THE OBJECT OF AUDITOR-CLIENT'S RELATIONSHIP A THEORETICAL APPROACH

Măgdaș Nicolae[1] ORCID: 0000-0001-6595-468X

Abstract: *The need of focusing the questionnaire upon the auditor-client relationship was revealed taking into consideration the fact that the relationship between auditor-client is of high significance and was cited by CFOs as one of the most critical interpersonal factors affecting the negotiation. The auditor-client relation is where the economic and legal domains meet and interact, determining together the way interactions unfold. The audit contract not only defines the object, length, price and conditions of the audit mission through its binding legal power towards the parties, but also determines the rights and obligations for both the auditor and the client. The aim of this paper was to analyze the role of professional bodies and to present the UK perspective about the new outcomes of the auditing market and regulatory area related to auditor client relationship. The results indicate that the big proportion of NAS generated incomes serves as a red flag for the risk of having this influence the independence of the auditors as the audit companies become more and more commercialistic and alternative services orientated.*

Keywords: auditor, client, relationship, UK, professional bodies

JEL classification: M40

Introduction

In the current context of the constantly changing rules governing the world economic market, the information provided by economic actors is a very important point in making economic decisions at any level. The accelerated growth of the global economy as well as competition in all areas has the effect of increasing the need for credible and quality economic information. For decades, the audit profession has been troubled by changes and widespread controversy over issues such as the responsibility of auditors and their role in detecting fraud and error. This problem has reached unprecedented levels in the bankruptcies of well-known companies, such as Enron (Porter and Gowthorpe, 2004). Research on audit quality and audit reporting has a long history (Francis, 2011). This is not surprising, as audit quality is at the core of the audit market. The audit mission has no value if the public does not trust it (Maijoor & Vanstraelen, 2012). Given this context, the quantity and quality of economic information provided by companies, to all users of economic information has become one of the most important points for healthy and lasting economic development.

During the audit process, the relation developed between auditor and client is complex, involving many aspects and being governed by a negotiation (Antle & Nalebuff, 1991; Gibbins et al., 2001; Sanchez et al., 2007; Salterio, 2012) related to the auditor's findings and the audit report. This is of key importance because it threatens the core of the auditing profession itself, the reliability of the information provided by the auditor. If this can be a subject of negotiation and, as a result, information can be hidden and not disclosed by the auditor, then we can truly state that the object of negotiation is the auditor's independence itself (Azmi & Hoong, 2014; Azmi & Voon, 2016).

The literature uses different terms to express the auditor-client relationship, due to its complex nature, some authors prefer to use auditor-client relationship, interaction or management relationship,

[1] Babeș - Bolyai University of Cluj - Napoca, Faculty of Economics and Business Administration, 58 - 60 Th. Mihali Street, Cluj - Napoca 400591, Romania, nicolae.magdas@econ.ubbcluj.ro
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others more direct and focused on a specific area are using the terms auditor-client negotiation, realignments or disagreements, or even audit-client tenure (Ghosh&Moon, 2005; McCracken et al., 2008; Brown & Wright,2008; Kleinman et al.,2010; Ye et al.2011; Svanberg & Öhman, 2016; Grant, et al.,2018).

In an auditing process, based on a juridical contract, between the external auditor and client management, according to with the literature intervene a negotiation concerning the client's financial reporting, having several material accounting and disclosure implications, and frequently arose due to the unclear regulations. Nearly all negotiations resulted in an agreement and were followed by the reappointment of the auditor (Gibbins et al., 2001).

Research methodology

The applied approach is deduction, which starts by reviewing current theory (Bryman, 2011; Saunders et al., 2012). For deduction there needs to be existing theory, in this case, it is true enough, meaning that the literature is not extensive on the subject as a whole but enough to be able to logically make the connections needed for the creation of our research questions. Another reason for choosing deduction is that our interest lies more in explaining the relationship and consider that this is the best choice for the current research.

Our strategy of research consists in providing a concentric analysis of the auditor-client relationship, from the outside perspective and until we reach the core elements and the negotiation procces that might occur regarding the oppinion and other elements of the audit report among with the factors and contextual features that could influence the relationship and negotiaton procces, as well as it's outcome.

The role of accounting professional bodies

As in every profession, accounting and auditing sector also need professional bodies in order to generate regulations and enforce them. This need is for achieving the main scope of maintaining a reliable and trust providing profession for the economic and business environment.

There are several professional bodies enstated at EU level and different ones enforced at national level which are different from one country to another.

