

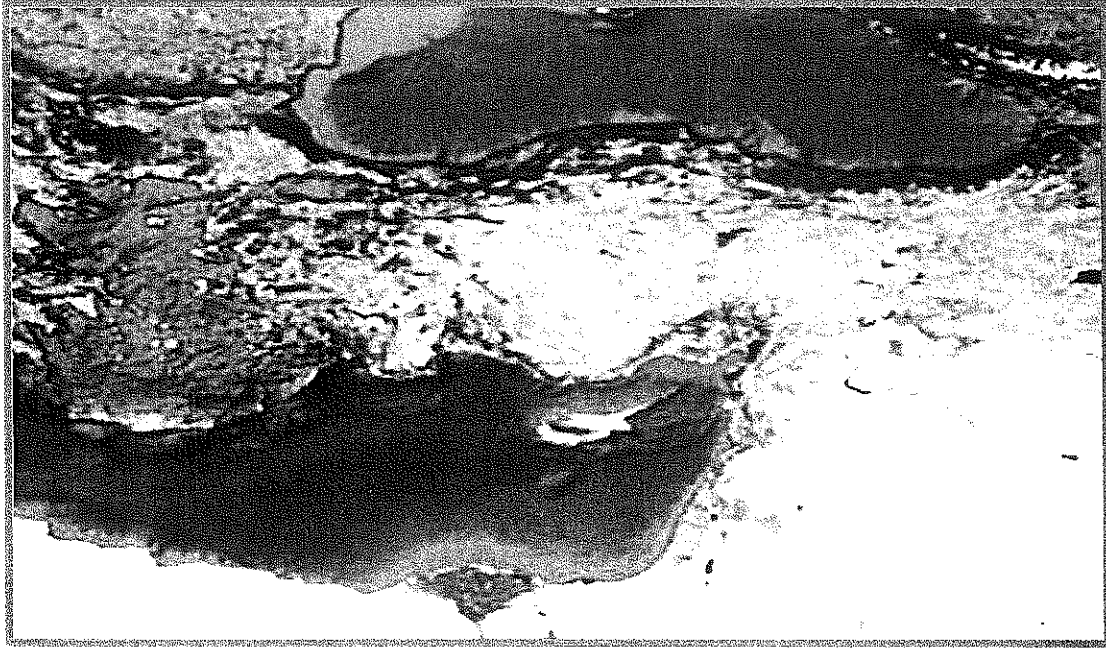
**III International Conference on
Luca Pacioli in Accounting History**

**III Balkans and Middle East Countries
Conference on Accounting and Accounting History**

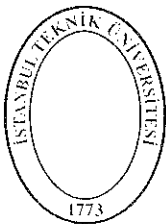
June 19-22, 2013 / Istanbul / Turkey

Conference Proceedings

Vol. III



Middle East



Spanish Association for Accounting
and Business Management

aeca

Accounting History Commission



TÜRMOB
TÜRKİYE SERBEST MUHASEBECİ MALİ MÜŞAVİRLER
VE YEMİNLİ MALİ MÜŞAVİRLER ODALARI BİRLİĞİ



ECONOMIC CRISES AND INDEPENDENT AUDITING SINCE THE 20TH CENTURY

Emre Ergin

Kocaeli University, Turkey

emre.ergin@kocaeli.edu.tr

Abstract

Do the economic crises improve independent auditing process or is auditing not properly designed to prevent crises? This article conducts a survey into the history of economic and financial crises, and other events that have been influencing the auditing profession which has changed enormously since the last century.

The second industrial revolution and scientific management emphasized the internal approach for the firms with the objective of efficiency and productivity. The great merger movement in the United States during 1895-1904 gave rise to giant enterprises from small manufacturing firms. This event turned proprietary management into executive management. The Great Depression of 1929 shifted the attention to external audit. This economic crisis was also the beginning of the debate of the executives and their compensation. Until 1934, businesses were not legally required to pass through an independent audit. The losses of the shareholders resulted in Securities Exchange Act in the United States which imposes independent audit of all the public trading companies. The independent audit has taken its roots in the 1929 economic crisis which is still remembered. The Asian economic crisis in 1997-1998 that spread to Russia, Brazil and Argentina draws attention to the need of corporate governance. The Enron case necessitated the introduction of the new auditing standards by the Sarbanes-Oxley Act.

