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GUARDING THE GUARDIANS  
ESSAYS ON AUDIT REGULATION

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GUARDING THE GUARDIANS  
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I confirm that Hansrudi Lenz and Markus Grottke contributed to chapter 4. Hansrudi Lenz contributed to this chapter by providing written comments on the versions of June 2015, August 2015 and November 2015, by conducting linguistic changes to the versions of August 2015 and November 2015 to enhance their readability and by revising the paragraph on the comparison of the regulatory trends in the U.K., Canada and the US.

Markus Grottke contributed to this chapter by developing and writing the theoretical framework, by conducting and analysing seven interviews, by revising the introductory section and writing the discussion sector, by providing written comments on the versions of April 2015, June 2015, August 2015 and November 2015, and by implementing linguistic changes to the versions of August 2015 and November 2015 to enhance their readability.

**Statement of use of third party for editorial help**

I confirm that the thesis was proof-read by Andrew Cartwright and Neil Jackson to correct language, spelling and grammar mistakes.



To Adele, who has always been there.





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“The regulation of auditing oscillates between concerns about the limits of state intervention and of self-regulation.”  
(Rogowski, 1994, p. 19)

## Introduction

### The Politics of Auditing

Financial reporting and auditing are vital elements of global capital markets. While financial reporting, by providing corporate disclosures and financial statements, enables investors and stakeholders to make decisions on to how best to allocate their capital, auditing ensures that the information is accurate and reliable and that it faithfully represents the state of the enterprise. The belief in the market’s efficiency is bolstered, in particular, by the trust placed in auditing being able to operate as an external monitoring function, something that has led to the audit profession being perceived as the “guardians of truth in markets” (Volcker, 2002). However, concerns over these guardians’ responsibilities, and over their trustworthiness, are raised on a regular basis every time it transpires, in the face of serious accounting scandals, that the profession has failed to meet societal expectations.<sup>1</sup> On this view, audit regulation is a direct response to emerging distrust in the audit profession in order to preserve the public’s belief in the role and mission of financial auditing (Guenin-Paracini & Gendron, 2010; Power, 1993, 2003).

To begin with, audit regulation is centred on the discussion, development and implementation of audit standards. These standards are principle-focused and provide a framework for performing and promoting financial auditing. Moreover, it is concerned with mechanisms designed to ensure that these standards are applied in practice with the aid of a bundle of monitoring and enforcement processes.<sup>2</sup> Finally, and at the heart of audit regulation, there are those questions that centre on the changing relationships between the profession and the state, on the limits of self-regulation and on the role played by state actors in the configuration and organization of auditing (Puxty, Willmott, & Lowe, 1987; Robson, Willmott, Cooper, & Puxty, 1994) – debates that are heavily influenced by the profession’s demand for regulation *by* the profession, in preference to regulation *of* the profession.

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<sup>1</sup>In the accounting literature, the value and purpose of the statutory audit is discussed in the context of the so-called “audit expectations gap” debate, which refers to the discrepancy between actual audit practices and the perceptions harboured by those stakeholder on whose behalf auditing is being carried out (e.g. Bui & Porter, 2010; Humphrey, Turley, & Moizer, 1992; Porter, 1993; Power, 1993).

<sup>2</sup> It is important to emphasize that audit regulation should not be confused with accounting regulation, as the latter encompasses not just audit regulation, but, financial reporting regulations, too.

Self-regulation has traditionally been seen as epitomizing the hallmark of professional services and procedures. It asserts the independence of the professions' technical practices from socio-political "interferences" by the state or by other actors and has fed the reputational base of the "profession" by signifying and confirming its integrity and its expertise (Robson et al., 1994). Yet in the last decade, the pendulum has swung away from self-regulation towards state actors playing a more active role, a trend that was initiated at the beginning of this century, when the detection of massive accounting frauds and of seriously manipulated financial statements at Enron, WorldCom and other U.S. major companies severely put the public's belief in financial markets in general and in auditing in particular to the test. As early as the 1970s and 1980s, the collapses of large U.S. companies resulted in questions being raised over the profession's ability to regulate itself properly (Federal Committee, 1976, p. 22), but these audit failures were successfully "particularised" with a view to preserving financial self-regulation. The events surrounding Enron, however, brought the debate to a new level. At Enron alone, investors lost approximately \$67 billion, and they lost a further \$161 billion at WorldCom, and the U.S. stock exchange dropped by more than 22 percent within just six months (Humphrey & Loft, 2011), at a time when the U.S. economy was in any case already turning down. An outcry from the public for the political actors to "do something" (Mulford & Comiskey, 2011, p. 423) put legislators under pressure, particularly as the U.S. midterm elections were about to take place (Romano, 2004). Faced by this political and economic tsunami, Congress passed the Sarbanes-Oxley Act (SOX) in July 2002. The legislation represents a turning point in audit regulation, as it replaced 30 years of self-regulation by profession-independent oversight under the Public Company Accounting Oversight Board (PCAOB). Having been treated for decades as something that was sacrosanct, fiercely protected and safeguarded not just by the profession, but by state actors, too, self-regulation suddenly turned into something that jeopardized the stability and integrity of financial markets. This regulatory volte-face in the U.S. was observed somewhat sceptically on the old continent.

Although in various European countries, debate over the external quality assurance provided by auditing began to emerge as an issue in audit regulation in the 1990s, there was general consensus that ensuring audit quality was the core element of professional self-regulation. Europe's strong emphasis on substance over form, in contrast to the allegedly more legalistic, rule-bound traditions seen in U.S. financial reporting, in combination with the high educational standards that statutory auditors were perceived to have, were felt to constitute barriers that would prevent any European version of Enron from happening. However, serious accounting scandals in Italy (Parmalat), Denmark (Nordisk Fjer) and in the Netherlands (Ahold), demonstrated the need for serious reflection on audit regulation in Europe (Humphrey, Loft, & Woods, 2009). Eventually, in 2006, the European Union revised the regulatory framework on statutory auditing, thus responding not just to these national incidents of accounting fraud, but also to pressure from

U.S. legislators, who did not believe that the European framework was sufficiently rigorous. The new Directive on the auditing of company accounts specified the requirements for external quality assurance and required Member States to introduce “public oversight” into their national regulatory frameworks. Although, the focus of the national oversight entities lies on the audit practices at the national level, their emergence is a key element in broader trends at a global level.

In response to major economic turbulence in the mid-1990s, such as the devaluation of the peso in Mexico 1994 and the financial crisis in Asia in 1997, international organizations such as the European Union, the World Bank, the International Organization of Securities Commissions or the Financial Stability Board both supported and strategically mandated the establishment of a new international financial architecture. The logic underlying the new regulatory dogma was based on an orientation to global capital markets, with the global use of standardized market valuation practices being perceived to be necessary for financial stakeholders and for a rapidly globalizing economy alike (Bengtsson, 2011; Perry & Nölke, 2005). The objective was to stabilise globally integrated financial markets by diffusing universal standards and global codes of conduct (Humphrey et al., 2009; Wade, 2007a). From this perspective, the emergence of audit oversight entities on the local level is one visible outcome of a move away from a doctrine that wants to “liberalize the market” towards one that wants to “standardize the market” so as to safeguard and to bolster confidence in the quality of financial reporting and globalized financial markets (Wade, 2007b). As a result of this global regulatory trend, the notion of independent oversight over statutory auditors emerged, within one decade, to become a pivotal instrument for tackling perennial problems with corporate financial reporting and auditing; today, audit oversight constitutes an essential feature of audit regulation.

The implementation of audit oversight regulation in the local context shapes, changes and destabilises the institutions in which accounting and the audit profession had traditionally been embedded. It is the interplay of tensions created by this institutional umbrella that informs the four studies constituting this PhD thesis. In a nutshell, the first chapter of this thesis sheds light on the U.S. historical causes behind the current global regulatory structures and assesses, on the basis of an analysis of research findings, the shift from self-regulation to regulation independent of the profession. Based on a cross-country research approach, the second chapter offers insights into how “independent” oversight regulation has been understood and implemented by European Member countries. In the third chapter, the local institutional struggles that inevitably accompany such institutional shifts are unveiled and analysed by re-reading the implementation and development of the German oversight system from a critical qualitative research perspective. The fourth chapter reveals the side-effects of regulation and practices that are increasingly aligned with international demands and it outlines the intra-professional conflicts between large



accounting firms operating on a global scale, on the one hand, and small, local firms, on the other hand.

*Chapter 1: What do we know, and what is lacking? – the shift from self-regulation to public oversight in the U.S.*

By reviewing and synthesising 30 years of research on U.S. audit regulation, the first chapter of this thesis assesses the extent to which the shift from self-regulation to government regulation can be supported through research. To this end, the literature on the former self-regulatory peer-review system under the aegis of the American Institute of Certified Public Accountants (AICPA) and the literature on the current PCAOB system are analysed, categorised and contrasted through a framework drawn from regulation literature. In this way, the study outlines whether peer reviews and inspections produce valid results, whether these results are considered in financial decision-making, and, ultimately, whether conclusions can be drawn on the impact exercised by the two approaches to audit regulation on audit quality. As such, the study extends prior assessments of the regulation of public company auditing in the U.S. (Abernathy, Barnes, & Stefaniak, 2013; Glover, Prawitt, & Taylor, 2009; Kinney, 2005; Palmrose, 2013), as it is only the direct analytical comparison of self-regulation and regulation carried out independently of the profession that makes it possible for conclusions to be drawn as to the legitimacy of the institutional change from self-regulation to public audit oversight.

As outlined above, once public audit oversight had been established in the U.S., regulators around the globe emulated the forms and practices set up by the PCAOB in order to monitor financial auditing and to enhance their own legitimacy. The outcome of this powerful demonstration of coercive and mimetic isomorphism (DiMaggio & Powell, 1983) forms the focus of the second chapter.

*Chapter 2: Same but different – the diffusion of a European audit oversight system*

By analysing, measuring, and comparing the independence of the audit oversight systems used in all the European member states, the second chapter highlights how the European member states have translated the concept of “independence” into regulatory outcomes. The concept of “regulatory independence” is operationalized on the basis on public policy research. The results are visualized by a Partial Order Scalogram Analysis (POSAC), which allows us to draw conclusions about the similarities exhibited by various countries and about their relative levels of independence. In revealing the strong interrelations between regulators and the audit profession in a whole multitude of countries, the results challenge the notion of “independent” audit regulation.

The reason for regulatory divergence is that regulatory changes take place within a tangled web of multifaceted and intertwined national, cultural and politico-economic institutions (Ordelheide, 2004; Puxty et al., 1987).<sup>3</sup> Regulatory reforms and changes involve the multiple combinations and varied power settings made up by public, private and societal actors. They constitute the “intervening variable” in the adaptation process, shaping the scope and extent of national responses to exogenous regulatory dynamics (Blavoukos, Caramanis, & Dedoulis, 2013, p. 142; see also Lodge, 2000). As a result of the clientelist political system in Greece, for instance, the local audit regulator “has failed to come to a decisional point in the flow of influence, power, and policy in the realm of accounting” (Caramanis, Dedoulis, & Leventis, 2015, p. 26).<sup>4</sup> The impact of the German politico-economic intervening variable in the process of establishing audit oversight mechanisms is the focus of the third chapter of this thesis.

*Chapter 3: Chance to remain the same – the establishment of German audit oversight*

Studies on German audit oversight structures generally revolve on the question of *how* the audit regulation is designed, implemented or organised (Baker, Quick, & Mikol, 2001; Gabor, 2005; Keller & Schlüter, 2003; Köhler, Marten, Quick, & Ruhnke, 2008; Marten, 2001; Marten & Köhler, 2000, 2005; Marten, Köhler, & Meyer, 2003; Niehus, 2000; Paulitschek, 2009). By contrast, this chapter focuses on the questions of *why* and *how* the German audit oversight system was established and developed in its specific way. The German counterpart to the PCAOB, the APAK, was initially established in the form of “embedded oversight”. In this kind of oversight system, which is a widespread phenomenon in audit regulation, committees that claim to embody genuine public representation oversee (private) accounting bodies (Loft, Humphrey, & Turley, 2006). The extent to which such a regulatory approach adheres to or alters the logic of self-regulation remains, however, an empirical question. Answers to this specific question and to the general interplay between the German audit profession, the regulators and the political actors are provided by blending Lawrence and Suddaby’s (2006) conceptualisation of institutional work.

Institutional work is a concept within new-institutional analysis. The main feature of the concept is that it relaxes the assumption of neo-institutional thinking that individuals or organizations are “cultural dopes” (Muzio, Brock, & Suddaby, 2013, p. 708) who are completely unaware of their institutional environment. Institutions are social-political structures that are deeply embedded in

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<sup>3</sup>The effect of country-specific factors was also identified in other accounting research areas. Studies on the degree to which accounting standards in different jurisdictions have been harmonised, for instance, have revealed the extent to which there has been an international divergence in financial reporting as a result of cultural traditions (Baydoun & Willett, 1995), socio-economic traditions (Nobes, 1990; Theunisse, 1994), legal traditions (Chung, Farrar, Puri, & Thorne, 2010; Evans & Nobes, 1998; La Porta, Lopez-De-Silanes, & Shleifer, 1998, 2006; La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997), political factors (Luther, 1996) or a combination of various factors (Salter, 1998; Saudagaran & Diga, 1997; Williams, 1999).

<sup>4</sup> It should be noted that the institutional settings exert influence on normative and coercive pressures. Ordelheide (1999, 2004) demonstrated that European Directives were least successful in harmonising accounting rules in those member states that have a long tradition of regulating accounting (Ordelheide, 1999, 2004).

time and space, maintained by rules and convictions, strong relations and entrenched resources (Scott, 2008). Neo-institutional theory is based on the assumption that organizations tend to comply with institutional pressures, and it focuses on explaining organizational homogeneity within institutional environments by identifying the mechanisms that determine organizational structure (e.g. DiMaggio & Powell, 1983). However, from the late 1980s onwards scholars began to criticize the lack of agency within institutional analysis, in particular, when institutional change rather than institutional stability was the object of the empirical analysis. Scholars began to focus on the possibility that actors might act intentionally to contribute to institutional change, and they documented the ability of actors holding key strategic positions or possessing other forms of power to make a significant contribution to preserving or, alternatively, disrupting existing institutions (DiMaggio, 1988; Fligstein, 1997; Greenwood, Hinings, & Suddaby, 2002; Holm, 1995; Meyer & Jepperson, 2000; Suddaby & Greenwood, 2005). Based on this development, Lawrence and Suddaby (Lawrence & Suddaby, 2006; Lawrence, Suddaby, & Leca, 2009) conceptualized a useful taxonomy of institutional work, which associates specific types of institutional work with institutional outcomes: institutional change, maintenance or disruption.

