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Whistle-blowing by external auditors: Seeking legitimacy for the South African Audit Profession?

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ABSTRACT

Auditing is often cited as playing an important role in managing agency-related costs and, accordingly, being integral to the sound functioning of capital markets. There may, however, be more to the attest function than a technical rational practice. By virtue of relying heavily on claims to technical expertise, professionalism, prudential judgement and public confidence, auditing is both a source of legitimacy for organisations and, paradoxically, dependent on claims to legitimacy for its continued existence. From this perspective, recent regulatory developments, purportedly enacted to increase arms-length control over the profession, may not only be about improving perceived audit quality and practice but also about ensuring continued faith in the well-established 'rituals' of the assurance function. A reporting duty imposed on South African external auditors, akin to whistle-blowing, is used as a case study to explore this perspective. In doing so, this paper contributes to the scant body of interpretive research on auditing, simultaneously offering one of the first insights into auditing regulation from an African perspective.

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1. Introduction²

In South Africa, in addition to the duty to express an opinion on a client's financial statements, the external auditor is obligated to bring reportable irregularities (RIs) to the attention of an independent regulatory body. This complementary reporting requirement has its genesis in the 1950s when the position was taken that the auditor owed a duty to society that necessitated doing more than just attesting to the fair presentation of financials (Nel, 2001). Following a number of international and local corporate failures, the reporting requirement was broadened and firmly entrenched as part of local audit practice, leaving South Africa among the few jurisdictions where auditors have, in effect, a wide-reaching duty to blow the whistle on client transgressions (Maroun & Gowar, in press; Nel, 2001; Opperman, 2009).

Claims to serving the public interest by mandating additional disclosures by auditors is fully consistent with the criticisms that traditional audit reports are overly technical, lack depth and are more concerned with the limitation of auditor liability than the provision of decision-useful information to stakeholders (European Commission, 2010; IAASB, 2012; King, 2012; Solomon, 2009). The reliance on external regulatory provisions for South African auditors is also in line with international trends that have seen the decline of self-regulation in favour of more arms length control of the profession post

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² Non standard abbreviations include: the Auditing Profession Act No. 26 of 2005 (APA); Public Accountants' and Auditors' Board (PAAB); Independent Regulatory Board for Auditors (IRBA); International Auditing and Assurance Standards Board (IAASB); International Financial Reporting Standards (IFRS); International Standards on Auditing (ISA); Reportable Irregularities (RI); South African Institute of Chartered Accountants (SAICA).

Enron et al. and in response to the global financial crisis (Malsch & Gendron, 2011; Tremblay & Gendron, 2011). From a rational economic perspective, added controls over the attest function are part of the process of improving audit quality, adding to the reliability of corporate reporting and lowering the cost of capital (Clinch, Stokes, & Zhu, 2012; Francis, 2004; Jensen & Meckling, 1976; Watts & Zimmerman, 1983). As an integral part of the capital market ethos there may, however, be more at work. With audit being paramount for the credibility of capital market systems, what the institutionalisation of external regulation may signal is the need to ensure continued trust in the assurance process (Malsch & Gendron, 2011). As explained by Giddens (1990, 1991) and Unerman and O'Dwyer (2004), at the heart of modern expert systems is an assumed confidence by users that these systems function soundly. Corporate debacles have the potential to undermine this, leading to widespread and reflexive withdrawal of trust threatening economic, social and political stability. Consequently, news laws and regulations may have an important role to play, not only in reforming audit practice in the name of efficient reporting, but in bolstering the legitimacy of the profession when trust in the expert system has been shaken.