This article aims to show the link between the economic crises and auditing through a historical perspective. The global as well as country-specific dimensions are explored. It is witnessed that the frequency and the magnitude of the economic crises increase in time. As seen in the last century, auditing has a reactive character than a proactive one. Thus, it would be wise to take additional measures for the future of independent auditing.

Key words: Economic Crises, Independent Auditing, Auditing Standards, 20th Century.

Introduction

Although the economic and financial crises can be traced back to the Roman Empire period, independent auditing mechanism has become mandatory for public companies only after the 1929 Great Depression. The recent 2008-2009 financial market crisis was the result of institutionalized fraud and financial manipulation the bailouts led to the largest transfer of money wealth in recorded history, and created an insurmountable public debt (Chossudovsky and Marshall, 2010, xvi). It seems that the lessons and warnings were not taken into account since the last century. For instance, Berle and Means (1932) argued that managers must be controlled in order to avoid losses. Moreover, according to Adam Smith (1937), managers cannot watch partner's money with the same vigilance with which partners watch over their own so the negligence and profusion, therefore, must always prevail in the management of affairs of a company. Yet, the crises persist, and they do not differentiate between poor and rich nations. Jorda, Schularick, and Taylor (2011, 345) identified 79 systemic financial crises in the 14 developed countries they studied in the past 140 years. Kaminsky and Reinhart (1999, 474) determined 102 crises for the period 1970-1995 including both industrial and

developing countries. Aggarwal (2003) studied the debt crisis since the 1800s, and pointed out to the difficulties to find a resolution between creditor and debtor when default or debt-rescheduling occur.

Modern crises consist mostly in private bank failures, private debt defaults, and sovereign debt defaults or debt restructuring. The mechanism was put in so forth to resolve the conflict of interest between shareholders and managers (Jensen and Meckling, 1976), and public and government (OECD, 2005). External oversight institutions, such as independent auditors, and their reports are one of the strong recommendations to solve this conflict. However, the widespread application and the effectiveness of auditing are problematic. In most of the countries, auditing is obligatory only for public companies. Auditing is not imperative for non-public, and small or medium-sized companies. Additionally, public institutions are free from independent auditing. There exists also an unwillingness to issue negative audit reports by being too conservative by the fear to create a turmoil for the company and the financial markets (Catanach, and Ragatz, 2010, 23). The growing use of management judgments and estimates in financial reporting enable them to create their own values and manage earnings, which make easily mislead auditors in their judgment (25).

This article aims to trace the historical evolution of independent auditing in respect to economic crises. The starting point of independent auditing is considered to be the aftermath of the 1929 Great Depression as it firstly became mandatory for firms. The economic and financial crises seem to shape the independent auditing profession through history. "Auditing" in this article refers to "independent auditing" unless specified otherwise.

1. Origin of the "Auditing" Term

The origin of the auditing term dates from the 1400s and comes from "audite" meaning the sense or act of hearing. The "audit" as a verb is attested from the 1950s, and referred to official examination of accounts which originally was an oral procedure (Merriam-Webster).

Some sources give evidence that economic events and activities were inspected on tablets in Babylon, agricultural production were controlled in order to calculate the tax on them during the period of pharaohs in Egypt, public organizations were established in order to audit the treasury of the Roman Empire. Control mechanisms were established by some European countries which participated in the organization of merchants during the trade in Silk Road (Hesap Uzmanları Derneği, 2004). For a long time, the auditing activities were applied as a method to maintain governmental accountancy. Governments were either interested in the control of its own activities or the proper collections of its receivables. The bankruptcy of the firms was not a primary concern as the suffering party was mostly the proprietors rather than the general public. During the first Industrial Revolution, auditing began its evolution into a field of fraud detection and financial accountability. Businesses led by owner-managers were interested by the examination of all the documents and possible fraudulent activities in their business. Auditing was solely the inspection of all vouchers for payments, especially the cash ones. The interested parties of the results of the examinations of the books were the proprietors. Nevertheless, these examples cannot be interpreted as auditing in the contemporary sense it is defined.