The German case is representative of both institutional continuity and institutional change, demonstrating how different actors are intertwined within the organizational field. The fluid German context lends itself particularly well to the concept of institutional work, as in this specific context actors are more likely to be fully aware of – and to become engaged in – acts of institutional agency (Muzio et al., 2013, p. 709). The analysis reveals how different actors were involved in parallel, but interlinked through multifarious dimensions of institutional work – with both intended and unintended institutional outcomes. It suggests the existence of a strategic allegiance between the professional institute and large audit firms, the “accounting establishment” (Durocher, Gendron, & Picard, 2014, p. 7), and political actors – one designed to preserve the self-regulatory logic of audit regulation. In addition, the rereading of trends in German oversight demonstrates the particular impact exerted by intra-professional dynamics on relations between the state and the profession and shows how professions can be both the mechanism for, and the primary target of, institutional change and transformation.

#### *Chapter 4: Side-effects of global regulations – The intra-professional conflicts in the German context*

The fourth chapter puts the intra-professional dynamics of the German audit profession under the microscope and illustrates a rare example of local resistance from small auditors against the accounting establishment. These intra-professional conflicts resulted from the major transformations that have been taking place in the audit profession over the last twenty years. The regulation of practices, rules, and accounting standards started to be relocated from national sites to a new, international regulatory environment. This setting is dominated by

internationally linked audit firms, which have transformed themselves into powerful international entities. Yet, the “new logics of post-professionalism” (Suddaby, Cooper, & Greenwood, 2007, p. 356), are accompanied by the strategic attempts by these firms to preserve the historical and economic privileges of a “profession” at the national level, because debates on the role, functioning and interpretation of the audit profession are particularly problematic for this segment of the profession: “Big firms can only exist as ‚great‘ firms because they are part of the same profession as small firms“ (Ramirez, 2013, p. 860). However, conflicts between large audit firms and small audit firms have always existed in the German history of auditing.

It was because the profession lacked any real cohesion that auditing became institutionalized comparatively late in Germany. In the 1920s, so-called book examiners, various professional groups, and audit firms controlled by banks had starkly diverging ideas on how the legal arrangements governing German accounting and audit regulation should be organised and institutionalised in detail (Evans, 2003; Harston, 1993). As a result, the state embarked on a course of active interference through which it introduced a statutory audit and formally established the profession of the public accountant (*Wirtschaftsprüfer*) (Gietzmann & Quick, 1998; Quick, 2005). In the following decades, the underlying tensions between different segments of the profession continued to simmer, though they were kept under control by the Institute of Public Auditors in Germany (IDW) and the Federal Chamber of Public Accountants (WPK) until the late 1990s. Starting from this date, the chapter offers a critical analysis of the micro-politics of the professional groups in Germany and outlines the multifarious economic and political factors, which led to the mobilisation of small- and medium-sized auditors that eventually culminated in the takeover of the Federal Chamber of Public Accountants. In this way, the chapter provides a counterweight to the vast volume of literature highlighting the national and international dominance enjoyed by the Big Four (e.g. Suddaby et al., 2007).

The conflicts are analysed through the lense of practice theory (Nicolini, 2012; Schatzki, 1996, 2001). The basic idea of practice theory is to understand phenomena such as power, language, social institutions and transformation as being the result of interacting fields of social practices and material arrangements. Practices are “sets of material activities that are fundamentally interpenetrated and shaped by broader cultural frameworks such as categories, classifications, frames, and other kinds of ordered belief systems.” (Lounsbury & Crumley, 2007, p. 996).

The perspective enables the identification of the differing practices pursued in the working environments of large audit firms, on the one hand, and small auditors, on the other. The study demonstrates the negative side effects bound to be produced by any system of standardized audit regulation that fails to differentiate between different segments of the profession.

From a methodological point of view, the third and the fourth chapters are both longitudinal qualitative critical case studies, which are based on a variety of data sources and triangulation research methodology (Denzin, 2009; Lincoln & Guba, 1985). From a theoretical perspective, both chapters share a multidimensional view of agency in which agency and structure are inextricably linked to each other. Both concepts, practice theory on the one hand, and institutional work on the other hand, aim to find more balance between methodological individualism and social determinism. In fact, in order to solve the “embedded agency paradox”, a term that refers to the old structure vs. agency debate in social sciences (Seo & Creed, 2002), scholars started to explicitly integrate elements of practice theory into neo-institutional thinking (DiMaggio & Powell, 1991). Both concepts therefore introduce both some degree of reflexivity about how actors engage with their institutional environment and an active capacity that has the potential to cause variation in institutionalized patterns of reproduction (Battilana, Leca, & Boxenbaum, 2009; Lawrence & Suddaby, 2006; Muzio, Brock, & Suddaby, 2013). The application of the concepts is based on a constructivist research approach that regards theory as a frame that helps to produce novelty in the understanding of previously unappreciated aspects of German audit regulation and to orient the research process in line with certain assumptions (Power & Gendron, 2015). Hence, the production of credible, trustworthy and interesting insights into audit regulation is the overall aim of both chapters.

Audit regulation is currently caught up, to a degree that has perhaps never been witnessed before, in an enormously dynamic process of fundamental change that are caused by multiple, interrelated trends. These include the transformation of domestic audit firms into powerful, international actors (Greenwood et al., 2002; Greenwood & Suddaby, 2002), the proclaimed death of traditional professional bodies (Cooper and Robson, 2006), the global diffusion of international standards (Botzem, 2010; Botzem & Quack, 2005) and the increasing importance of the international regulations laid down by both formal and informal organizations (Arnold, 2005; Humphrey et al., 2009; Humphrey & Moizer, 2008). Within this empirical environment, I hope that this thesis with the following four chapters can contribute to our understanding of audit regulation – both from a theoretical and from an empirical standpoint.

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“If accountants can’t solve their problems, someone will.”

(Congressman Jack Brooks in Larson, 1987, p. 118)

## Chapter 1

# Changing from self-regulation to public oversight: a literature review of 30 years of research on external quality assurance in the U.S.

### Abstract

This paper reviews empirical research of the past 30 years to assess and extend our knowledge of audit regulation. The traditional self-regulatory system of the U.S. accounting profession came to an end in 2002, when, the Public Company Accounting Oversight Board (PCAOB) was established to oversee the audits of publicly traded companies. This paper contributes to the controversial debate about the two concepts of external quality assurance – government oversight versus the profession’s self-regulation – by reviewing the academic literature about the former profession’s peer review system and the current PCAOB system. The research findings of the former self-regulatory peer-review system and the current PCAOB system are categorised and compared through a framework drawn from the literature on regulation. The ensuing analysis reveals that the introduction of peer reviews improved audit quality. However, when peer reviews became mandatory, review reports were neither recognised by decision makers nor perceived as instruments for signalling audit quality. Moreover, the analysis reveals how empirical studies demonstrate the PCAOB’s positive effect on audit quality yet the audit profession remains rather sceptical about the PCAOB’s effectiveness. Finally, the comparison identifies striking issues that have not undergone further research.<sup>5</sup>

**Keywords: external quality assurance, self-regulation, peer review, PCAOB inspection**

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<sup>5</sup> This chapter benefited from the feedback of William Messier, Brian Shapiro, Robert Day, Robert Kirsch, Sytse Duiverman, James Dalkin, and participants at the 2013 European Auditing Research Network Symposium (EARNet) in Trier, the 2014 American Accounting Association (AAA) Public Interest Section in San Diego, and the 2014 British Accounting and Finance Association (BAFA) Annual Conference in London.

## 1.1 Introduction

How can audit quality be enhanced and will this reassert public confidence in financial auditing? These are questions that frequently arise in discussions on how to react suitably to accounting manipulations. One course of action is to control the service quality of audit firms through external quality controls. Regulating quality assurance in the U.S. began in the 1980s when the American Institute of Certified Public Accountants (AICPA) initiated a voluntary peer-review programme (Sperry, Spede, & Hicks, 1987). A system of this kind subjects audit firms' quality control systems and audit engagements to an external review that is conducted by another professional audit firm. Peer review became mandatory in 1988 and remained, with some modifications, in operation until 2002. Then, however, corporate reporting went through a particular crisis when trust in financial reporting was undermined by a series of severe fraud scandals, which brought into question whether the self-regulatory system of the profession can adequately guarantee a high level of audit quality. As a direct result, Congress passed the Sarbanes-Oxley Act (SOX) in 2002, which replaced the traditional self-regulatory system of the accounting profession with a system of public oversight, making the SOX the most incisive corporate-governance legislation since the Securities Acts in the 1930s (Boster, 2007; Church & Shefchik, 2012; Humphrey, Moizer, & Turley, 2006). Although the Act led to a variety of fundamental changes in financial reporting (Kinney, 2005), the most important element was the introduction of mandatory governmental inspections.

This study focuses on research findings on the mode of external quality assurance in two regulatory regimes: the PCAOB's inspections and the peer reviews of the former self-regulatory regime.<sup>6</sup> External quality controls aim at assessing whether audit firms have developed appropriate quality control policies and procedures, and whether these are followed in practice in order to comply with professional accounting and auditing standards (Arens, Elder, & Beasley, 2011). Although quality assurance is only one element of the broader notion of audit regulation (Simnett & Smith, 2005, p. 47) it is argued that, in particular, the way a system of external quality control is organised, implemented, and overseen does have an effect on the degree to which the broader regulatory framework achieves its goal of protecting the interests of investors and the public (Carcello, Hollingsworth, & Mastrolia, 2011; Francis, Andrews, & Simon, 1990; Palmrose, 2013).<sup>7</sup> The importance of external quality control mechanisms is reflected in the post-SOX period, when many other countries reformed their legal system by introducing public oversight, including systems of profession-independent inspections (Canning & O'Dwyer, 2013; Caramanis,

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<sup>6</sup> The term "review" is used for quality assurance of the former AICPA self-regulatory system and the term "inspection" refers to the current PCAOB oversight system.

<sup>7</sup> Other elements are the educational system, the licensing, and registration of statutory auditors, as well as standard-setting or disciplinary systems, which can all either be organised within the accounting profession or under the control of a government agency.

Dedoulis, & Leventis, 2015; Hazgui & Gendron, 2015; Malsch & Gendron, 2011). Given the U.S. transition's significant influence on the organisation of auditing, on the local and global regulatory landscape, it is important to review the effects of the PCAOB and to assess whether the transition was successful and, if so, in which aspects. A better and holistic understanding of the different systems is necessary for further reforms and to decrease the risk of producing politically unintended and potentially dysfunctional consequences. This paper contributes to the controversial debate about the two concepts of external quality assurance—government oversight versus the profession's self-regulation—by reviewing the academic literature about the former profession's peer review system and the current PCAOB system. The purpose of this paper is to provide a comprehensive analysis and synthesis of empirical research on the external quality assurance mechanisms of U.S. audit firms. To this end, the study incorporates the findings on the former AICPA peer-review system and contrasts them with research results on the current PCAOB system. As such, the study extends prior assessments of the regulation of public company auditing in the U.S. (Abernathy, Barnes, & Stefaniak, 2013; Glover, Prawitt, & Taylor, 2009; Kinney, 2005; Palmrose, 2013), as only the direct analytical evaluation of the two regulatory regimes allows drawing conclusions about the legitimacy of the institutional change from self-regulation to public oversight.

The categorising of prior research findings is based on a framework that is derived from regulation literature. The framework serves as a benchmark for assessing the legitimacy of each of the two regulatory regimes in three ways: first, it analyses whether peer reviews and PCAOB inspections yield valid results; second, it considers whether peer reviews and inspection results were used in financial decision-making processes; third, the framework focuses on the impact of peer reviews and PCAOB inspections on the level of actual audit quality. Hence, the multiple findings of each research study were unbundled and arranged according to the three aspects of the developed framework. The sources of this study were articles in accredited journals and working papers. Relevant papers were identified by searching the databases (e.g. Business Source Premier, EBSCOhosts, Emerald Management eJournals, and Jstor databases) with the following keywords: peer reviews, self-regulation, AICPA, inspections, PCAOB, Public Company Accounting Oversight Board, and audit quality. In addition, the reference section of each study is reviewed to detect papers not identified during the initial database search.

The remainder of this paper is structured as follows. The next section outlines the framework for categorising the research findings and describes the historical development of external quality controls in the U.S. as principles, structures, and tendencies of audit regulation become clearer when viewed in their historical, economic, and political context. In the next two sections the research findings on peer review and on PCAOB inspections are separately analysed, followed by

a comparison in the subsequent section. This is followed by an outline of further research and concluding remarks.

## 1.2 Organising framework

To assess regulatory regimes, it is necessary to be clear about the relevant benchmark. In audit regulation there has never been much agreement concerning the assessment of mechanisms regulating the audit profession (e.g. Mautz, 1984). Disunity results, due to methodological and conceptual problems of identifying assessment measures as well as disputes on who should determine and define them (Arens et al., 2011; Sutton & Lampe, 1991). The benchmark for this paper is based on arguments from regulation literature that are presented when regulatory arrangements and performance are discussed, analysed and evaluated.

Baldwin et al. (2012) argue that five principles constitute the legitimacy of a regulatory regime. A legitimate regulatory regime must be validated and supported by a legislative mandate. The second principle refers to the accountability of the regulatory regime that has to be properly accountable to, and controlled by, democratic institutions. The third principle is that fair, accessible, and transparent procedures have to be guaranteed in terms of intra-organisational processes and with respect to those who are regulated. The fourth principle centres on the sufficient level of expertise and technical knowledge, which have to be incorporated in the regulatory regime. The last principle demands that a regulatory regime has to yield efficient outcomes. Although the five principles are fraught with difficulties, they constitute a set of benchmarks for assessing regulatory regimes.

The first two principles are not included in the analysis as they relate to the policy process, which established the specific regulatory regime. The study concentrates on the latter three criteria – the expertise, transparency, and efficiency principles – and applies them to the field of audit oversight regulation and external quality controls.