Professional bodies - EU level

Member States of the European Union are legally obliged to adopt and implement the regulations that are aproved at European level such as Directives and Regulations. The international regulations are completed by the regulations issued in the European Union by the regulating bodies, the European Parliament, the European Council and also, the European Commission.

- *Committee of European Auditing Oversight Bodies* - enforced at European level (EC, 2016), with the role supervising auditing activity, it replaces the former supervision body, the European Group of Auditors Oversight Bodies and it is composed of representative from the national audit oversight bodies which exist at EU level on one hand, and from the European Securities and Market Authority.
- *Audit Regulatory Committee* - it has in it's member structure representatives from all European Member States and it's primary role is directly linked to the European Commission's activity, which it assits in the proccess of implementing audit regulation measures.

Professional bodies - National level (Romania)

- *Body of Expert and Licensed Accountants in Romania (CECCAR)* - founded in 1921, it is now one of the strongest and biggest professional accounting body in South-East Region of Europe, having more than 40000 members. Due to globalization and international colaborations, CECCAR has joined both International Federation of Accountants (IFAC) and Federation of European Accountants (FEE). CECCAR has actively contributed to the harmonisation of national regulations to the ones enforced by the European Commission, by adapting the the European regulations to the national context.

- *Public Oversight Authority for Statutory Audit (ASPAAS)* - starting with 2017, it is the authority empowered by law to regulate the statutory audit activity and also supervise both financial auditors and entity. It is a public institution functioning under the supervision of the Ministry of Finance. It's board is composed of six various and non-practitioners members as follows: a representative of the Ministry of Finance, a representative of the CAFR, a representative of the Ministry of Justice, a representative of the Authority for Financial Services, a representative of the Romanian National Bank, a representative of the Romanian Trading Chamber. The key activities developed by ASPAAS acording to the Organisation of the Public Oversight of the Audit Profession in Europe Survey developed by Accountancy Europe in March 2018, are: approval and registration of statutory auditors and audit firms, quality assurance system, adoption of relevant standards, investigative and administrative disciplinary system and continuing education. ASPAAS has the possibility, of which it has already disposed, to delegate, for a period of maximum 5 years with reneval possibility, some of the attributions to the existing professional body CAFR. As for the main objectives of ASPAAS, some of the most important ones are: increasing the professionalism of financial auditors and audit firms, increasing the quality of the statutory audit, oversight in the public interest of the statutory audit activity, ensuring the effectiveness of its own activities in the field of statutory audit, according to the requirements of the EU regulations and other regulations in the field, according to the previous mentioned survey.
- *Chamber of Financial Auditors in Romania (CAFR)* - founded in 1999, it is the competent authority in charge of regulating and conducting monitoring activities upon the conduct of financial audit activities carried out in Romania, excepting the statutory audit. The first major action adopted by CAFR was to adopt two major international regulations as a steppingstone for financial auditing in Romania: the International Standards for Audit (ISA) and the Framework for International Standards for Auditing through RO OUG 75/1999. One of the main activities that are given on behalf of CAFR by the law are: enforces quality controls for its members, conducts and oversees the continous professional formation programme for its members, at request it can remove the quality of a financial auditor for a member or a company, proposes regulation changes, represents the Romanian audit proffesion at international level.

The view of UK for the new outcomes of the auditing market and regulatory area

Since 2007, financial markets crisis has brought up to the light that in order to ensure proper-functioning framework in the internal market there are several issues that should serve as starting ground, issues regarding financial reporting and the supervision of financial institutions on the one hand and auditing on the other hand. An audit, in conjunction with both satisfactory supervision and corporate governance, can add towards the companies' financial health by assuring higher financial stability in their reports (European Commission [EC], 2015).

Certain events that occurred in the past, for example, the demise of Arthur Andersen as a consequence of the Enron case, have developed in the economy much scepticism, and a handful of globally known audit firms (the Big 4) are accessible to carry out their audits on big complex institutions. Therefore, the possibility of having one of these audit firms collapsing would directly impact upon the investors' trust and confidence without adding the gruesome impacts it would have on the whole financial stability (EC, 2015).