2. From Proprietors Management to Executive Management

The need for independent audit was not seen essential as the firms were directed for a long period by the proprietors who owned all or a majority percentage of the firm. Being on the

field, proprietors took the strategic and operational decisions, and not only managed but also supervised the business activities of their entities. Indeed, they were accomplishing the role of the internal control with their presence. During this period, the main concern of that era was efficiency and profitability. Hence, the first industrial revolution (1760-1840s) which began in Britain and spread to Western Europe and the United States witnessed a transition from hand production methods to manufacturing processes (iron, steam technologies and textile production). The second industrial revolution (1860-1914) was marked by mass production and the production line, especially in steel, railroads, electricity, and chemicals industries. The studies of Frederic Taylor, Henry Gantt, Henri Fayol and many other practitioners have contributed to management science which corresponds to this second industrial revolution period. This period has seen the emergence of big companies. Economy of scale was seen as an important strategy in order to decrease the costs per unit, and supply to the market which was hungry for purchase.

The second industrial revolution also changed management. The Great Merger Movement which was realized between 1895 and 1904, changed drastically the American manufacturing by the consolidation of small manufacturing firms into giant enterprises intended to dominate their industry. This merger necessitated a new form of management. Proprietors gave the authority to non-owner, salaried executives. The proprietary management transformed to executive management (Wells, 2010, 696). Owner-managers of the past took a passive role. They probably have not imagined their firms led by these professional executives who would see the worst economic crisis of the whole human history.

3. The Great Depression of the 1930s and the Start of the Mandatory Independent Audit

The owners who gave the management of their corporations to the non-owner salaried executives suffered brutally when the 1929 economic crisis hit the United States. This crisis had a worldwide negative effect on other developed countries where the industrial production was negative double digit percentage, and unemployment was more than 100% increase during the 1929-1932. Even the least affected Japan's economy shrank by 8% (Blum, Cameron, and Barnes, 1970, 885).

The losses of the shareholders, unemployed workers, shifted the attention to the independent auditing. Owners realized an increasing need to monitor the financial activities of their companies. The fraud prevention and accuracy of the results became equally important for the proprietors. On the other hand, state institutions realized that the firms should not only be controlled by internal forces but also by external and independent authorities. The survival of the firms were not only a problem of the firms themselves, but critical for the prosperity of the whole society. The independent audit was not legally obligatory until the 1929 Great Depression. In 1934, Securities Exchange Act in the United States imposed independent audit of all the public trading companies. This decision and date marked the beginning of the mandatory auditing which had already a voluntary auditing character.

The 1929 economic crisis was not just a turning point in terms of auditing for the United States. The German government struggled with national economic problems from World War I to the 1930s. Stock company and bank failures forced the acceptance of the 1931 Company Law, followed by the Presidential Decree, which has mandated annual audit for large public firms in Germany. As in the United States, economic crises made pressure for business reforms and legislation mandating audit in Germany (Harston, 1993, 139).

American Institute of Certified Public Accountants (AICPA) developed 10 generally accepted auditing standards (GAAS) in 1947, and the standards, with minor modifications, remained the same. These standards are not sufficiently specific to conduct an audit, but provide a framework so the interpretations can be provided (Arens and Loebbecke, 2000, 29).

4. Shift from Fraud to Materiality Concept

The concept of materiality was explicitly established by the seventh edition of Montgomery's Auditing in 1949. In 1950, the American Institute of Accountants included "analysis and review" to its list of auditing method. Especially the audit of income accounts should not be done by testing, but analyses and comparisons. In the early 1950s, sampling method was non-statistical which was based on the appraisal of risk (Matthews, 2006, 120-21). The outspread of the demand for auditors and the impracticability of detail testing of large accounts gave way to the development of the testing procedures. Auditors developed a way to statistically select samples as representative of the firm's overall performance. This was a less costly alternative to examining every case in detail, and it offered mutual benefits for the auditor and its client.