### *Regulatory expertise*

In the context of external audit assurance, the expertise principle is associated with the knowledge and proficiency of reviewers and inspectors. Expertise in the field of audit engagement has to be ensured to understand the underlying business environment processes, especially when financial estimates rest on complex and future-oriented uncertainties (Pecher, Solomon, & Trotman, 2013). However, in the field of financial auditing, the expertise principle is inextricably linked with the degree of independence and objectivity of the reviewers and

inspectors.<sup>8</sup> Paraphrasing DeAngelo (1981), reviewers and inspectors not only have to be able but also have to be willing to discover and report a breach in the audit firm's quality control system. It is no coincidence, therefore, that the literature on audit regulation argues that the change from self-regulation to government inspections represents a trade-off of expertise for independence (e.g. Carcello et al., 2011; DeFond, 2010; Palmrose, 2006). This trade-off arises from the perception of government regulators as being more independent than self-regulators but lacking in industry expertise (Bellovary & Mayhew, 2009; DeFond, 2010; Grumet, 2005). Expertise and independence are therefore of vital importance to determine the validity of external quality assurance processes. In other words, the judgments must be objective and based on reliable and valid information and justification.<sup>9</sup> Validity refers to the degree to which a measurement tool (i.e. reviews and inspections) measures what it claims to measure (i.e. audit quality). Based on these considerations, the first way in which the research studies are categorised is stated in the following research question:

RQ1: Do peer reviews and inspections lead to valid results?

Insights about the validity of peer reviews and PCAOB inspections were found in a variety of studies with various research approaches. Some studies have examined whether there is evidence for a relationship between reviewer characteristics and review findings (Colbert & Murray, 1998; Wallace, 1991), or whether review and inspection results are biased by the information advantage of reviewers and inspectors (Emby, Gelardi, & Lowe, 2002; O'Keefe, King, & Gaver, 1994). Other studies have drawn conclusions on the validity of the results from a comparison of peer review and PCAOB reports about the same firm (Anantharaman, 2012; Ragothaman, 2012). Moreover, the analysis of the responses of audit firms to reviews and inspection outcomes (Bishop, Hermanson, & Houston, 2013; Blankley, Kerr, & Wiggins, 2012; Church & Shefchik, 2012; Wallace & Cravens, 1994), or to surveys about the opinion on the external assurance processes (Daugherty & Tervo, 2010; Ehlen & Welker, 1996; Newman & Oliverio, 2010), allowed for conclusions about the validity of the system.

### *Regulatory transparency*

The transparency criterion leads to the second principle that concerns how the research findings are categorised. Research has shown that market participants reward companies that employ high-quality auditors (Barton, 2005; Knechel, Krishnan, Pevzner, & Stefchik, 2013). From this perspective, transparency relates to whether peer review and inspection reports allow market

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<sup>8</sup> Although the concepts of independence and objectivity have a substantial overlap, they cannot be used entirely synonymously. Whereas "independence" is more an organisational attribute, "objectivity" relates to the unbiased mental attitude of reviewers and inspectors.

<sup>9</sup> For the interconnection of "independence" and "regulatory expertise" in regulation theory see also Ottow (2015, pp. 1–13).

participants to draw conclusions on the service quality of the specific audit firms. This is based on the assumption that investors use the results of external quality controls as surrogates for the unobservable quality of financial statement in processes of financial-decision making. The literature on regulation suggests that transparent oversight aids the efficiency of supervision (Ottow, 2015, p. 12). By linking this argument to audit regulation, the recognition of review and inspections outcomes by market participants exerts pressure on the audit firm to improve audit quality based on the valid findings of the reviews and inspections. The second approach to categorisation is therefore stated as:

RQ2: Do financial markets recognise peer reviews and PCAOB reports as useful instruments for decision-making?

Empirical studies have shed light on this question by analysing the variability in audit fees (Francis et al., 1990; Giroux, Deis, & Bryan, 1995) and by examining the number of clients that the audit firm gained or lost (Daugherty, Dickins, & Tervo, 2011; Hilary & Lennox, 2005; Lennox & Pittman, 2010). Changes in those dependents are attributable to the market's reaction to peer review and PCAOB results. In other studies, questionnaires and surveys (Alam, Hoffman, & Meier, 2000; File, Ward, & Gray, 1992; Schneider & Ramsay, 2000; Woodlock & Claypool, 2001), or experimental designs (Payne, 2003; Robertson & Houston, 2010; Robertson, Stefaniak, & Houston, 2014; Wainberg, Kida, Piercey, & Smith, 2011) have been used to reveal whether financial experts recognise peer review and PCAOB results as being useful for decision-making. Common to all studies is that the analysis of the informative value of peer review and inspection results allows conclusions to be drawn on how the systems will be perceived to affect audit quality. It remains an open question whether peer reviews and inspections improve audit quality.

#### *Regulatory Outcomes*

Regulation must be able to meet the goals of regulation. Therefore, regulation literature defines regulatory efficiency as a condition for a legitimised regulatory regime. Efficiency is defined in terms of achieving given objectives at the lowest possible cost. However, so far, studies that incorporated the cost into their analysis do not exist in the field of audit regulation. Therefore, the third approach of the framework focuses on the effectiveness of the peer review system and the PCAOB inspection. This is in line with Ottow (2015), who uses the notion of effectiveness rather than efficiency as a principle that regulatory agencies in general have to fulfil (Ottow, 2015). From this understanding, a regulation is effective if it makes quantifiable improvements in the results concerned. The audit oversight's main objective is to maintain, respectively to improve audit quality. Thus, the third and final question is:

RQ3: Do peer reviews and inspections improve audit quality?



Empirical work on the association between external quality assurance and audit quality is hampered by the lack of observable measures of audit quality. In other words, much of the difficulty in assessing the external quality control instruments for improving audit quality is related to the “elusiveness of the concept itself” (Alam et al., 2000, p. 410). Nevertheless, conclusions about the effect of external quality controls on audit quality were identified in many research studies. Empirical work on the former peer-review system has applied alternative evaluation methods to assess whether reviewed firms provide higher audit quality than non-reviewed firms (Deis & Giroux, 1992; Krishnan & Schauer, 2000; O’Keefe et al., 1994; Rollins & Bremser, 1997). In contrast, research on the PCAOB inspections has used audit client-specific measures to evaluate the extent to which inspection contributes to audit quality (Abbott, Gunny, & Zhang, 2013; Carcello et al., 2011; Gramling, Krishnan, & Zhang, 2011; Gunny & Zhang, 2013; Offermanns & Peek, 2011). Other studies have researched the effect of inspection on the composition of the audit market (DeFond & Lennox, 2011), which allows conclusions about the general level of audit quality. Others have directly asked financial experts about the effect of peer reviews and PCAOB inspections on audit quality (Blankley et al., 2012; Daugherty & Tervo, 2010; Felix & Prawitt, 1993; McCabe, Luzi, & Brennan, 1993; Newman & Oliverio, 2010).

### **1.3 Background: development of U.S. audit regulation**

#### 1.3.1 The emergence of external quality controls

External quality control has been a central element in the debate on maintaining and enhancing audit quality, ever since in the 1960s, for the first time, questions about the performance, the credibility, and the role of audit firms began to rise (Zeff, 2003).<sup>10</sup> The collapse of large companies resulted in huge losses to their investors and heightened congressional concern for the safety of customer funds (Federal Committee, 1976a). As a result of several disciplinary actions by the Securities and Exchange Commission (SEC), large audit firms organised sporadic firm-on-firm reviews (Fogarty, 1996; Sperry et al., 1987). However, the debate about auditing came back in 1973 when detection of massive accounting frauds at Equity Funding and Penn Central Railroad brought the profession under serious attack by the U.S. Congress. For the first time, the profession’s legitimacy for self-regulation was heavily questioned. In particular, the investigations of two congressional subcommittees put the profession on the defence.

The Subcommittee on Oversight and Investigation (Federal Committee, 1976a) criticised the self-regulatory framework of the American Institute of Certified Public Accountants (AICPA) for insufficiently serving the public interest, and regarded the SEC’s “hands-off approach”

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<sup>10</sup> Until the 1960s, the rapid increase in importance of audit companies in financial markets remained almost unobserved by the public and the media (Zeff, 2003, p. 196).

concerning the organisation and supervision of the accounting profession as insufficient to protect public investors (Federal Committee, 1976a, pp. 31, 83). The Subcommittee on the Accounting Establishment (Federal Committee, 1976b) went as far as to mark the AICPA an aggressive lobbyist association combating government intervention in the profession's affairs (Federal Committee, 1976b, pp. 11, 66, 103, 104). Because the regulatory setting was perceived as inadequately designed, the Subcommittee demanded the introduction of an inspection programme under a governmental authority:

“The Federal Government should itself periodically inspect the work of independent auditors for publicly-owned operations. Such a mandatory inspection programme should be designed to provide assurance to the public and Congress that independent auditors are performing their responsibilities competently in accordance with proper standards of conduct. Periodic quality review could be conducted by the General Accounting Office, the SEC, or a special audit inspection agency” (Federal Committee, 1976b, p. 22).

Although the proposal did not find a political majority, it was clear that the profession had to enhance its system of quality assurance. According to William Gregory, the institute's board chairman in 1979/80, reforms became necessary because the council of the AICPA believed that Congress would enact new legislation to regulate the profession if “immediate steps were not then taken to bolster the profession's system of self-regulation” (Gregory in Zeff, 2003, p. 201). Eventually, a voluntary peer-review programme was officially initiated by the AICPA in 1976 (Giroux et al., 1995, p. 65).

### 1.3.2 The voluntary peer-review system from 1977 to 1988

Two different sections within the AICPA administered the peer review programme: the SEC Practice Section (SECPS) for firms auditing SEC clients and the Private Companies Practice Section (PCPS) for all the other firms. Members of the programme were required to undergo a peer review at least every three years and were required to adhere to the AICPA's quality control standards (Loscalzo, 1979, p. 78; Sperry et al., 1987, p. 382). The programme was opposed by smaller audit firms, which considered the costs of a review process to be excessive (Fogarty, 1996, p. 244). However, since the programme was established on a voluntary basis, audit firms were able to avoid the costs of a peer review by leaving the programme. Although the idea of a mandatory programme was frequently discussed (e.g. in the Anderson Committee of 1983), it was not implemented as it was argued that the costs would lead to a substantial erosion of membership (AICPA, 2005). This explains why the review programme never attracted a critical mass of practice units: by the mid-1980s, of about 46,000 AICPA member firms, only 13 per cent have been peer reviewed (Huff & Kelley, 1989, p. 35). However, the profession's rejection of the programme soon became problematic.

In the 1980s, the increasing competition among the large audit firms worsened the professional climate and weakened the position of the audit firms in their relationship with their corporate clients (Donabedian, 1993). In addition, the saturation of the audit market and the continuous expansion of consulting services caused the traditional business models of the big accounting firms to be changed. The changing environment came along with the detection of several cases of fraudulent financial reporting and corporate failures. Once again, congressional hearings began to focus on the role of inappropriate audit practices. In 1987, the Treadway Commission, financed by the AICPA, was established to analyse “the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of [...] fraud” (Securities and Exchange Commission (SEC), 1989, p. 2). Eventually, the Commission concluded that the regulatory instruments were functioning well and as intended (Treadway Commission, 1987, p. 68). Thus, it considered but finally dismissed the possibility of replacing the existing private-sector regulation with direct government regulations and only called for a requirement for audit firms with public clients to participate in a peer review programme. This was in part due to the general understanding in the 1980s, in which government regulation was forced back by the government and the SEC adopted a less outwardly confrontational posture towards the accounting profession. Nevertheless, the AICPA was set under pressure to enhance the acceptability and perception of its peer review system. To this end, in particular the peer review’s participation rate had to increase significantly.

In April 1987, the AICPA asked its members to vote whether the participation of the peer review programme should become mandatory for audit firms auditing one or more SEC clients. However, the profession rejected the introduction of a mandatory peer review system. Peer review became a divisive topic for the auditing community, pitting small audit firms that opposed it against larger firms that supported it (Berton, 1986). The later became indirectly supported by SEC, which threatened to launch its government review programme if the profession continued to reject peer reviews. This caused the AICPA to start broad-based lobbying actions among the profession. In a second vote in January 1988, AICPA members voted to adopt a mandatory peer review system, yet, a significant minority of almost a quarter of the members still opposed the introduction of a mandatory peer review in the final ballot (Berton, 1988). Nevertheless, the peer review system became mandatory.

### 1.3.3 The mandatory peer review system from 1988 to 2002

Audit firms had the choice to become a member of the SECPS or to enrol in the newly created AICPA Quality Review Programme (QRP). The procedures of the QRP and the SECPS review were similar and were designed as a compliance test to ensure the appropriateness of the firms’ quality systems. The only major difference was that the results in the SECPS were available for

the public, whereas the content of the QRP's reviews were confidential. The fact that for SEC auditing firms two similar but separate peer review programmes were in operation caused confusion within the profession and towards its stakeholders (American Institute of Certified Public Accountants (AICPA), 1995). As a result, from 1990 onwards, Certified Public Accountancy (CPA) firms with public company clients were required to join the SECPS (Russell & Armitage, 2006, p. 47).<sup>11</sup> Audit firms in the SECPS were reviewed every three years and each review covered a 12-month period. Audit firms could choose to be reviewed by a team which was either assembled by the AICPA, a private CPA association, or a review team where all members belonged to another audit firm, the latter being chosen in more than 90 per cent of the cases (Gunny & Zhang, 2006).

Following the major reform in 1987, the profession's mandatory peer review system operated for 14 years. The fundamental transition from the third to the fourth regime was then executed within just a couple of months when, between autumn 2001 and spring 2002, a wave of revelations of accounting fraud at large U.S. companies eroded the financial and political establishments (Romano, 2004, p. 116).

In the autumn of 2001, Enron, at that time, the seventh-largest company in the U.S. collapsed. The detected fraud involved misreported cash flows, fictitious income, and off-balance sheet liabilities. In January 2002, Global Crossing filed for Chapter 11 bankruptcy protection and was accused of being engaged in various fraudulent accounting practices. In March, Tyco International's top management was accused of the theft of over €100 million from the company. In the same month, the fraud of Adelphia Communications, which was the fifth largest cable company, became public after the company announced that it had lied about its financial condition, and in June, the company collapsed into bankruptcy. Then, when the U.S. markets were just beginning "to recover from the hangover left after the fraud-induced bankruptcy at Enron (Mulford & Comiskey, 2011, p. 422), another multi-billion fraud became news. In June 2002, WorldCom filed for bankruptcy; its assets had been inflated by about \$11 billion, nearly \$4 billion was added improperly to property, plant, and equipment—all unnoticed by the auditor.