Additionally, there are also audit committee functioning in companies applying corporate governance which, even though are not professional bodies, do help in easing the communication between company's management (working based on the applied corporate governance code) and the external auditors (that have to comply with regulations issued by government and above mentioned professional bodies). UK, made some consistent recommendation starting even with the Code of Best Practice that has been applied by listed companies beginning with 1993. The recommendations target the manner in which the company and it's shareholders interact with the auditors, stating that the audit committee, as a linkage between the two parties ought to:

- check financial reports prior to proposal to the full board;
- certify satisfactory resources for the internal audit function and establishment of that function with the external auditors;
- appoint and assess the remuneration of the external auditors;
- debate the findings of the audit with the external auditors (Beattie et. al., 2001).

Of course, the audit committee, provided it functions at adequate parameters could help management in dealing with various issues that could arrise. Moreover, reserach shows correlation between higher quality in functioning of audit committee and the assurance that the company processes and finds solutions for whistle-blowing disclosures through the means of internal channels (Lee&Fargher, 2018). The audit committee is a well-settled body in some of the companies and needs to properly interact with the management in order to reach it's goals. In order to do so, the audit committee needs to have a representative to carry out the discussions with the management. Even though most of literature does not distinguish between audit committee's members and the chair, they do have different roles, responsabilities and required set of skills. The audit committee's chair has to manifest, in addition to the financial and accounting knowledge, also leadership and communication skils through his activity multiply interacting with leading company memebers (Khemakhem&Fontaine, 2019). The audit committee's role in a company is of major importance as o functioning body of the company, but it's memebers could not work isolated from other company members in achieving their objectives. There certain limitations in effectively exercising their function in overseeing fraudulent financial reporting, limitations such as proffesional or social ties as well as governance characteristics. Out of these, social ties to the CEO are the one that, like in the case of external auditor's independence, are negatively linked to audit committee actions in evaluating the risk of fraudulent financial reporting and management integrity (Wilbanks et. al., 2017). As stated before, audit committee does interact in their work woth other company members or bodies to succesfully evaluate and assess. Audit committee relies, for assessing the above mentioned risks, mostly on the CFO and the head of internal audit in case of company's internal members, and on the external audit partner as an independent source (Wilbanks et. al., 2017). To conclude on this matter, the role of audit committee can not be overseen as it is of major importance from assessment and communication perspective.

Considering that UK has a well developed auditing sector and market, we also focused on the new outcomes of the auditing market and regulatory area related to auditor client relationship.

A report of UK Parliament's Committee reveals the proportion of the incomes generated by audit services for the major auditing companies in the UK, out of their total fee incomes for 2017 (Fig.no 1). What needs to be noticed is the unbalanced report among the audit services and non-audit services as income generators. The big proportion of NAS generated incomes serves as a red flag for the risk of having this influence the independence of the auditors as the audit companies become more and more commercialistic and alternative services orientated.

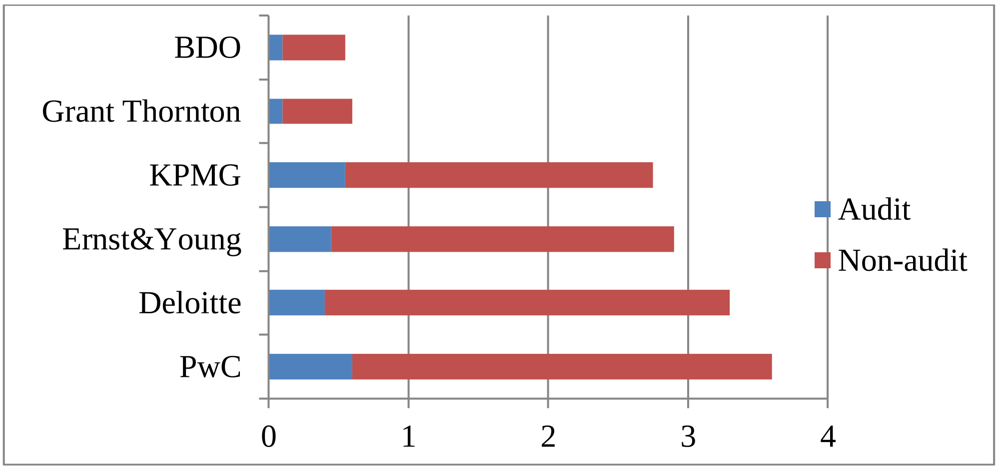

Fig. no. 11 Earnings of the largest accountancy firms in the UK
*UK fee income, 2017 (£bn)
Source: UK Parlament House of Commons Library

Moreover, the committee discovered that 50% of the last five years conducted audits at Deloitte and PwC have finally surpassed with more than 10% the originally budgeted costs. Out of these audits with consistent cost overruns, there was a negotiation conducted by the Big Four over an expanded payment in 60 to 83% of the cases (Table no. 1). Deloitte has supplementary stated that in only 24% of cases had the overrun been fully covered by the increase.