By the mid-1960s, statistical sampling was replaced by the second generation of audit approaches in the big US and UK audit firms: the systems approach of analytical auditing. This new approach spread quickly around the world both by the international auditing firms and by the existence of globally used textbooks such as Skinner and Anderson (1966), and Cooper (1966) (Jeppesen, 2010, 519).

5. 1980-1982 Economic Recession Followed by the Rise of Petroleum Prices in the 1970-1980s

The world has experienced new economic crises that stems from the rise of petroleum prices. In addition to the price competition of auditing firms during the 1980s (Saul, 1996, 133), the concentration in the global audit market where the Big Six audits 73% of the client base, accounting for 88% of the value worldwide (CIFAR, 1995) transformed auditors to businessmen. Auditing became a commodity among many others being marketed (Sikka and Willmott, 1995; Elliott, 1995, 120-121; Saul, 1996, 133). Auditors have adopted a risk focused approach in order to point to the area of companies where there are most vulnerable.

Risk assessment as a new concept in auditing appeared in the 1980s. Montgomery, in his 1985 edition, emphasized the primary importance in the audit strategy which was the auditor's assessment of overall audit risk (Sullivan et al., 1985, 203). Higson (1997, 206) affirms that most of the firms moved to a risk-based approach in the 1980s. The audit risk model focuses audit according to materiality and risk judgments, thus drastically reducing or omitting the areas of audit where the inherent risk of material errors is considered low and where the control risk is low. After analyzing the entity and its existing internal control, the auditor allocates a greater portion of its resources to the high-risk area of financial statements (Konrath, 2002, 7).

Following the heavy price competition of the late 1980s, the big audit firms in the beginning of the 1990s began to develop strategic approach (Davis, 1995; Jeppesen, 1998). The new approach focuses on the inherent risk and the control risk in order to warn management to put controls in place. With this strategy, the risk and hence the audit work is decreased (Jeppesen, 2010, 520).

6. 1997-1998 Asian Crisis and the Corporate Governance

Today's developed Asian countries had realized high growth rates and rapid industrialization between the early 1960s and 1990s. This success was admired by all other nations. However, the liberalization wave hit the Four Asian Tigers and the Tiger Cub Economies. This triggered a chain reaction and spilled over Russia in 1998, Brazil in 1999, Argentine in 2001, and in other Latin America countries. Economic crises have gained a systemic character. Crisis, either country-specific or regional, shakes the whole world economies. Globalization and technology made all the economies vulnerable to a specific crisis.

One of the critics was the six largest international accounting firms which followed Asian local auditing standards and practices instead of internationally accepted ones. Auditors gave an unqualified report for many East Asian corporations and banks a few months before these companies faced "going concern" problems (Rahman, 1998, 47). 1997 Asian crisis has ameliorated auditing practices in most of the Asian countries. For instance, Korea agreed to upgrade accounting and disclosure standards to include audits of financial statements of large financial institutions, and semi-annual disclosure of nonperforming loans, capital adequacy in order to access to the International Monetary Fund emergency loans. However, auditing was not enough to prevent crises. Thus, the attention has shifted to corporate governance after the 1997 Asian Crisis. The insufficient corporate governance mechanisms in these countries revealed the weaknesses of the institutions in their economies. The need for corporate governance has been witnessed also during the first half of the 1990s when many CEOs have been dismissed, namely in IBM, Kodak, Honeywell, by their boards in the United States. OECD published the Principles of Corporate Governance in 1999, and revised the principles in 2004. These are the most consequential guidelines on corporate governance. Most of the countries developed their codes based on the OECD guidelines. Based on the OECD guidelines, more than 20 national corporate governance codes along with other international organizations and private sector associations created the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting to generate their Guidance on Good Practices in Corporate Governance Disclosure. This internationally agreed benchmark consists of disclosure items across five broad categories, auditing being one of them. The others are board and management structure and process, corporate responsibility and compliance, financial transparency and information disclosure, and ownership structure and exercise of control rights. The works for the corporate governance fostered the auditing process.