Both Enron and WorldCom were audited by Arthur Andersen, which received an unmodified peer review conducted by Deloitte & Touche in December 2011 (Mason, 2005, p. 6). These corporate scandals resulted in an outcry from the public for the political actors to "do something" (Mulford & Comiskey, 2011, p. 423). As a lobbyist put it: "When the WorldCom scandal hit, it became to me, a bit of a very different attitude and atmosphere, if not a political tsunami" (in Romano, 2004, p. 145). Within that tsunami, Congress passed, almost unanimously,

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<sup>11</sup> In 1995, the QRP and the PCSP were merged into the AICPA Peer Review Programme, which from that moment organised peer reviews for non-SEC auditors.

the Sarbanes–Oxley (SOX) legislation in July 2002, which replaced the 30-year-old self-regulation by one statutory regulation, overseen by Public Company Accounting Oversight Board (PCAOB).<sup>12</sup>

#### 1.3.4 Governmental inspections under the PCAOB regime

The goal of the SOX was to improve audit quality and to increase the liability of audit firms to third parties relying on audited financial reports, and it contains 11 titles<sup>13</sup>. Although the creation of the PCAOB is not the only feature of the SOX, it is unquestionably the primary focus and it is explicitly committed to:

“oversee the audit of public companies [...] in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports” (SOX Sec. 101 (a)).

Since it comprises elements of both private and governmental bodies, the regulatory architecture of the PCAOB is described as a unique “quasi-public” entity (Boster, 2007, p. 135). The PCAOB is overseen by the SEC, which appoints the members of the PCAOB’s Board and approves new rules and auditing standards for it (SOX Sec. 101 (e); Sec. 107 (a)). Most importantly, the SOX grants the SEC the right to modify the powers of the PCAOB and holds the authority over the organisation’s budget (SOX Sec. 109 (b)). At the same time, the SOX explicitly established the PCAOB as an independent, private, non-profit entity (SOX Sec. 101 (1)). This releases the organisation from the administrative burdens of a federal agency because it benefits, for example, from the higher flexibility in the recruitment process of employees (Lennox & Pittman, 2010, p. 86). The SOX mandates that three members have to be independent from the accounting profession while two members must be certified public accountants (SOX Sec. 101 (e)).

To fulfil its tasks, SOX vested the PCAOB with a sustainable funding system. By Sec. 102 (f) and Sec. 109 (e) public companies are annually obliged to pay, based on their equity market capitalisation, an accounting support fee to the PCAOB, which represent 99 per cent of the PCAOB’s operating revenues (Public Company Accounting Oversight Board, 2011). The PCAOB has about 800 staff members who are located in 16 offices throughout the U.S. It

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<sup>12</sup> The passing of the Act was accelerated by midterm elections in autumn 2002 (Romano, 2004) and the down swinging of the U.S. economy. Banner (1997) concluded that most of the major instances of securities regulation have come right after sustained price declines, when dropping prices removed the opposition to regulation.

<sup>13</sup> Title I establishes the new regulatory body, the PCAOB, and determines its powers. Title II aims at strengthening the audit firm’s independence and prohibits actions that may cause a conflict of interest. Title III increases the accountability of the top management when an audit is executed and strengthens the role of the Audit Subcommittee in the corporate governance process. Title IV improves the integrity and reliability of financial disclosures, prohibits personal loans from a company to its directors or executive officers, and requires the establishment and reporting of an internal control system for SEC-registered companies. Title V specifies the regulation of analyst reports, while Title VI and VII address and strengthen the role of the Security and Exchange Commission (SEC). Title VIII reinforces the penalties on corporate and criminal frauds. Title IX is related to white collar crime and Title X to corporate tax return. Title XI reviews additional guidelines regarding the rules and punishments concerned with fraudulent corporate activities.

performs its work through four programme areas: the development of new auditing standards, the registration of public accounting firms, the inspection of public accounting firms, and the enforcement and investigation process in cases of violations of laws and the PCAOB's rules.

Undeniably, the inspection process is the PCAOB's most crucial task, as it is seen as the primary vehicle for improving overall auditing quality (Boster, 2007, p. 131; Carcello et al., 2011, p. 85; Church & Shefchik, 2012, p. 45; Roybark, 2006; Wegman, 2008, p. 8). Likewise, former PCAOB chairman Daniel Goelzer stated that the inspection programme is the "fundamental tool Congress gave to the Board to restore public confidence in audited financial reporting" (Goelzer, 2005, p. 1). PCAOB inspections examine a firm's work on selected audit engagement and the firm's quality control system (SOX 104 Sec. 104 (d); PCAOB, 2011, p. 5). More than half of its budget is used to fund inspections, and more than 60 per cent of PCAOB staff work in the field of registration and inspection (Hanson, 2012; Public Company Accounting Oversight Board, 2011). The inspection aims at identifying:

"any act or practice or omission to act by the registered public accounting firm, or by any associated person [...] that may be in violation of this Act, the rules of the Board, the rules of the Commission, the firm's own quality control policies, or professional standards" (SOX Sec. 104 (c)).

All auditing companies with publicly traded securities in the U.S. must be registered with the PCAOB, and thereby are subject to the PCAOB's oversight system (SOX Sec. 102 (a)).<sup>14</sup> The PCAOB distinguishes between annual and triennial inspections: audit firms with more than 100 clients are inspected every year, firms with 100 or fewer clients every three years (SOX Sec. 104 (b); PCAOB Rule 4001). Broadly, the inspection process covers a wide spectrum of activities, from the evaluation of an audit firm's tone-at-the-top, partner compensations, and compliance with professional codes of conduct for the proper application of audit procedures and documentation, as well as assessing the appropriateness of the audit evidence collected (Glover et al., 2009, p. 230). During an inspection, the inspectors have access to any record in the firm and receive information by oral interviews and written responses (PCAOB Inspection Rule 4006). The selection of the audits for inspection is based on a risk-assessment, meaning that all the audits conducted by the audit firm are unlikely to be subjected to evaluation (Blankley et al., 2012, p. 76; Wegman, 2008, p. 9).

For every inspection, the PCAOB prepares an inspection report (SOX Sec. 104 (g)). The report is reviewed by the PCAOB, which then issues a final inspection report (SOX Sec. 104 (b), (f)).

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<sup>14</sup> At the end of 2011, 2,388 firms were registered with the PCAOB, 38 per cent of which were non-U.S. firms (Public Company Accounting Oversight Board, 2011). As a result of the SOX, the AICPA restructured its peer review system. The AICPA Peer Review Programme is today the single programme for all AICPA firms subject to peer review. Thus, many audit firms with public firms as clients are today subject to monitoring by both the PCAOB and the AICPA's peer review system (Bellovary & Mayhew, 2009, p. 8).

Until the final transmission of the report to the SEC, the inspected audit firm has several chances to ask for modifications or to attach comments to the report (PCAOB Inspection Rule 4008). The findings are disclosed in two sections. The first section is related to the inspection of the firm's audit engagements. The report distinguishes between "clean reports", where no audit defects in the selected audits are identified, and "deficiency reports" that list all serious weaknesses found in the chosen engagements. The second section describes the deficiencies identified by the inspectors in the internal quality control system. In addition, the report includes the audit firm's response to the findings. Until 2009, statistical information about the specific inspection was only provided in reports for triennially inspected audit firms. Since 2010, all reports contain a broader scope of information, putting the discovered deficiencies into statistical context (Wainberg et al., 2011). The PCAOB issues all reports on its website. However, the report is only partially published: SOX Sec. 104 (g) and PCAOB Rule 4009 state that observed weaknesses in the firm's quality control system will only be published if the firm fails to address these deficiencies within one year.<sup>15</sup> Identified weaknesses, which were resolved, remain unknown to the public. The only possibility for the PCAOB to advise the public of the results of its inspections are summaries, compilations, or general reports where the identification of the firm to which the quality control criticism is related is not possible (PCAOB Inspection Rule 4010). If no violations with the PCAOB's rules or standards are identified, the inspections process ends with the disclosure of the report.

In the next section, the research findings on the former self-regulatory peer review system and the current inspection PCAOB system are categorized and analysed along the framework, and finally compared.

## **1.4 Analysis of the AICPA Peer-Review System**

### **1.4.1 Outcome validity of peer reviews**

As outlined in the organising framework, the validity of an external quality control system is determined by the independence and expertise of the reviewer and the inspector respectively. Wallace (1991) was the first to research whether the results of peer reviews were affected by the reviewer's degree of independence from the reviewed audit firm. Independence was operationalised, classifying the reviewer into three main categories: an AICPA appointed review team, firm-on-firm arrangement, or an association-sponsored review team. As, however, no significant relationship was found between the type of reviewer and peer review outcomes, the

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<sup>15</sup> The PCAOB has not explained why defects in the quality control system are not made public (Hilary & Lennox, 2005). Hodowanitz and Solieri (2005) argue that the effective lobbying of the Big 4 to ensure censorship of the more sensitive findings as the reason for keeping the findings concerning the quality control system under lock.

study concluded that peer reviews provided valid and reasonable results. More recent studies, however, conflicted with the results of Wallace (1991).

Hilary and Lennox (2005) and Anantharaman (2012) provided evidence that reviewing firms were more likely to issue unfavourable opinions if they were a direct competitor of the reviewed firm, whereby the local distance between the two firms served as proxy for competition. Anantharaman (2012) showed that firms that chose their reviewers were more likely to obtain more favourable peer reviews compared to firms which were reviewed by a review team composed by the AICPA. In addition, the study demonstrated that experienced reviewers were more likely to issue unfavourable review reports than less experienced reviewers. Lennox and Pittman (2010) examined whether an audit firm was more likely to switch to another reviewer if its previous peer review outcome was cautious or adverse. The strategic reviewer change by audit firms would be consequential to the revealed relationship between a specific reviewer and review outcome (Wallace, 1991). Indeed, the findings indicated that audit firms were more likely to switch to another reviewer if their previous peer review opinions were modified or adverse. In this sense, the peer review programme caused audit firms to strategically select their reviewers as the type of reviewer had a considerable effect on the review outcome.

The information advantage of the reviewer over the audit firm was identified by King et al. (1994) and Emby et al. (2002) as another factor affecting the validity of the reviewer's outcome. They found that reviewers were unable to disregard outcome knowledge in the peer review process, which led to biased peer review results. King et al. (1994) showed that the allegation of lack of independence of the audit firm negatively impacted the reviewer's assessment of the audit quality of the firm under review. This ultimately resulted in less favourable review results. Emby et al. (2002) demonstrated that auditors who knew about a specific negative outcome rated outcome-consistent evidence items as more important while positive outcome information did not appear to affect the reviewers' evidence evaluation.

Although the majority of research findings provide evidence that the validity of peer reviews was impaired for several reasons, the accounting profession had an opposing view. Ehlen and Welker (1996) documented that audit firms have a positive perception of their reviewers and the system in general. The accounting profession's satisfaction with self-regulation can also be seen in the study of Wallace and Cravens (1994) and their analysis of statements by reviewed firms about their review reports. Based on a descriptive analysis of response letters to the AICPA, the study concluded that the majority of the reviewed firms accepted the proposed suggestions from the reviewers.



Taking the different studies together, an interesting picture emerges: while the accounting profession publicly emphasised that the peer review system worked effectively in terms of improving audit quality (Ehlen & Welker, 1996; Wallace & Cravens, 1994), it seems that they also actively took advantage of the existing loopholes of the system (Hilary & Lennox, 2005; Lennox & Pittman, 2010). Table 1 provides an overview of empirical studies with findings concerning the validity of the peer review system.

**Table 1: Findings on the outcome validity of peer reviews**

Authors & date	Method*	Research design	Sample	Key findings
Wallace (1991)	A	Statistical analysis of the relationship of the type of peer reviewer and review findings. Three different reviewer kinds: AICPA-appointed review team; CPA firm; state sponsored team.	352 public peer review files from 1980 through 1986.	The type of reviewer did not affect the number of negative review findings.
Wallace & Cravens (1994)	A	Descriptive analysis of peer reviewee response letters to the AICPA.	AICPA cover letters accompanying review files from 1980 through 1986.	The majority of the reviewed firms accepted the proposed suggestions from the review team.
King et al. (1994)	E	Experiment on the effect of a reviewer's knowledge of a proceeding against the audit firm.	49 experienced auditors reviewed an attestation engagement performed by auditors from small accounting firms.	Peer reviewer's knowledge of a negative allegation negatively influences a peer reviewer's evaluation.
Ehlen & Welker (1996)	S	Survey among CPA firms about peer review.	586 reviewed firms nationwide.	Reviewers were seen as fair in the review process.
Emby et al. (2002)	E	Examination of the influence of prior outcome knowledge on peer evaluation judgments of audit partners.	122 audit partners from Canada and the United States.	Auditors who received outcome information tended to rate outcome-consistent items of evidence as more important.
Hilary & Lennox (2005)	A	Statistical analysis of the relationship between peer reviewer characteristics and review findings.	Sample of 1,001 reviews issued in the years 1997 to 2003.	Several characteristics of a peer reviewer affected the review outcome.
Lennox & Pittman (2010)	A	Statistical analysis of the association between review outcome and the change of an audit firm's reviewer.	545 PCAOB inspection reports in 2007; 1,001 peer review reports between 1997 to 2003.	Audit firms chose their reviewers strategically.
Anantharaman (2012)	A	Comparison of peer review reports and PCAOB inspection reports.	407 firms' last peer review and first PCAOB inspection report.	The type of reviewer affected the review result.

A: archival, E: experimental, S: survey.

#### 1.4.2 Recognition of peer reviews by the financial market

The recognition of review results was analysed in empirical archival research and in studies focusing on individual participants.

Archival research used different indicators for the reaction of the financial market to analyse whether peer review outcomes were used and perceived as a quality-differentiating factor (Francis et al., 1990; Giroux et al., 1995; Hilary & Lennox, 2005). The first insights about the market's reaction to review results was provided by Francis et al. (1990). They hypothesised that in the case of perceived quality differentiation among audit firms, peer reviewed firms would charge higher audit fees. However, they did not identify audit fees as being associated with participation in the (at that time) voluntary peer-review system. Giroux et al. (1995) extended the study to the public sector audit market. In contrast to Francis et al., they found that firms that had been reviewed positively were able to charge significantly higher audit fees because the specific public sector audit market was characterised by a high level of competition and a broad range of low quality audit suppliers. Hilary and Lennox (2005) used the changes in the number of clients as being indicative of the audit market's awareness of peer reviews. As in their sample, reviewed firms that achieved clean opinions gained clients, whereas firms given modified opinions lost clients. The authors concluded that peer reviews were able to provide credible information to audit clients and that the audit market reacted to the information provided by peer review reports.