Table no. 1 Negotiated increased fee

	KPMG	Deloitte	PwC	EY
>10 per cent cost overrun	16%	50%	50%	32%
Of those, negotiated increased fee	83%	80%	70%	60%

Source: letters from the Big Four to BEIS Committee Chair in answer to the questions posed in the Chair's letter dated 13th February 2019 (Note: where the yearly breakdown was provided, the average percentage was calculated)

The information from the Business, Energy and Industrial Strategy Committee also shades light upon the dominance of the Big Four (Figure 2) in the UK market as a particular case. The discrepancy among the Big Four and the closest situated rivals were emphasized by the announcement in November 2018 revealing the merger between BDO and Moore Stephens. This would have as a result them becoming the UK's fifth biggest audit firm. The report also shows that from a total fee income perspective, the merger between the sixth and tenth biggest audit firms would create a company not bigger than 30% of the size of KMPG, this being the smallest of the Big Four firms in the same terms.

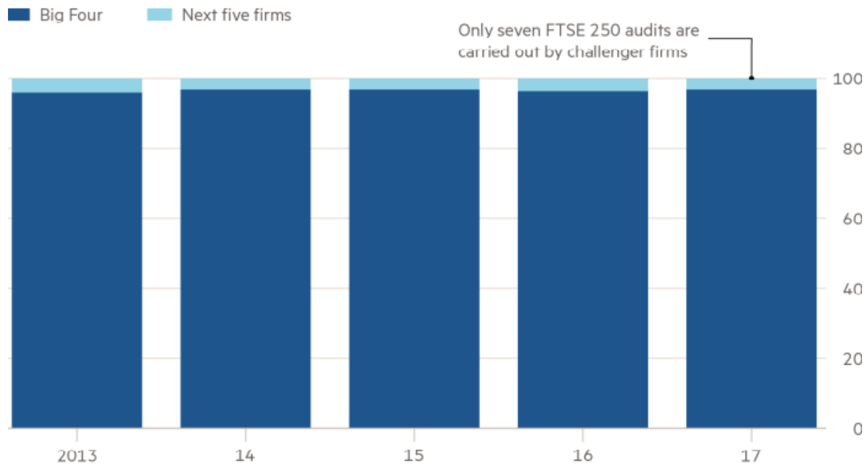

Fig.no. 2 Dominance of the Big Four in the UK
The concentration of FTSE 250 audits, 2017 (%share)
Source: FRC, 2017

Another fact that has been concluded by the Committee in the report is that once a company has been a Big Four client, it rarely switches to audit companies other than the Big Four. Moreover, when a company decides to shift from a challenger audit company, it absolutely always does that towards an audit company amongst the Big Four.

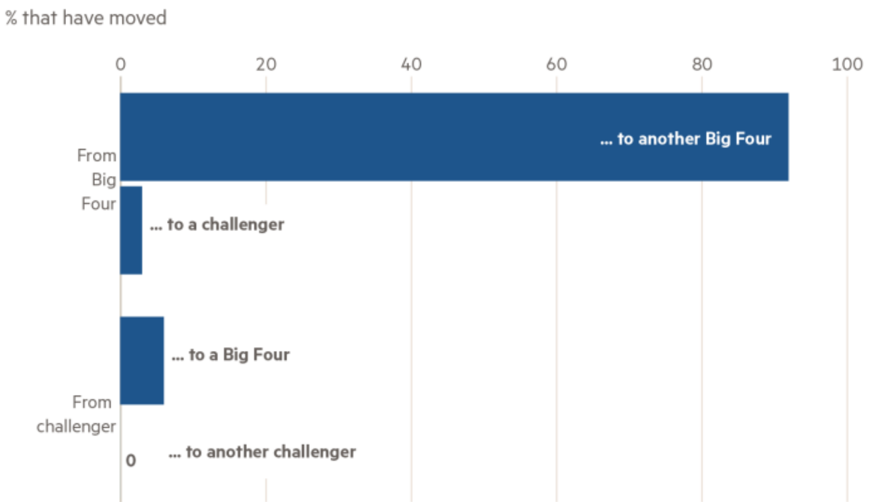

Fig.no. 33 Companies rarely switch to challenger audit firms
Source: CMA

As it is shown in Figure 3 the audit companies that control over 90% of UK's audits for large companies (PricewaterhouseCoopers, Deloitte, EY and KPMG) ought to, according to the Committee, make a "full legal separation" of their auditing and consultancy work. Based on a 100 page report from the Business, Energy and Industrial Strategy Committee UK lawmakers had offered guidance towards an absolute cap reported to the market share of the Big Four. Other suggestions also included preoccupations for senior company management's liability for mistakes in their financial reports.