The OECD disclosure and transparency principle of corporate governance emphasis on external annual audit should be conducted by a competent and qualified independent auditor in order to provide an objective assurance to the board and shareholders so that the financial statements fairly represent the financial position and performance of the company in all material respects. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit (OECD, 2004, 22). The vast adoption of OECD corporate governance principles by countries influenced the companies to have a positive attitude towards them. Some institutions began to assess ratings on corporate governance to firms. These ratings are seen as an adherence to corporate governance and a competitive advantage in the market.

7. Enron-Arthur Andersen and Sarbanes-Oxley Act

A crisis of confidence emerged towards auditors when the energy giant Enron filed for bankruptcy at the end of 2001. \$100bn was claimed as revenue by means of institutional and systematic accounting fraud. The scandal caused the dissolution of its auditor Arthur Andersen, one of the big accounting companies. The Andersen had other improper audits, such as Waste Management, Sunbeam, the Baptist Foundation of Arizona, and WorldCom. The bankruptcy of WorldCom, which quickly surpassed Enron as the biggest bankruptcy in history (the record is held by Lehman Brothers and Washington Mutual in 2008) led to a domino effect of accounting and like corporate scandals. These scandals cost investors billions of dollars and eroded public confidence.

In order to restore trust in the corporate and auditing system, the Sarbanes-Oxley Act of 2002, also known as the "Public Company Accounting Reform and Investor Protection Act" and "Corporate and Auditing Accountability and Responsibility Act" was enacted as a reaction to corporate and accounting scandals. The act set new or enhanced standards for all public company boards, management, and public accounting firms in the United States. The act obliged top management to certify the accuracy of financial information, put severe penalties for fraudulent financial activity, and increased the independence of the external auditors. The Public Company Accounting Oversight Board, or PCAOB, is formed to oversee, regulate, inspect and discipline accounting firms in their roles as auditors of public companies. The act covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. For instance, new auditor approval requirements, audit partner rotation, and restriction for auditing companies to provide non-audit services for the same clients were new issues in the auditing process. Similar laws have been enacted in other countries, namely in Japan, Germany, France, Italy, Australia, Israel, India, South Africa, and Turkey.

8. The Great Recession of 2007-2008 and Fair-Value Accounting

Many of the large institutions had invested in risky securities that lost drastically their value with the deflation of housing bubbles in the United States and Europe. Efforts to rescue investment bank Bear Stearns and others could not be sustained when others such as the Lehman Brothers lined up. This valuation, the application of the fair value concept, was one of the reasons of this crisis. The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157: Fair Value Measurements in September 2006 to provide guidance about how entities should determine fair value estimations for financial reporting purposes. The legal liabilities of global accounting firms (Big Four) was reduced while the effectiveness of the independent auditor's report has been diminished by the move to fair-value reporting (Catanach and Ragatz, 2010, 25). Standard setters require extensive disclosures of fair values by how they are derived. However, historical costs for these fair-value assets are not reported. Thus, there is a risk of overstatement by the management that can persuade the auditor. Additionally, the auditor may rely wrongly on the valuation of his expert. This disclosure will make a meaningful and lasting contribution to improving financial reporting transparency and ethical business decision making.

9. IFAC and ISAs

The accounting and auditing practices set mostly by AICPA in the United States were taken as a reference for most of the countries. In Europe and in other parts of the world, countries had their own principles, and even companies had their own guidance for accounting,

reporting, and auditing. Globalization of accounting started when the International Federation of Accountants (IFAC) was founded in 1977 in Germany, at the 11th World Congress of Accountants. Beginning with 63 founding members from 51 countries, IFAC's membership has grown to now include 173 members and associates in 129 countries and jurisdictions worldwide.