The second broad research strand examined the perceptions and attitudes of individual actors (e.g. individual investors, clients of audit companies) towards peer review (Bellovary & Mayhew, 2009; Deis & Giroux, 1992; File et al., 1992; Schneider & Ramsay, 2000; Woodlock & Claypool, 2001).

File et al. (1992) asked bankers and auditors for their opinion on the influence of several factors on their judgment of an auditor's credibility. The findings support Francis et al. (1990) and identified peer review reports as having the least influence on financial judgments. Similar results were found in the study by Schneider and Ramsay (2000), in which bank lending-officers executed an ex-post evaluation of audit quality. The authors found that peer reviews did not directly affect the willingness of the bank lending-officers to approve lines of credit. This is consistent with Woodlock and Claypool (2001), who revealed that almost two thirds of audit committees of public companies did not consider peer review reports when recommending an audit firm to the management of the company. In line with these results, Bellovary and Mayhew (2009) showed with experimental research design that peer review reports did little to enhance quality choices.

Surveys among audit firms about the perception of their stakeholders towards review reports revealed a similar and critical attitude from audit firms. In the survey of Elsea and Stewart (1995), over 90 per cent of CPA firms doubted that their clients were interested in their review results and only 20 per cent believed that companies referred to review results when selecting a CPA firm for auditing services. Consequently not even half of the members used their reviews as promotional or marketing instruments. Similar results were revealed in a survey study by Ehlen and Welker (1996), in which a large majority shared the opinion that their client firms did not seem to care about the reviews. Interestingly, in both surveys, audit firms that had been conducting reviews for a longer period of time were less critical than auditors who had just begun to work as peer reviewers, which might suggest that experiencing a review reduced the initial negative attitude to it.

Payne (2003) identified the timeliness of a report's issuance as a factor which would explain the financial market's disinterest for review results, as found by the majority of studies (Alam et al., 2000; Ehlen & Welker, 1996; Elsea & Stewart, 1995; File et al., 1992; Francis et al., 1990; Schneider & Ramsay, 2000; Woodlock & Claypool, 2001). He assumed that the ability of an audit firm's client to deduce audit quality from the peer review findings decreased as the time between peer reviews increased. In fact, the results of his experiment indicate that a one-year review period, in contrast to the three-year review period at that time, would have allowed clients to identify high-quality auditors. This is consistent with a survey by Russell and Armitage (2006), in which audit firms stated that a three-year cycle provided a two-year window for performing substandard work. The peer review's complexity was identified as an alternative and/or additional explanation by Alam et al. (2000), who showed that review experts questioned the investment community's ability to understand the underlying procedures and mechanisms of a peer review process, which would lead the investors to disregard review results in decision-making processes.

Table 2 provides an overview of empirical studies with findings concerning the perception and recognition of peer reviews in financial decision-making.

**Table 2: Findings on the perception and recognition of peer reviews by financial actors**

Authors & date	Method*	Research design	Sample	Key findings
Francis et al. (1990)	A	Audit fees as proxy for audit quality, to see whether reviewed firms are perceived as quality-differentiated auditors.	208 audit observations in 1984/1985.	Voluntary membership in the peer review programme did not affect the audit fees of audit firms.
File et al. (1992)	S	Perception of bankers and auditors about peer reviews.	Questionnaires sent to 100 bankers and 100 randomly selected auditors.	Peer review reports had only marginal effect on financial judgments of financial experts.
Elsa & Stewart (1995)	S	Perception of CPA firms about the peer reviews system.	437 questionnaires from reviewed Colorado CPA firms.	Audit firms did not think that their clients were interested in their peer review results.
Giroux et al. (1995)	A	Audit fees as proxy for audit quality, to see whether reviewed firms are perceived as quality-differentiated auditors.	232 quality review control audits conducted by the Texas Education Agency for its fiscal years 1985 to 1988.	Peer reviewed audit firms charged higher audit fees compared to non-reviewed firms.
Ehlen & Welker (1996)	S	Perception of CPA firms about peer review.	586 reviewed firms nationwide.	Audit Firms believed that their clients would not show interest in review results.
Alam et al. (2000)	A	Perception of financial analysts, banks, and audit clients of peer review.	233 usable responses: 42 per cent from CPA firms, 42 per cent from banks, and 18 per cent from financial analysts.	Participants did not believe that audit firms clients and investors understand the procedures and mechanisms of a peer review.
Schneider & Ramsay (2000)	S	Perception of bank lending officers about peer reviews.	Survey of 193 bank-lending officers.	Peer reviews did not directly affect the financial judgment of bankers.
Woodlock & Claypool (2001)	S	Perception of peer reviews by audit committees.	Checklist survey of 68 audit committees serving large publicly traded corporations.	Audit committees selected audit firm without considering peer review reports.
Payne (2003)	E	Experiment designed to investigate audit quality and pricing under settings that manipulate the timing of the peer review process.	Eight multi-period laboratory markets contracting via a computerised sealed-offer auction. Each market has four buyers (clients) and four sellers (auditors).	The three-year review cycle impeded market's reaction towards peer review.
Hilary & Lennox (2005)	A	Association between peer review reports and changes in number of clients.	1,001 reviews issued in the years 1997–2003.	Reviewed firms gained (or lost) clients after they received clean (or modified/adverse) opinions.

A: archival, C: commentary, E: experimental, I: interview, R: review, S: survey.

### 1.4.3 Impact of peer reviews on audit quality

As outlined in the framework, the third aspect of categorising the research focuses on the link between external quality controls and the audit quality delivered. To draw conclusions about the peer review system's effect on audit quality, various studies have used alternative audit quality measures, and analysed whether reviewed audit firms in comparison with non-reviewed firms provided higher audit quality (Casterella, Jensen, & Knechel, 2009; Deis & Giroux, 1992; Krishnan & Schauer, 2000; Rollins & Bremser, 1997).

Deis and Giroux (1992) compared the peer review findings for small CPA firms, which were auditing school districts, with findings of external quality controls conducted by the Audit Division of the Texas Education Agency. They concluded that peer-reviewed audit firms performed higher quality audits. Rollins and Bremser (1997) analysed whether certain audit firm characteristics were related to enforcement actions against the auditor. In fact, the logistic regression model showed that peer-reviewed firms were less likely to receive SEC sanctions than non-reviewed audit firms. Krishnan and Schauer (2000) used the level of compliance with Generally Accepted Accounting Principles (GAAP) as being indicative of audit quality. They examined the financial statements of various companies to evaluate whether the required accounting disclosures had been made in different areas. They found that the statements of peer-reviewed firms complied more with GAAP than those of non-reviewed audit firms. Casterella et al. (2009) associated audit quality with the occurrence of litigation or claim of malpractice against an audit firm. On the basis of a regression model, they revealed that the number of weaknesses identified in peer review reports was associated with audit failure.

Instead of an alternative audit quality measurement, Giroux et al. (1995) used audit fees as being indicative of audit quality. The study revealed that peer-reviewed audit firms charged significantly higher audit fees. As no fee differences were identified on a per-hour basis, the authors concluded that higher fees correlate with more extensive audit procedures, which in turn indicated a higher level of quality audits.

The empirical findings which demonstrated the peer review's positive impact on audit quality was supported by Grant et al. (1996), who modelled auditing as a multi-person social dilemma. In a series of laboratory experiments, they showed the difficulty of obtaining a high level of average audit quality in a setting with no external quality controls, whereas audit quality increased in a peer review system.

In contrast, Alam et al. (2000), O'Keefe et al. (1994), and Shafer et al. (1999) neglected the positive link between peer reviews and audit quality. Similarly to Krishnan and Schauer (2000), O'Keefe et al. (1994) analysed the violations of the GAAS. However, in their analysis the

participation in peer reviews was not significantly related to violations. Shafer et al. (1999) questioned whether adverse peer review opinions were viewed as deterrents to aggressive reporting decisions. In an experiment, professional auditors were asked to estimate the likelihood of a material misstatement being detected as a result of a peer review. Most of the participants stated that the effect of peer reviews was marginal, leading the authors to conclude that peer reviews did not provide adequate incentives for firms to reduce the incidence of financial statement misstatements. Alam et al. (2000) asked audit firms, audit clients, financial analysts, and bankers to rank the importance, and evaluate the effectiveness, of different aims of the peer review programme. The results show that the peer review instrument was not perceived as an adequate instrument for reducing audit failures and detecting audit fraud in financial statements. Interestingly, the peer review programme was identified as an important and effective measure to maintain the self-regulatory system of the profession.

Surveys among audit firms that participated in peer reviews provided similar results. Although there was a generally positive orientation towards peer reviews, audit firms questioned the programme's contribution to audit quality (Ehlen & Welker, 1996; Felix & Prawitt, 1993; McCabe et al., 1993). In the survey of McCabe et al. (1993), almost all respondents reported that peer review increased a firm's ability to comply with professional standards. At the same time, almost half of the respondents doubted that peer review improved the likelihood of detecting material misrepresentation. The negative view concerning the association between peer review and delivered audit quality is consistent with the figures of Felix and Prawitt (1993). In their study, only one third of respondents reported positive changes in their audit practices as a result of peer review. This revelation is also supported by the study of Ehlen and Welker (1996) in which almost every firm that had been reviewed more than once described reviews as more cosmetic than substantial.

Russell and Armitage (2006) identified several loopholes within the peer review system which might explain the profession's sceptical view of the system's effect on audit quality. The authors showed how particular aspects of the systems allowed audit firms with defective quality control systems to successfully pass a review process. Through a questionnaire, reviewed firms were asked whether they used actions that were defined as potential loopholes. Almost half of the audit firms responded that they worked on selected engagement documents before these were submitted to the reviewer. One fifth of the firms were even able to self-select the engagement subject for review and the majority selected cases with a low risk of receiving negative peer-review comments.

Table 3 provides an overview of empirical studies with findings on the effect of peer reviews on the audit quality delivered.

**Table 3: Findings on the effect of peer reviews on the audit quality delivered**

Authors & date	Method*	Research design	Sample	Key findings
Bremser & Gramling (1988)	A	Number of comments as proxy for educational contribution to audit quality.	66 CPA firms that had been peer reviewed at least twice.	The participation in a peer review decreased the number of comments in review reports.
Deis & Giroux (1992)	A	Relationship between peer review membership and governmental control findings.	308 quality control reviews from 1984 to 1989.	Peer review improved the quality of audit services.
Felix & Prawitt (1993)	S	Perception of CPA firms about the peer review system.	115 questionnaires filled by audit firms.	30 per cent of CPA members reported positive changes in their audit practices as a result of peer reviews.
McCabe et al. (1993)	S	Perception of CPA partners about the peer review system.	195 firms participating in peer reviews.	The majority of firms doubted that peer review increased a firm's ability to detect material misrepresentation.
O'Keefe et al. (1994)	A	Statistical analysis of the relationship between peer review and violations of GAAS reporting standards.	935 reports from 1986.	The participation in peer review was not related to violations of reporting standards.
Giroux et al. (1995)	A	Time of audit engagement as a surrogate for audit quality.	232 quality review control audits conducted by the Texas Education Agency between 1985 to 1988.	Reviewed firms spent more time on audit engagements.
Grant et al. (1996)	E	Experimental design, auditing modelled as a multi-personal social dilemma.	A series of laboratory experiments using 142 upper level undergraduate accounting majors and first-year MBA students as subjects.	Audit quality increased in a self-regulatory regime.
Rollins & Bremser (1997)	A	Relationship between peer review and enforcement actions.	91 enforcement cases.	The participation in peer reviews decreased the likelihood of receiving SEC sanctions.
Colbert & Murray (1998)	A	Statistical relationship between reviewee characteristics and peer reviewer's review findings.	422 small CPA firms.	Firms with a larger number of previous reviews received more favourable ratings.
Shafer et al. (1999)	E	Experiment about the impact of formal sanction threats on auditors' behaviour.	Research instruments were mailed to a random sample of AICPA members.	Peer review did not provide adequate incentives for audit firms to reduce the incidence of financial statement misstatements.
Krishnan & Schauer (2000)	A	Relationship between peer review and compliance with GAAP.	35 clients of Big-6 firms, 129 clients of non-Big-6 firms.	Participation in peer review increased compliance with GAAP.

Alam et al. (2000)	S	Survey on the effectiveness of peer review in improving audit quality among key constituents.	233 usable responses: 42 per cent from CPA firms, 42 per cent from banks, and 18 per cent from financial analysts.	Peer review did not effectively reduce audit failures and detecting audit fraud in financial statements.
Casterella et al. (2009)	A	Relationship between files of insurance company specialising in professional liability and peer review reports.	158 files of an insurance company that specialised in professional liability coverage for local and regional accounting firms.	Peer review was identified as an effective mechanism for differentiating quality among audit firms.

A: archival, C: commentary, E: experimental, I: interview, R: review, S: survey.

## 1.5 Analysis of the PCAOB Inspection system

### 1.5.1 Outcome validity of PCAOB inspections

In the developed framework, the validity of external quality controls is determined by the independence and expertise of the individuals involved. However, from the studies on PCAOB inspections, particular insights about the technical skills and knowledge of PCAOB inspectors can be found (Blankley et al., 2012; Glover et al., 2009; Newman & Oliverio, 2010), while the independence of PCAOB inspectors remained neglected.

Glover et al. (2009) found individual cases in which inspectors failed to look at the riskiest areas of an audit, or drew incorrect conclusions, due to the technical complexity or their lack of prior experience in the specific field of engagement. Blankley et al. (2012) were then the first who analysed the audit firms' comments on the inspection report. The inspection results were classified as "deficient", "severely deficient", and "pervasive failure" reports. Most firms with engagement deficiencies disagreed with the inspections and stated that the critical findings were the result of inadequate documentation and/or the incorrect application of accounting principles by the inspectors, but they did not indicate actual audit deficiencies. In general, studies highlight that in particular the audit firms with detected deficiencies showed high levels of disagreement and dissatisfaction with the competencies and technical knowledge of the inspectors (Blankley et al., 2012; Newman & Oliverio, 2010), while inspectors were generally perceived as knowledgeable, competent, and fair (Newman & Oliverio, 2010) and appropriately prepared (Daugherty & Tervo, 2010). While most of the studies solely analysed triennially inspected audit firms, Church and Shefchik (2012) also included Big 4 firm data in their analysis. They found that the Big 4 firms disagreed more frequently with PCAOB findings than second-tier firms.

