, are rapidly expanding. The author highlights the potential tradeoff between innovation in audit techniques and compliance with standards, as excessive compliance procedures could lead to inefficiencies and impaired auditor judgment. In light of the recent changes to audit reporting standards, the author gives an overview of the enhanced audit reporting requirements and the perspectives and evidence for and against this initiative.

It is widely accepted that technological advancements will significantly impact auditing. Part C of the chapter explores the effect of information technology and automation on the future of auditing. The author notes that although there is progress in adopting new audit technologies (e.g., using drones for stock take), the perception of the other stakeholders is that auditors are slow in taking up more sophisticated techniques. The barriers identified include the conservatism of regulators, and the reluctance of the Big 4 firms to change their status quo. In addition, there is a mix of views on the potential impact on the auditing industry brought about by the new technology, such as blockchain. As the author puts, ‘accountants and professional bodies are aware of impending changes in this area, but not necessarily aware of what to do.’

In Part D of the chapter, the author discusses issues around the globalization of auditing, including cross-border audit inspections, and reviews the academic research on cross-country audits. The author then provides a critical discussion on the trend of research-informed auditing standard-setting and the barriers in producing research that informs regulators faced by researchers. Finally, the appropriateness of the partnership model of audit firms is questioned in light of the higher demand for transparency and accountability of auditors. Drawing on the major trends discussed, several predictions around the future of auditing are made at the end.

In the final chapter, the author reflects on the critical issues for future research around audit quality, auditor independence, audit regulation, audit markets, governance, and auditing research about private companies. A large body of recent research findings is reviewed. Under-researched areas and unresolved issues requiring future research are discussed.

Discussion

The three books complement one another and provide a comprehensive examination of the future of audit and financial reporting, the future of the audit industry, and the future of auditing research. The two volumes of the *Disruptions in Financial Reporting and Auditing* series assess anecdotal views and events, and propose solutions to the current issues. The authors present a balanced analysis to reflect a variety of perspectives and opinions. The *Future of Auditing* focuses on the economic foundation of the value of auditing and audit regulations, drawing on theories and scientific evidence.

I agree with the authors that auditing will continue to be relevant, and some sort of reform is necessary to address the crisis of confidence the industry is facing. Auditor independence is one of the fundamental drivers of audit quality, and it is at risk under the current system where the auditor is appointed and rewarded by their client. With the advancements of audit technologies (which improve auditor capabilities), the independence issue will become more critical than the competency issue. In other words, regulators should work on auditor’s incentives to challenge the management and report on issues discovered. In the cases of Tesco and Carillion, the risk items that eventually led to the reporting failures were recognized by the auditors as they were disclosed as CAMs in the audit report. Despite this, the perception is that auditors failed to communicate and act on the extent of the risk appropriately and succumbed to management pressure. To establish independence, I favor the authors' proposal to cut off the money link between the auditor and the auditee, and reform the auditor appointment process, discussed in chapter 9 of *Disruption in the Audit Market*, although achieving this could be challenging.

Another issue that is discussed in all three books is that the scope and diversity of auditing should expand for the industry to stay relevant. What happened at Theranos, which I find very interesting and is briefly discussed in chapter 3 of *Financial Failures & Scandals*, highlights the importance of assurance services for private entities, of forward-looking and non-financial information. Audit services beyond the scope of traditional financial statement audits are developing. For example, there is a growing demand for the assurance of operating metrics following the financial scandal of Lurkin Coffee (Liu, 2020). These developments will likely help restore confidence in the industry and improve auditor accountability. As suggested in chapter 4 of *The Future of Auditing* (page 58), the new forms of auditing present an area that is less understood and 'offers tremendous potential for valuable future research,' which I thoroughly agree with.

Finally, while there is evidence that larger audit firms (the Big Four) are linked to higher audit quality, we know little about if non-Big Four audit firms with relatively less reputation capital and narrower international reach are able to deliver higher quality audits when they become similar in size to the Big Four. Relevant to the discussion of the three books, some recent developments in China are worth noting here. The Chinese audit market is characterized by having numerous non-Big Four competitors; some have grown in comparable size to the Big Four.[1] One example is Ruihua CPA, which had surpassed the size of EY and KPMG in 2013 through the merger of RSM and Crowe Horwath's membership firms in China. However, Ruihua was implicated in a number of financial scandals subsequent to the merger, including a recent high-profile failure, Kangde Xin Composite Material, which falsified profits of UDS 1.7 billion between 2015 and 2018 (Zhao, 2019). The audit firm has suffered severe reputation damage, and had their new initial public offering clients suspended by the securities regulator. In 2019, the number of listed clients of Ruihua was down to only 27, from over 300 clients in 2018 (Wang

[1] Prof. Paul Gillies (2014) in his book *The Big Four and the Development of the Accounting Profession in China* provides a detailed discussion on the development of the audit industry in China.

and Guo, 2019). An implication is perhaps that an increase in market share is not necessarily an indication of improvement in quality for non-Big Four audit firms, and it remains a challenge for large non-Big Four audit firms to build trust and reputation. These observations are in line with the comments on the idea of supporting the growth of mid-tier audit firms discussed in *Disruption in the Audit Market*.

Overall, these books are timely and highly relevant to the current developments in the auditing profession, and thought-provoking. The content would be of interest and informative to audit regulators, standard setters, researchers, students, and practitioners. I recommend these books to anyone who takes an interest in the auditing profession and auditing research.

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