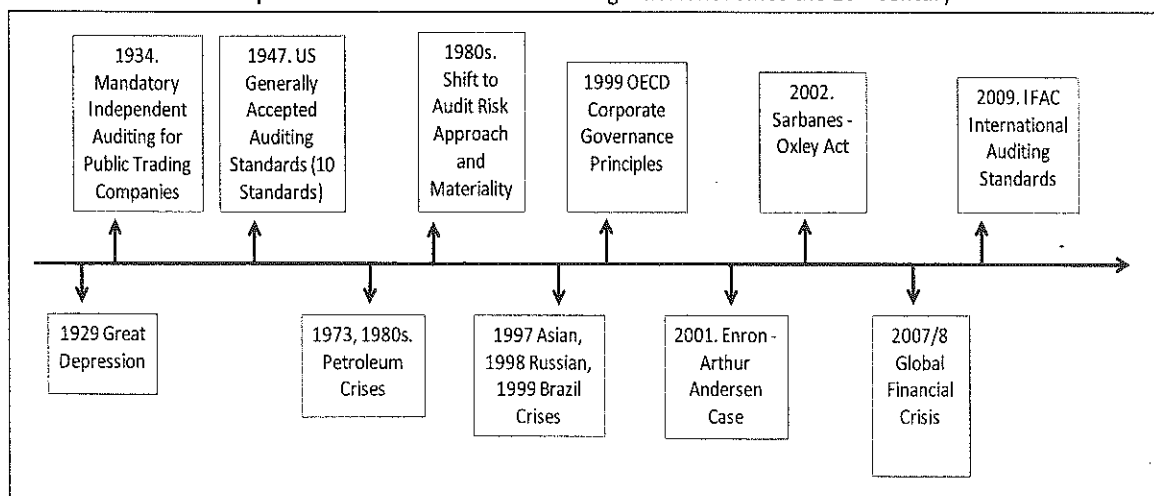
IFAC was established to strengthen the worldwide accountancy profession in the public interest by developing high-quality international standards in auditing and assurance, public sector accounting, and ethics. It serves as the international spokesperson for the accountancy profession.

One year later in 1978, International Auditing Practices Committee (IAPC) was founded. The IAPC's initial work focused on three areas: object and scope of audits of financial statements, engagement letters, and general auditing guidelines. In 1991, the IAPC's guidelines were recodified as International Standards on Auditing (ISAs). In 2001, a comprehensive review of the IAPC was undertaken. In 2002, the IAPC was reconstituted as the International Auditing and Assurance Standards Board (IAASB) as is known today. In 2003, IFAC approved a series of reforms designed, among other things, to further strengthen its standard-setting processes, including those of the IAASB, so that they are responsive to the public interest. In 2004, the IAASB began the Clarity Project, a comprehensive program to enhance the clarity of its ISAs. This program involved the application of new conventions to all ISAs, either as part of a substantive revision or through a limited redrafting to reflect the new conventions and matters of clarity generally. IFAC has published the International Auditing Standards in 2009 to be effective for audits of financial statements for periods beginning on or after December 15, 2009.

Conclusion

The economic crises are not a new phenomenon. The 1998 collapse of Long-Term Capital Management, the 2000 dot-com bubble, the 2005 housing bubble, and the recent financial market crisis have accumulated losses during the last decade alone. The frequencies and magnitudes of the crises seem to increase. Graphic 1 shows some major global economic crises and other events that affected the auditing process since the last century.

Graphic 1. Economic Crises and Auditing Milestones Since the 20th Century



Auditing process has evolved from a detailed audit (inspection and verification of all vouchers in order to report mainly to proprietors), to analytical approach, system approach,

risk approach, and strategic approach. Today, management estimates, fair-value calculations, auditor's materiality level, proper risk assessment are the critical, and now more subjective factors for reaching the auditor's opinion. Although the financial reporting disclosures are very detailed, the standard reporting is usually a very short one. Most of the time, it is very difficult for an average person to understand the report and all the disclosures are related to financial statements. On the other hand, the nature and volume of the businesses have become more complicated than ever. All the efforts to prevent economic crises showed that crises are persistent and unpredictable. It would necessitate auditors to become specialized in business types and industries in order to understand the economic activities of their clients better. It seems that the economic and financial crises will continue to structure the auditing profession.