Ragothaman (2012) demonstrated PCAOB inspectors to be tougher than peer reviewers. She compared the non-remediated weaknesses in the quality control system of triennially inspected audit firms with quality control weaknesses identified in peer review reports. The comparison



revealed that PCAOB quality reports disclosed a higher number of weaknesses regarding engagement performance and independence than were detected by modified and adverse peer review reports. However, it has to be noted that the absence of an overall grading of the PCAOB reports creates serious methodological problems. Depending on whether the study used modified or unmodified AICPA peer reviews as the unit of comparison, entirely different results occurred.

Table 4 provides an overview of empirical studies with findings concerning the validity of the PCAOB inspection system.

**Table 4: Findings on the validity of the PCAOB inspections**

Authors & date	Method*	Research design	Sample	Key findings
Glover et al. (2009)	C	Evaluation of the PCAOB inspection process.	Anecdotal evidence.	Inspectors did not possess appropriate knowledge to assess audit engagements.
Daugherty & Tervo (2010)	S	Perception of triennially inspected audit firms of PCAOB inspections.	146 accountants of small, registered public accounting firms.	The performance of the PCAOB inspection team was seen as appropriate.
Newman & Oliverio (2010)	S	A survey, which focused on the PCAOB inspection process, of no-deficiency firms.	From a list of 251 firms, a random sample of 115 firms was selected with no attention to whether they had received one or two no-deficiency inspections.	The majority of firms viewed the inspectors as knowledgeable, competent, and fair.
Blankley et al. (2012)	A	Content analysis of the response letters to the PCAOB from triennially inspected audit firms	1,081 response letters.	Firms with engagement deficiencies were more likely to disagree with the PCAOB's assessment.
Church & Shefehik (2012)	R	Analysis of the inspection reports of large accounting firms.	All 2004–2009 inspection reports from large accounting firms.	Big 4 firms disagreed more frequently with findings than second-tier firms.
Ragothaman (2012)	A	Comparison of quality control deficiencies in PCAOB reports and peer review reports.	106 PCAOB reports for triennially inspected firms: 2,355 AICPA peer review reports for firms with less than 100 SEC audit clients.	PCAOB inspectors are tougher than peer reviewers as PCAOB quality control reports contained a significantly higher number of deficiencies than peer review reports.

A: archival, C: commentary, E: experimental, I: interview, R: review, S: survey.

### 1.5.2 Recognition of PCAOB inspections by the financial market

Research has revealed the reaction of financial markets to PCAOB reports in two particular ways. Empirical studies, on the one hand, have tested whether PCAOB reports are associated with client changes (Abbott et al., 2013; Daugherty et al., 2011; Lennox & Pittman, 2010) or with stock price movements of clients (Offermanns & Peek, 2011). Experimental studies, on the other hand, have focused on the evaluations of financial experts concerning audit opinions based on PCAOB reports (Robertson & Houston, 2010).

Lennox and Pittman (2010) analysed the association between the number of weaknesses (none, one, or many) in the PCAOB report and the changes in the number of clients following the report. Studies on the association between PCAOB reports and client changes (Abbott et al., 2013; Daugherty et al., 2011; Lennox & Pittman, 2010) are based on the assumption that, to evade market-imposed penalties (e.g., higher costs of capital), public companies dismiss audit firms with deficiencies. They therefore expected a relevant increase, or decrease, in market share in terms of clients after receiving favourable, or unfavourable, reports. However, as no significant relationship was found, the study concluded an audit firm's market share to be insensitive to PCAOB inspection reports. As their data consisted of triennially inspected firms, the three-year inspection cycle could be the reason because it creates a barrier that isolates high-quality auditors from low-quality providers, as revealed by Payne (2003) and Russell and Armitage (2006) in their studies on the peer review system. Another explanation could be seen in the way the template of the PCAOB reports is composed. In contrast to the former review system, which used predefined result categories (unmodified, modified, and adverse opinion), PCAOB reports do not provide users with a concluding and overall grading. Hence, it is not surprising that 76 per cent of audit firms with no-deficiency reports would prefer the PCAOB to introduce an overall measure of audit quality (Newman & Oliverio, 2010).

However, the findings of several other studies show that PCAOB outcomes are perceived and recognised for financial decision-making by the financial markets (Abbott et al., 2013; Daugherty et al., 2011; Offermanns & Peek, 2011; Robertson & Houston, 2010, p. 20).

Daugherty et al. (2011) pointed out that deficiency reports were positively associated with dismissal of audit firms by their clients. In addition, the analysis shows that companies that dismissed audit firms with reporting deficiencies were more likely to hire an audit firm with clean reports.<sup>16</sup> Abbott et al. (2013) came to the same result. They examined the association between GAAP-deficient reports and changes in the number of clients. The authors found that triennially

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<sup>16</sup> However, interestingly, Daugherty et al. (2011) did not find evidence that non-remediated quality control deficiencies (which are made public when they have not been solved after a period of 12 months) lead to a loss of audit clients, which conflicts with multiple studies (Hodowanitz & Solieri, 2005; Lennox & Pittman, 2010; Newman & Oliverio, 2010) that have criticised the PCAOB's policy of keeping findings of the quality control system under lock.

inspected audit firms were more likely to be dismissed by their clients compared to audit firms without reported GAAP deficiencies.

Robertson and Houston (2010) and Offermanns and Peek (2011) also found evidence for the financial market's perception of PCAOB reports. Robertson and Houston (2010) demonstrated that, under certain conditions, PCAOB reports can serve as a tool for signalling the credibility of audit opinions. They categorised deficiencies into "low-severity" deficiencies (failures that do not materially affect the financial statements) and "high-severity" deficiencies (failures that increase the probability that an audit will fail to detect a material misstatement). Then, financial experts were asked on a nine-point Likert-type scale to state their opinion about the ability of the inspection reports to positively affect the credibility of the firm's future opinions. Overall, participants believed that PCAOB inspections improve the credibility of future audit opinions. Offermanns and Peek (2011) found that shareholders are sensitive to the information contained in PCAOB inspection reports and view them as a meaningful signal of audit quality to investors. The researchers analysed the reaction of stock price movements of the audit firms' clients to 224 first-round and 134 second-round PCAOB inspection reports issued between 2005 and 2010. They demonstrated that the magnitude of market response to issuance of inspection reports corresponded to about 29 per cent of market response to earnings announcements.

With the exception of the findings of Lennox and Pittman (2010), the majority of empirical research indicates that financial markets are sensitive to PCAOB inspections. However, from a methodological point of view, the absence of an overall assessment hampers the cross-study comparison. Studies on the PCAOB regime use different approaches to categorise PCAOB reports into "good" and "bad". While several studies consider all identified deficiencies to be of economically equivalent importance and classify the reports according to the number of deficiencies (Hermanson, Houston, & Rice, 2007; Lennox & Pittman, 2010; Offermanns & Peek, 2011) or the rate of deficiencies (Daugherty et al., 2011), other studies distinguish between the kind of deficiency (Abbott et al., 2013) or between the degree of severity of the inspected deficiencies (Blankley et al., 2012; Robertson & Houston, 2010).

Even if PCAOB reports are considered by those making decisions, Wainberg et al. (2011) and Robertson et al. (2014) point out the risk of misreading the reports. Wainberg et al. (2011) asked experienced managers to make an auditor engagement decision on the basis of the PCAOB inspection reports for the audit firms. It appears that auditors continued to focus on anecdotal

deficiencies and failed to consider the implications of the statistical data provided in the reports.<sup>17</sup> Robertson et al. (2014) showed how PCAOB reports gave rise to a perception that was actually worse than reality, because the information provided in the reports was not taken into consideration equally: they showed how negative information in the reports had more of an effect on the judgment of financial experts concerning the credibility of the audit firm than did the positive information. Table 5 provides an overview of empirical studies with findings concerning the perception and recognition of PCAOB inspections in financial decision-making.

**Table 5: Findings on the perception and recognition of PCAOB inspections by financial actors**

Authors & date	Method*	Research design	Sample	Key findings
Lennox & Pittman (2010)	A	Association between the number of inspection findings and the change in the number of clients of small and large audit firms.	545 PCAOB inspection reports through 2007; 1,001 peer review reports between 1997 and 2003.	No association was found between PCAOB inspection outcome and client losses.
Robertson & Houston (2010)	E	Association between the type of deficiencies and the anticipation of future audit opinions.	142 MBA students as a proxy for non-professional investors.	PCAOB reports served as a useful tool to improve the credibility of audit opinions.
Offermanns & Peek (2011)	A	Variance in stock return of auditors' clients as an indication for market reaction to PCAOB inspection reports.	224 first-round and 134 second-round inspection reports from 2005 to 2010.	PCAOB inspection reports affected the value of an audit firm's client through their effect on information quality.
Wainberg et al. (2011)	A	Association between PCAOB reports and perceived and actual audit quality.	1,129 PCAOB reports for small audit firms for the years 2004 to 2010.	PCAOB reports were identified as ineffective instruments for signalling audit quality.
Daugherty et al. (2011)	A	Association between deficiency reports and the client loss of triennially inspected firms.	748 inspections performed on triennially inspected firms for the years 2005 to 2008.	Negative PCAOB reports increased the likelihood of losing clients involuntarily; deficiencies related to the quality control system had no effect.
Robertson et al. (2012)	S	Association between PCAOB reports and perceived audit quality.	90 responses from independent mailings to U.S. public company financial executives.	PCAOB inspection reports decreased perceived audit quality.
Abbott et al. (2013)	A	Relation between the PCAOB inspection reports with GAAP deficiencies, and the audit firms and their clients.	521 triennially inspected non-foreign accounting firms; PCAOB inspection reports filed from 2005 to 2007.	PCAOB inspections served as signal of audit quality for smaller firms.

A: archival, C: commentary, E: experimental, I: interview, R: review, S: survey.

<sup>17</sup> In the PCAOB's first years, it was even more critical to base the assessment of the audit quality of large accounting firms upon the number of deficiencies: PCAOB reports of large audit firms were anecdotal in nature and did not provide users with statistical information that would allow them to assess the relative frequency of the detected deficiencies which caused misperceptions of audit quality. Following critics concerning the informative value of the PCAOB reports, the PCAOB began to add statistical information to all of their reports since 2010.

### 1.5.3 Impact of PCAOB inspections on audit quality

The first insights about the impact of PCAOB inspections on audit quality can be found in studies which focused on the audit market composition. They showed how PCAOB inspections pushed “low-quality” auditors out of the market, which was interpreted as an increase of overall audit quality (Daugherty et al., 2011; DeFond & Lennox, 2011; Hermanson & Houston, 2008; Read, Rama, & Raghunandan, 2004).

Read et al. (2004) demonstrated that small audit firms were much more likely to cease performing SEC audits in the post-SOX period than in previous periods due to the perception of a more stringent oversight by PCAOB. According to Hermanson and Houston (2008) this was particularly the case for small audit firms, as the research data shows that firms that inadequately addressed their quality control defects were among the smallest firms in terms of partners and employees per client. The vast majority of quality control defects were thereby related to audit performance issues, followed by independence, monitoring and addressing identified weaknesses, partner workload, and review of interim financial statements.

The impact of PCAOB inspections on the segment of small auditors was also revealed by DeFond and Lennox (2011). The study indicates that from 2002 to 2004 almost every second small audit left the audit market. The exiting firms were of relatively low quality in terms of the total number and severity of weaknesses detected in inspections. The study used the likelihood of firms being issued with going-concern opinions as being indicative of audit quality, thereby determining that existing firms did in fact belong to the group of low-quality audit firms. The underlying assumption of studies using the frequency of going-concern opinions being indicative of audit quality (Gramling et al., 2011; DeFond & Lennox, 2011; Gunny & Zhang, 2013) is that that low-quality audit firms are more likely to yield to the pressure of their client, and therefore issue fewer going-concern opinions. The result was supported by Daugherty et al. (2011), who found that deficiency reports caused involuntary and voluntary client losses. The figures show that low-quality audit firms voluntarily resigned from their clients because the costs associated with regulatory compliance outweighed the benefits of auditing publicly traded companies.

Several other studies have followed the approach of DeFond and Lennox (2011) and have utilised client-specific measures of audit quality, such as the frequency of going-concern opinions (DeFond & Lennox, 2011; Gramling et al., 2011; Gunny & Zhang, 2013) or the quality of earnings management (Carcello et al., 2011), to determine whether PCAOB inspections affect the quality provided by audit firms. The results point out the positive effect of PCAOB inspections on audit quality.

Gramling et al. (2011) based their analysis on inspection reports of triennially inspected audit firms from 2004 to 2006. They showed that audit firms with deficiency reports were more likely to issue going-concern opinions for financially distressed clients after their inspection than prior to their inspection. In contrast, Gunny and Zhang (2013) did not find a correlation between inspection outcome and the propensity to issue going-concern opinions. However, Gunny and Zhang (2013) also used abnormal accruals and restatements as an indication of audit quality. This is based on the idea that higher quality audit firms are more likely to limit management's accounting policy choices, thereby reducing earnings management, than low-quality audit firms. The authors grouped the PCAOB reports into three categories and matched the clients to each triennially inspected auditor. The figures showed that low-audit-quality audit firms were positively associated with firms receiving a seriously deficient inspection report. Carcello et al. (2011) used reduced earnings management as being indicative of audit quality. They compared the financial statements of Big 4 clients over the 12-month period before the issuance of the inspection report and the 24-month period subsequent to the issuance of the inspection report. A significant decline was found in accruals following each of the first and the second PCAOB inspections. Thus, the study showed that PCAOB is an effective instrument for reducing earnings management.

Another approach was followed by Gunny and Zhang (2006) who, similarly to Ragothaman (2012) and Anantharaman (2012), compared the outcomes of a firm's first PCAOB inspections with its last peer review report and used the level of accounting discretion and earnings informativeness as indicators of earnings quality. Their results identified PCAOB reports to be superior to peer reviews at distinguishing earnings quality across the portfolio of small audit firms.