"We are not confident in relying solely on the integrity of auditors to do the right thing in the face of conflicting interest," was stated by the committee in the report. "For the big firms, audits seem too often to be the route to milking the cash cow of consultancy business."(pWC, 2019).

As presented, the interactions between the audit and client and, as collateral influences, interactions with the shareholders, stakeholders, capital market, regulations and law enforcing organizations creates a very complex informational web. This can only be understood by a prior analysis of the types of relationships that are shaped and observed between the auditor and the client.

In order to regain confidence, as providing also accountancy and auditing services could raise questions regarding a potential conflict of interest, UK's regulating bodies have made further steps based on the perviously mentioned report. The major regulator of this industry, the Financial Reporting Council (FRC) gave a message to the Big - 4 companies that it has expectations regarding the separation of the auditing division from the rest of the company latest in 2024. "Operational separation of audit practices is one element of the FRC's strategy to improve the quality and effectiveness of corporate reporting and audit in the UK following the Kingman, CMA and Brydon reviews" was stated by the FRC chief executive, Sir Jon Thompson.

Moreover, UK has identified the need for better regulations and better enforcement in order to achieve the proposed goal of mainting and improving trust in the auditing profession and prevent other audit failures. Therefore, UK authorities have annouced the future replacement of the Financial Reporting Council (FRC) with a new watchdog, the Audit, Reporting and Governance Authority (ARGA), which will receive higher powers. The Audit, Reporting and Governance Authority (ARGA) will be able, through its legal powers, to request, without needing to take a previous court action, the auditors and the companies to resubmit their accounts. Therefore, we can conclude that UK represents a particular case from the regulations perspective as it tries to be one step forward in restoring confidence and enhance security in the business, economic and auditing environment by enforcing better regulations and oversight bodies along with the separation of auditing departments from the other services in case of Big-4 companies, which represent a genuine stepping stone in auditing regulating proccess.

Conclusions

Auditing has been a very valuable tool in economic markets since ancient times. This has emerged as an effect of increasing information users' distrust of existing information in increasingly large and effervescent markets. According to the literature, the validation of information presented in the financial statements with the help of an audit report provided by an independent auditor is a key point in the conduct of economic transactions, especially in regulated capital markets.

At the international level, the events of the early 2000s called into question the results of the audit profession, namely the Independent Auditor's Report and thus the regulatory bodies were forced to take steps to correct them. The introduction of KAM - Key Audit matters through the International Audit Standard 701 is also a great advantage for shareholders but especially for investors as they can much better interpret the information provided in audit reports. Regarding the national economic environment, Romania made considerable efforts with the exit from the communist period in order to be able to develop at the level of the western states and tried to take over as much of the knowledge and regulations of the international professional bodies.

In conclusion, the audit and the audit report are a benchmark in the decision-making of both shareholders and potential investors. The independent auditor's report now provides more than ever firm assurance that the financial statements presented by the audited companies are in line with international standards as well as local benchmarks and country laws. The issuance of financial statements audited by independent financial auditors is also a criterion for listing on the global capital markets.

One of the goals of this research is to provides starting point for future empirical research in auditing negotiation. There is room for further investigation as there is evidence that auditors and client management (in United Kingdom) do tend to agree in a major degree upon the topics the negotiation would tackle, such as financial disclosure, fees, or disclosure. This suggest that negotiation among auditors and clients is a well acknowledged practice that more likely to evolve than to disappear, constantly raising new challenges for all involved parties. As mentioned before, auditor-client relation is a continuously transforming organism that is partially analyzed by our study, which opens the grounds for future developments and research.

The length and the quality of the relationship are a good indicator on how the negotiation will proceed and, on what model explains and predicts it better, taking into consideration other contextual factors. On a longer relationship certain condition may be preset such as having each party a more fixed and firm position regarding its role in their overtime interaction with the other party. No matter the negotiation model applied, one of the recognized factors to influence auditors' performing in negotiation is energy.

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