In this context, this research uses detailed interviews with a sample of leading corporate governance experts to explore how a regulatory reporting duty imposed on South African auditors may be contributing to the perceived legitimacy of the audit profession. Most of the work on auditing has a positivist focus (Francis, Reichelt, & Wang, 2005; Lesage & Wechtler, 2012; Vakkur et al., 2010) with conventional research treating regulation as an exercise in applied economics and rational choice models (Cooper & Robson, 2006). This leaves a clear need for more interpretive studies that highlight complex social and institutional forces at work on auditing in real world settings (Humphrey, 2008; Khalifa, Sharma, Humphrey, & Robson, 2007; Power, 2003).³ While there have been some interpretive studies that shed light on the relevance of legitimacy in an audit context (Fogarty, Helan, & Knutson, 1991; Humphrey & Moizer, 1990; O'Dwyer, Owen, & Unerman, 2011; Power, 2003; Sikka, Puxty, Willmott, & Cooper, 1998) these are not without limitations. Although a sound theoretical framework is laid, in many instances a clear need for detailed contextual analysis remains (Humphrey, 2008). Often, the practical implementation of new regulatory requirements differs from intended effects and among functional sites, necessitating research on how regulation is interpreted and responded to, not only by regulatory bodies, but by audit firms and users of audit reports (Cooper & Robson, 2006). Myopia reiterates this need, with much of the prior interpretive work grounded in the USA or Europe. Studying South Africa's RI provides a relatively unique African perspective on audit reporting, shedding light on the operation of external regulation in a non Anglo-Saxon setting and simultaneously offering one of the first accounts on a mandatory reporting duty imposed on auditors (Brennan & Solomon, 2008; Cooper & Robson, 2006). In addition, by recognising the need for theoretical eclecticism a legitimacy-constructed view on the RI provisions offers an alternate account of the role of external regulation within the corporate governance paradigm, free of the confines of agency theory that has all too often been used to account for audit practice (Brennan & Solomon, 2008; Humphrey, 2008; Llewelyn, 2003). Finally, the research adds to the current debate on the role of external regulation and need for enhanced audit reporting at an international level, as well as in Africa's largest economy.

The remainder of this paper is organised as follows: Section 2 discusses legitimacy theory in brief and uses it to explain the shift from self to arms-length regulation of the audit profession. Section 3 elaborates on the method. Section 4 highlights how a relatively unique reporting duty imposed on the South African external auditor may be an important source of legitimacy for the South African Audit Profession. Section 5 concludes.

2. Theoretical framework and prior literature

Legitimacy is 'a generalised perception or assumption' that an organisation's actions resonate with a socially constructed value systems and are, thus, regarded as desirable or appropriate (Suchman, 1995, p. 574). The prior research identifies three 'sub-sets' of legitimacy. First, pragmatic legitimacy is rooted in an organisation's policies being perceived as valuable by constituents (exchange legitimacy) or responsive to their interests (influence legitimacy) (Ashforth & Gibbs, 1990; Fogarty, 1992; Meyer & Rowan, 1977; Suchman, 1995). To some extent, organisations may also achieve dispositional legitimacy by being personified as 'moral', 'trustworthy' or 'socially responsible' (Suchman, 1995). Pragmatic legitimacy is, however, based largely on 'self-regarding utility calculations' (Suchman, 1995, p. 585) and can often be won by using material rewards. Second, moral legitimacy transcends self-interest and emanates from being well placed within socially constructed value systems. Organisations are judged according to their accomplishments (consequential legitimacy), whether they are located in socially desirable sectors (structural legitimacy) and according to how they achieve their objectives (procedural legitimacy) (Meyer & Rowan, 1977; Suchman, 1995). Finally, an organisation may be accepted as valuable or trustworthy on the basis of generally accepted belief, or 'taken-for-grantedness' (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Powell, 2007; Suchman, 1995) giving rise of cognitive legitimacy. If an organisation's purpose is understood within a

³ There is a considerable body of work examining the effect of arms-length regulation on audit practice. This research, however, tends to rely on inferential testing often based on audit quality surrogates to reach conclusions on the effects of regulations, like SOX, on audit practice. For example, examining the effect of PCAOB inspections, Carcello et al. (2011) consider changes in firms' abnormal accrual balances while DeFond and Lennox (2011) examine how these quality inspections impact the propensity to modify audit reports on the basis of concerns about the going concern assumption. Similarly, Vakkur et al. (2010) and Bronson et al. (2011) rely on archival data to argue that SOX may have had unintended consequences.

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