Studies that have surveyed audit firms have revealed the positive attitude of the profession concerning the system's effect on audit quality. The findings suggest that small and large accounting firms evaluate the inspections differently. Whereas smaller firms do not agree with the statement that the inspection process has affected their audit services, large firms feel inspections have positively affected their audit business. Congruently, smaller firms do not agree that PCAOB inspections have improved overall audit quality, while larger firms view inspections as a positive contributor to audit quality (Daugherty & Tervo, 2010). Not surprisingly, the majority of firms with no reported deficiencies believe that the system contributes positively to the actual quality. Interestingly, although firms responded that, after having implemented reforms following their first inspection round, they received a no-deficiency report in their second inspection, still more than two thirds would prefer a five-year inspection cycle to a three-year one (Newman & Oliverio, 2010). Table 6 provides an overview of empirical studies with findings on the effect of PCAOB reports on audit quality.

**Table 6: Findings on the impact of PCAOB inspections on audit quality**

Authors & date	Method*	Research design	Sample	Key findings
Lennox & Pittman (2010)	A	Association between the number of inspection findings and the change in the number of clients of small and large audit firms.	545 PCAOB inspection reports through 2007; 1,001 peer review reports between 1997 and 2003.	No association was found between PCAOB inspection outcome and client losses.
Robertson & Houston (2010)	E	Association between the type of deficiencies and the anticipation of future audit opinions.	142 MBA students as a proxy for non-professional investors.	PCAOB reports served as a useful tool to improve the credibility of audit opinions.
Offermanns & Peek (2011)	A	Variance in stock return of auditors' clients as an indication for market reaction to PCAOB inspection reports.	224 first-round and 134 second-round inspection reports between 2005 and 2010.	PCAOB inspection reports affected the value of an audit firm's client through their effect on information quality.
Wainberg et al. (2011)	A	Association between PCAOB reports and perceived and actual audit quality.	1,129 PCAOB reports for small audit firms for the years 2004 to 2010.	PCAOB reports were identified as ineffective instrument for signalling audit quality.
Daugherty et al. (2011)	A	Association between deficiency reports and the client loss of triennially inspected firms.	748 inspections performed on triennially inspected firms for the years 2005 to 2008.	Negative PCAOB reports increased the likelihood of losing clients involuntarily; deficiencies related to the quality control system had no effect.
Robertson et al. (2012)	S	Association between PCAOB reports and perceived audit quality.	90 responses from independent mailings to U.S. public company financial executives.	PCAOB inspection reports decreased perceived audit quality.
Abbott et al. (2013)	A	Relation between the PCAOB inspection reports with GAAP deficiencies and the audit firms and their clients.	521 triennially inspected non-foreign accounting firms; PCAOB inspection reports filed from 2005 to 2007.	PCAOB inspections served as signal of audit quality for smaller firms.

A: archival, C: commentary, E: experimental, I: interview, R: review, S: survey.

## 1.6 Comparison

The first question for which the literature was analysed was whether reviews and inspections lead to valid results. As explained in the framework, the validity of the results is determined by the expertise and objectivity of the external quality controls. The former peer review system was mostly criticised for its perceived lack of objectivity—only one study did not make this observation. In contrast, multiple studies revealed that the outcome results were significantly affected by the characteristics of the reviewing firm, representing a loophole that audit firms used to strategically change their reviewer after unfavourable review outcomes. Research studies with a similar focus could not be identified for the current PCAOB regime. Although the PCAOB is

established as a formally independent authority, the objectivity of inspectors should not be taken for granted. For this reason, formal independence and objectivity should not be used entirely synonymously. The formal independence of the PCAOB regime might not prevent its inspection process being influenced by the specific background and former affiliation of the particular inspectors.

Regarding the level of expertise, the peer review system was highly accepted and reviewers were seen as competent. Concerning PCAOB inspections, Big 4 firms disagree more frequently with the findings than smaller firms. However, as only two studies directly asked audit firms about their opinion on PCAOB inspectors, and neither took into consideration the firms that already left the auditing market, conclusions have to be made with reservations. Table 7 shows the synthesised results of the validity of peer reviews and PCAOB inspections.

**Table 7: Synthesised results on outcome validity**

Elements of validity	AICPA peer reviews	PCAOB inspections
Expertise	High (perception of audit profession).	Mixed (limited data).
Independence	Impaired (review result affected by type of reviewer).	No studies exist.

The framework's second criterion refers to the question of whether financial markets recognise peer reviews and inspection reports as informative. When the peer review system was voluntary, financial markets considered peer review reports to be informative signals of audit quality (compared to non-reviewed firms). However, when the system became mandatory the peer review system's signalling power decreased significantly: peer review reports had only a marginal effect on the financial judgments of financial experts and were not considered by audit committees in the selection process of audit firms. Peer reviews were not seen as transparent instruments to signal audit quality. The accounting profession shared this perception, as they did not believe that their clients would take review results into consideration. Thus, it can be concluded that while it was possible to differentiate between peer reviewed firms and non-reviewed firms, markets were not able to differentiate between the results of the different types of review.

Empirical findings concerning the market's awareness of PCAOB reports are less clear. Indeed, some authors do not identify an association between PCAOB outcomes and client losses, whereas others point out that negative reports increase the likelihood of losing clients involuntarily and that stock movements of audit firms' clients are sensitive to the issuance of inspection reports. Interestingly, not much work can be found on the perception of individual financial experts or of the accounting profession about the PCAOB inspections. Only one study



indicates that PCAOB reports improve the credibility of future audit opinions. Table 8 shows the synthesised result of whether peer reviews and PCAOB inspections were recognised for decision-making purposes.

**Table 8: Synthesised results on recognition for decision-making purposes**

AICPA peer reviews	PCAOB inspections
Voluntary system: recognised for decision-making.	Mixed findings.
Mandatory system: not-recognised for decision-making.	

Finally, the framework's third aspect focuses on the impact of peer reviews and PCAOB reports on audit quality. Empirical work on peer reviews has mostly used alternative assessments, such as outcomes of inspections conducted by state authorities, SEC enforcement actions, or compliance with GAAP, to reveal the impact of peer reviews on overall audit quality. The studies indicate that reviewed firms (compared to non-reviewed firms) conducted higher quality governmental audits, were less likely to receive SEC sanctions, and showed fewer violations of GAAS reporting standards. Empirical work on the PCAOB has primarily used client-specific measures to assess the contribution of the inspection to overall audit quality. The results indicate that PCAOB opinions can distinguish earnings quality and that audit firms with detected deficiencies are more likely to issue going-concern opinions. Moreover, the rate of abnormal accruals of clients of audit firms declines subsequent to inspections. Another indicator of the PCAOB's contribution to overall audit quality is that studies show that PCAOB inspections incentivise low-quality audit firms to exit the audit market.

Table 9 shows the synthesised result of the impact of the peer reviews and PCAOB inspections on overall audit quality.

**Table 9: Synthesised result of the impact on audit quality**

AICPA peer reviews	PCAOB inspections
Voluntary system: increase of audit quality.	Increase of audit quality.
Mandatory system: no effect on audit quality.	

Nevertheless, it is important to note that surveys indicate that financial actors were highly critical of the peer review programme's ability to enhance audit quality; figures show that the majority did not believe in the system's effect on audit practices or its ability to detect material misrepresentation during a review process. Under the new PCAOB framework, triennially inspected firms tend to neglect the effect of PCAOB inspections on audit quality, while large audit firms believe the PCAOB to be efficient and effective in improving overall audit quality.

## 1.7 Research gaps

The following section points out some blind spots in the field of audit regulation research. These are derived from findings in regulation theory and from the comparison of research on the peer review system with research on the PCAOB system.

### *Individual characteristics of reviewers and PCAOB inspectors*

Research has examined the validity of peer reviews in various ways. However, it is striking that apart from direct surveys among the profession, studies on the expertise of peer review teams or analyses that take a closer and detailed look at the composition of review teams do not exist. Hence, insights are missing about the outcome and process effects of individual reviewer's characteristics and of review team compositions. In particular, research has to address the possible effects of auditors for which peer reviews represent only an ancillary activity to their primary audit-related responsibilities (Carcello et al., 2011, p. 86). This is particularly important because, in the U.S. and other countries, the peer review system is still the dominant mode of external quality control for audit firms with non-listed companies as clients. The same research gap is identified concerning the PCAOB inspections. Although, anecdotal evidence indicates that PCAOB inspectors possess a high level of auditing experience (Glover et al., 2009; Lennox & Pittman, 2010), not much is really known about their background, their rationales for working for a governmental agency, their ties and intertwining in the auditing profession, and other possible process- and outcome-related factors.

### *Process of PCAOB inspections*

In regulatory regimes the risk of "creative-compliance" exists. This term refers to the practice of "complying with" rules by box-ticking, rather than taking substantive organisational steps (Baldwin et al., 2012). Although Fogarty (1996) previously criticised that the "peer review process is predicated on the rather dubious presumption that the quality of the audit can be understood by an examination of the audit's working papers", the inspection procedures under the PCAOB are not significantly different. They are based on an ex-post evaluation of the work conducted by the audit firm, and a disagreement with the audit firm's opinion about an audit engagement is interpreted as evidence of audit deficiency (Peecher et al., 2013, p. 21). Thus, it is likely that the PCAOB inspectors' judgments are affected by the same factors as those found in studies on peer reviews (Emby et al., 2002; King et al., 1994; Peecher et al., 2013), and that the efficacy of PCAOB inspections may be enhanced by focusing on process modifications. This is particularly important as the intensity of inspections (e.g. the amount of inspected audits) is not static: during an inspection, the inspection plan can be revised in order to target additional audits, which in most instances increases the number of deficiencies, and thereby worsens the formal assessment

of audit quality (PCAOB member Goelzer, 2005). To date, this field has only been partially addressed by proposing evaluations of the inspection by the inspected firm (Daugherty & Tervo, 2010), or by arguing for a transition from outcome-oriented judgments to a more process-oriented approach (Peecher et al., 2013). Future research has therefore to move beyond the classical dichotomy of reviews versus inspections, to reveal the potential of process modifications of external quality controls on audit quality.

### *Organisational learning*

Regulatory failure needs to be separated from the organisational failures of regulated parties. As Baldwin et al. (2012) explain, “a late train [does] not necessarily indicate poor railway regulation”. In the end, it is the audit firm that determines audit quality. Although the outcome results for an audit firm increase with the number of visits of the regulatory authority (e.g. Colbert & Murray, 1998; Hermanson & Houston, 2009), the organisational learning process is unknown as the process of adjusting audit practices due to identified deficiencies is still unclear. In other words, what is really learned from the inspection process and whether and how the findings change and shift current audit practices, remains unfathomable. Insights about the organisational learning are in particular important to interpret the trend of external quality control mechanisms. Trends were used both in research on the former peer review system (Bremser & Gramling, 1988; Colbert & Murray, 1998) and on the PCAOB inspections (Ragothaman, 2012), to draw general conclusions about the overall audit quality. However, the interpretation of a “positive” trend is associated with methodological difficulties as different factors might have an effect on the results without enhancing the level of audit quality. Alternative explanations for the positive trend might be that the inspection philosophy shifted over time or that the audit firms have become better prepared for the inspections by providing special attention to issues that are likely targets for inspection (i.e., high-risk issues) or by “styling working papers to appease inspectors” (Church & Shefchik, 2012, p. 61).<sup>18</sup> The lack of empirical findings about the processes of inspections and about the organisational learning of audit firms can be partially explained by the fact that field work in auditing is not existent (Gendron & Bédard, 2001; Power, 2003). However, qualitative methods, such as participatory observations, could explore the interplay of inspectors and the audit team during an inspection process – and provide answers to what is *really* learnt from external quality controls.

### *Research driven by data rather than importance*

Regulatory actions fail when the established regulatory regime does not produce the outcomes stipulated in its mandate (Baldwin et al., 2012). The accounting manipulations of Enron and

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<sup>18</sup> In fact, the AICPA offered trial-run peer reviews to CPA firms without review experience to prepare them for the actual review process (Wallace, 1991).

other major companies were interpreted as evidence of serious shortcomings in the self-regulatory system of the auditing profession. Given the fact that the overall annual audit failure was close to none (e.g. Francis, 2004; Palmrose, 1988), it was especially the role of large audit firms that were in the focus of the public and political outcry. Large accounting firms exert significant influence on the U.S. economy: they audit more than 80 per cent of all U.S. public companies, accounting for approximately 99 per cent of U.S.-based issuer market capitalisation (Roybark, 2006, p. 145). Yet, there is a paradoxical mismatch between the importance of large auditing firms and research about the impact of PCAOB inspection on this particular segment of the auditing profession. While it is known that triennially inspected firms that have received deficiency reports have a higher ratio of clients to personnel and relatively small personal resources (Hermanson & Houston, 2008; Hermanson et al., 2007), less industry expertise (Gunny, Krishnan, & Zhang, 2007), and clients with low earnings quality (Gunny & Zhang, 2013), knowledge about annually inspected firms is limited.

To date, only Carcello et al. (2011), Church and Shefchik (2012), and Gunny and Zhang (2013) analyse Big 4 data. But while Carcello et al. (2011), demonstrate that PCAOB inspections distinguish audit quality, Gunny and Zhang (2013) do not find supporting evidence. Methodological problems are the lack of variation of PCAOB reports for Big 4 firms (Abbott et al., 2013) and the fact that, although quality control deficiencies have been found in every inspection of these firms, they remain beyond the scope of academia because all criticism was addressed in a timely manner, and therefore, remain undisclosed (Church & Shefchik, 2012). While there is a vast bulk of research on the effect of large auditing firms on the international regulatory arena (Gillis, Petty, & Suddaby, 2014; Humphrey et al., 2006; Suddaby, Cooper, & Greenwood, 2007), it seems that research has somehow overlooked the local roots and causes of the shift from self-regulation to government regulation. To date, it has only scratched the surface of the big question: does government regulation decrease the risk of large accounting scandals?