References

- Aggarwal, V.K. The Evolution of Debt Crises: Origins, Management and Policy Lessons. In *Sovereign Debt: Origins, Crises and Restructuring*, Aggarwal, V.K. and Granville, B. (Eds.). Royal Institute for International Affairs/Chatham House (2003). 11-35.
- Arens, A.A. and Loebbecke, J.K. *Auditing: an Integrated Approach*, 8th Ed., New Jersey: Prentice Hall International, 2000.
- Berle, A.A. and Means, G.C. *The Modern Corporation and Private Property*. New Brunswick, N.J., USA: Transactions Publishers, 1932.
- Blum, Jerome, Cameron, Rondo and Barnes, Thomas G. *The European World: a History*. Little, Brown, 1970.
- Catanach, Anthony H. and Ragatz, Julie Anne. "2008 Market Crisis: Black Swan, Perfect Storm or Tipping Point?," *Bank Accounting and Finance*, (April-May 2010), 20-26.
- CIFAR. *International Accounting and Auditing Trends*, Vol. II, 4th ed. Princeton: CIFAR Publications, (1995)
- Cooper, V. R. *Manual of Auditing*. London: Gee & Co., 1966.
- Chossudovsky, Michel and Marshall, A. Gavin. *The Global Economic Crisis: The Great Depression of the XXI Century*. Canada: Global Research Publishers, 2010.
- Davis, Roger. "Time may be ripe for a "fourth generation" audit," *Financial Times*, (10 August 1995), 22.
- Elliott, Robert K. "The future of assurance services: implications for academia," *Accounting Horizons*, 9:4 (1995), 118-127.
- Harston, Mary A. "The German Accounting Profession – 1931 and Before: A Reflection of National Ideologies," *The Accounting Historians Journal*, 20:2 (1993), 139-162.
- Hesap Uzmanları Derneği. *Denetim İlke ve Esasları*. Yıldız Ofset, İstanbul, 2004.
- Higson, Andrew. *Developments in Audit Approach: From Audit Efficiency to Audit Effectiveness*, in Sherer, M. and Turley, Stuart (Eds.), *Current Issues in Auditing*, London: Sage Publication, 2005. 198-215
- Jensen, M. and Meckling, W.H. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3(1976), 305-360.
- Jeppesen, Kim Klarskov. "Reinventing Auditing, Redefining Consulting and Independence," *European Accounting Review*, 7:3 (1998), 517-539.
- Jorda, O., Schularick, M. and Taylor, A.M. "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons," *IMF Economic Review*, 59:2 (2011), 340-378.
- Kaminsky, Graciela and Reinhart, Carmen M. "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems," *The American Economic Review*, 89:3 (1999), 473-500.
- Rahman, M. Zubaidur. "The role of accounting in the East Asian financial crisis: lessons learned," *UNCTAD Transnational Corporations*, 7:3 (1998), 1-52.

- Konrath, L.F. Auditing: a Risk Analysis Approach, 5th Ed., Canada: South-Western, 2002.
- Matthews, Derek. A History of Auditing: The Changing Audit Process in Britain From the Nineteenth Century to the Present. New York: Routledge, 2006.
- Merriam-Webster. An Encyclopedia Britannica Company. www.merriam-webster.com/dictionary/auditing
- Munro, Eileen. "The Impact of Audit on Social Work Practice," *British Journal of Social Work*, 34 (2004), 1075-1095.
- OECD. OECD Guidelines for Managing Conflict of Interest in the Public Service. France: OECD Publications Service, 2003.
- OECD. OECD Principles of Corporate Governance. France: OECD Publications Service, 2004.
- Saul, Ralph S. "What ails the accounting profession?," *Accounting Horizons*, 10:2 (1996), 131-137.
- Sikka, Prem and Willmott, Hugh. "The power of independence: defending and extending the jurisdiction of accounting in the United Kingdom," *Accounting, Organizations and Society*, 20:6 (1995), 547-581.
- Skinner, R. M. and Anderson, R. J. *Analytical Auditing: An Outline of the Flow Chart Approach to Audits*. Canada: Sir Isaac Pitman Ltd., 1966.
- Smith, A. *An Inquiry into the Nature and Causes of the Wealth of Nations*. New York: The Modern Library, 1937.
- Sullivan, J.R., Gnospelius, R., Defliese, P. and Jaeniski, H. *Montgomery's Auditing*, 10th ed. New York: Ronald Press, 1985.
- Wells, H. "No Man Can Be Worth \$1,000,000 a Year: the Fight Over Executive Compensation in 1930s America," *University of Richmond Law Review*, 44 (2010), 689-769.