**Table 10: Analysed data of studies on the PCAOB system**

Triennially inspected audit firms	Annually inspected audit firms
<ul style="list-style-type: none"> <li>• Hermanson et al. (2007)</li> <li>• Hermanson &amp; Houston (2009)</li> <li>• Daugherty &amp; Tervo (2010)</li> <li>• Daugherty et al. (2011)</li> <li>• Gramling et al. (2011)</li> <li>• Landis et al. (2011)</li> <li>• Ragothaman (2012)</li> <li>• Blankley et al. (2012)</li> <li>• Abbott et al. (2013)</li> </ul>	<ul style="list-style-type: none"> <li>• Carcello et al. (2011)</li> <li>• Church &amp; Shefchik (2012)</li> <li>• Gunny &amp; Zhang (2013)</li> </ul>

## 1.8 Conclusion

For the last ten years the U.S. audit profession has been monitored by PCAOB inspections under government oversight. This paper reviews research on both the former peer-review system and the current PCAOB system. Prior literature is analysed and synthesised along three research axes: the validity of reviews and inspections, the recognition of reviews and PCAOB inspections for decision-making by financial markets, and the effect of reviews and inspections on audit quality.

Research on the former peer review system is consistent with regard to several findings. First, the results indicate that the initial introduction of external quality controls enhanced the quality of services provided by audit firms. When reviewed firms were compared with non-reviewed firms, reviewed firms conducted higher quality governmental audits, were less likely to receive SEC sanctions, and showed fewer violations of GAAS reporting standards. When all firms were reviewed, however, financial markets began to ignore review reports. This can be explained by the inability of financial actors to differentiate the audit quality among peer reviewed firms and/or by the awareness of the system's main shortcoming: multiple studies provide evidence for the lack of objectivity to which the system was exposed.

When analysing research on the PCAOB regime, results indicate a positive impact of PCAOB inspections on audit quality. At the same time, however, audit firms themselves are rather sceptical concerning the effect of PCAOB inspection on audit quality. This mismatch has to be addressed by future research, in particular through research designs that focus on the intra-organisational learning processes of audit firms subsequent to PCAOB inspections. In addition, further research is necessary to elaborate whether financial markets really trust the credibility of public authorities. While one study demonstrated that audit firms' market shares are insensitive to the content of PCAOB reports, other studies reveal the opposite. The absence of an overall quality rating, the fact that quality-control findings are kept confidential, and the three-year inspection cycle for triennially inspected firms might explain the market's hesitation to take into account PCAOB inspections for decision-making purposes. These obstacles have also to be considered by other audit regulators, which aim at reforming their oversight structures to maintain or gain legitimacy in the public and the financial spheres.

This study cannot eliminate the potential confusions that are associated with history, which is the main limitation of this study. For instance, confounding SOX provisions hamper research on the PCAOB inspections. Provisions, as management certifications change with regard to audit subcommittee independence (SOX, Sec. 301), or bans on the provision of certain non-audit services (Sec 201), might simultaneously affect audit quality and other aspects under consideration. For this reason, it is all the more important to shed light on areas which have been

overlooked in research, but are from insignificant in importance. Research must disclose the inspection process and analyse how audit firms see themselves as learning organisations rather than pure audit units. In particular, research should focus on the effect of the PCAOB inspections on large accounting firms, since their role in the past balance-sheet scandals was the driver for change from self-regulation to government oversight. It remains to be shown whether direct government regulation has de facto decreased the risk of large accounting scandals, political tsunamis, and further rounds of regulatory reforms.

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“Other countries have established or are considering establishing PCAOB-like inspection bodies.  
The days of unfettered self-regulation are coming to an end”  
(PCAOB founding member Daniel Goelzer, 2005)

## Chapter 2

### **(In)dependent audit oversight: an interdisciplinary approach to comparing audit regulation.**

#### **Abstract**

The independence of audit oversight systems is the most essential prerequisite for restoring public confidence in audits after the recent accounting scandals and financial crisis. This study provides insights into the question as to how independent the “independent” audit oversight boards are. Their independence is measured both in terms of their organisational composition (e.g. appointment procedures of the board members) and regulatory competences (e.g. the way audit firms are inspected). Hence, this study takes a first step towards providing a quantifiable measure of the formal independence of audit oversight authorities. The results are visualised by a Partial Order Scalogram Analysis with Coordinates (POSAC), which allows conclusions about the similarities of various countries and their relative levels of independence. Although all countries encounter similar pressure to establish public (i.e. profession-independent) oversight systems, this study identifies how differently “independence” has been translated in regulatory outcomes. Whereas all countries claim to possess formal public oversight systems, there is a visible gap between countries with comparatively independent oversight systems, and the states with accounting bodies that still maintain far-reaching regulatory competences.<sup>19</sup>

**Keywords: audit regulation, audit oversight, regulator independence, cross-country comparison**

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## 2.1 Introduction

The changing relationships between the audit profession and the state are at the heart of national audit regulation. The establishment of the Public Company Accounting Oversight Board (PCAOB) in the U.S. in the aftermath of the fall of Enron has marked a turning point for the regulation of the accounting profession: it formally terminated the long-standing tradition of professional self-regulation and replaced it with public oversight. Profession-independent examination of auditing practice was seen as the essential tool to restore public confidence in financial auditing and secure its legitimacy. Triggered from the regulatory changes in the U.S., audit oversight structures soon mushroomed around the globe and challenged the institutionalised net of interrelations between the profession and the state (Canning & O'Dwyer, 2013; Caramanis, Dedoulis, & Leventis, 2015; Hazgui & Gendron, 2015; Malsch & Gendron, 2011). However, empirical cross-country comparisons about the interrelation between audit oversight systems and the accounting profession have not yet been provided.<sup>20</sup>

Traditional research on audit regulation is characterised by comparative studies incorporating a rather small and highly selective number of large countries (R. C. Baker, Quick, & Mikol, 2001; Eldaly, 2012; Evans & Nobes, 1998; Puxty, Willmott, & Lowe, 1987), or by qualitative case studies focusing on single countries (Blavoukos, Caramanis, & Dedoulis, 2013; Canning & O'Dwyer, 2013; Jonnergard, 2012; Malsch & Gendron, 2011; Öhman & Wallerstedt, 2012; Robson, Willmott, Cooper, & Puxty, 1994). A systematic and encompassing comparison of the intertwining of oversight entities and the accounting profession is still missing. Especially, there is a lack of comparative data on the configuration of oversight systems and the diverse understanding and interpretation of “independent oversight” across different jurisdictions. As a result, there is a paradoxical gap between the high relevance attributed to independent regulation and the empirical findings on the way in which this new regulatory paradigm has been translated into regulatory outcomes.

This study fills the research gap by offering a methodological operationalisation for measuring the level of independence of audit oversight structures by using an analytical framework for the first time. In other words, this study provides first insights about the independent nature of the audit oversight systems of the accounting profession. By comparing the independence of the audit oversight systems of all European member states and the U.S., this paper at the same time responds to calls for more cross-country audit research to advance the knowledge about various forms of public oversight systems (Humphrey & Moizer, 2008, p. 270; Maijoor & Vanstraelen, 2012; Schilder, 1996).

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<sup>20</sup> This stands in sharp contrast to other sub-disciplines of international accounting research. For instance, research on the international harmonisation of financial accounting standards has increased significantly within the last two decades (Baker and Barbu, 2007; Prather-Kinsey & Rueschhoff, 2004).

Assessing the institutional independence is important as it helps to shed light on the governance mechanisms of these pivotal financial regulatory entities. It is not argued that regulatory behaviour or action can be deduced entirely from the formal institutional design. Nevertheless, it provides a point of reference when referring to the “independent regulator”; an anchor, needed for current debates on further regulatory reforms and audit research on the relationship between the regulator’s action and its formal institutional design. The development of the framework is particularly needed as the meanings of rather broad regulatory categories (e.g. “agencies” and “authorities”) vary across countries, which frequently undermines the validity of cross-country comparisons (Thatcher, 2002c, p. 956). The methodological challenge of this study lies in the operationalisation and the measurement of the concept of audit oversight independence. Independence is measured in terms of the organisational compositions and regulatory competences of the audit oversight authorities. The results are analysed and visualised by a Partial Order Scalogram Analysis with Coordinates (POSAC), which allows conclusions about the similarities of various countries and their relative levels of independence. The basic idea behind this approach is that every analytical object can be decomposed into a certain number of distinct dimensions. Both measurements are then equally combined into one value of material independence, which is used to rank the analysed oversight authorities.

The U.S. PCAOB is added to the European sample given its pivotal role in shaping audit regulation on the global landscape. Its establishment triggered various rounds of regulatory reforms in the European Union, starting in 2006, when an EU Directive (2006/43/EC) for the first time required European member states to implement an independent oversight system.<sup>21</sup> Moreover, as the PCAOB’s power reaches beyond the U.S. boundaries, the subsequent development of the European oversight regulation, both on the national and the European level, was strongly linked to the PCAOB’s pressures to establish professionally independent – “PCAOB-like” – oversight authorities. Sections 102(a) and 106 of the Sarbanes-Oxley Act and PCAOB Rule 2100 require non-U.S. audit firms to be registered with the PCAOB and thereby subject to PCAOB inspections. From 2009, the PCAOB inspected non-U.S. audit firms in their respective home countries. This caused other countries to establish audit oversight authorities as the PCAOB made clear that only the establishment of “equivalent” bodies would avoid extraterritorial PCAOB inspections (see, for example, the statements of PCAOB members Goelzer, 2004, 2005, 2007; Olson, 2006; Ross, 2004). Complete independence from the accounting profession was seen by the PCAOB as “essential criteria” for determining whether the Board could rely on a non-U.S. oversight system to conduct inspections of PCAOB-registered non-U.S. audit firms (PCAOB, 2007; PCAOB member Ross, 2004).

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<sup>21</sup> European regulation can occur through several ways: if it is in the form of a Directive, member states must transpose the regulation into national law, but are free to choose the means of attaining the objectives set. Appendix 1 offers a detailed presentation of the history of audit regulation in the European Union.

Comparative analysis requires comparable data. To guarantee the study's validity, data about the oversight authorities was collected in two ways. First, an email questionnaire was sent to all 28 European oversight authorities in November 2013. The questionnaire focused on the legal provisions of the independence dimensions used for this study. By March 2014, answers were received from 22 oversight authorities.<sup>22</sup> Second, all national provisions on the compositions and responsibilities of the audit oversight systems were collected and analysed (Appendix 2: Legal sources).<sup>23</sup> Other sources of information were data from the website of the International Forum of Independent Audit Regulators (IFIAR) ([www.ifiar.org](http://www.ifiar.org)), along with the official websites of the oversight boards and their annual reports. The list of regulators and their basic institutional design and funding structure is presented in the Appendix 3. As it was neither possible to get in contact with the relevant authorities nor possible to identify and to obtain the relevant regulatory provisions, the oversight board of Cyprus could not be included in the analysis. To guarantee that the results represent the current oversight structures, the findings of the various sources were compared with each other and then directly translated to the coding scheme.<sup>24</sup> In case answers from the questionnaire needed further clarification or were unclear to the author, the responding authorities were approached via email and phone in a second round in order to guarantee an appropriate translation to the coding scheme. The validity of the final results was cross-checked by other auditing scholars and by various oversight authorities to which the results have been provided (e.g. France, Germany, Romania).

The rest of the paper is structured as follows. The next section presents the operationalisation of the “independent” audit oversight, on which the coding system used in this paper is based, and introduces the method for analysis. The third section illustrates and compares the independence values of all oversight systems. Explaining the ranking for each country would go beyond the scope of the paper. Nevertheless, the reasons and rationales behind the ranking of various extreme cases are presented. Finally, conclusions and suggestions for future research are given.

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<sup>22</sup> The following countries did not respond to the research request: Spain, Slovenia, Portugal, Italy, Estonia and Cyprus.

<sup>23</sup> In case, no English version of the legal text existed, the relevant regulations were identified and translated with the help of audit researchers from the particular country, who were contacted by the author.

<sup>24</sup> Two research assistants were involved in the data collection. The coding process (i.e. the translation of the collected materials into the coding scheme, however, was only made by the author.



## 2.2 Methodology

### 2.2.1 Notion of independence

Independence is considered to be a vital element of regulatory supervision. Independence from regulatees is essential in order to create a level playing field and to ensure market confidence in the impartiality of regulatory decision-making (Ottow, 2015, p. 11). Nevertheless, “independence” is a rather blurred concept as multiple definitions exist (Koen Verhoest, Peters, Bouckaert, & Verschuere, 2004). Following Majone (1997), independence can be conceptualised as an entity’s autonomy in decision-making (Majone, 1997). Autonomy, in turn, is the ability to translate one’s own preferences into authoritative actions without external constraints (Busuioc, 2009; Maggetti, 2007; Nordlinger, 1987). Given this paper’s research focus, independence is therefore defined as the autonomy of the oversight entity to self-determine its preferences and to make use of its regulatory competences, without constraints from the accounting profession, during the activity of regulation.<sup>25</sup>

Moreover, it is important to distinguish between formal independence and de-facto independence. Formal independence describes the status of an agency according to the legal acts that establish its authority. De-facto (e.g. actual) independence refers to the degree to which the oversight authority operates independently from the audit profession in practice (Hanretty & Koop, 2012, 2013; Maggetti, 2007; Tenbücken & Schneider, 2004). Measuring and comparing de-facto independence among all European member states would require an extremely complex research design. Therefore, this study assesses the formal independence of the audit oversight systems. Formal independence can be considered as the key factor when investigating delegation to regulatory agencies as it corresponds to the intentions of the decision-makers – policy makers and regulators – with regard to providing credibility to regulatory policies (Maggetti, 2007).<sup>26</sup> By focusing on the dimension of material independence, the country’s politico-administrative tradition or other non-legal determinants (i.e. policy style or administrative culture) of actual independence are outside the scope of this paper. Acknowledging the possible interferences of other factors does not, however, mean that formal independence is immaterial. On the contrary, various scholars trace actual independence back to formal independence (Furlong, 1998; Hanretty & Koop, 2013; Hayo & Voigt, 2007; K. Verhoest, Roness, Verschuere, Rubecksen, & MacCarthaigh, 2010).<sup>27</sup>

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<sup>25</sup> It has to be pointed out that audit regulators might also be dependent on political decision-makers. Blavoukos et al. (2013), for instance, show how the mode of governance of the Greek independent oversight board is highly politicized (Blavoukos et al., 2013; also Caramanis, Dedoulis, & Leventis, 2015).

<sup>26</sup> It is important to remember that the study’s focus should not be mixed up with debates on auditor-client independence (see e.g. Jeppesen, 1998; Suddaby, Cooper, & Greenwood, 2007).

<sup>27</sup> For a critical account about the translation from formal autonomy into real autonomy of regulatory agencies, see

## 2.2.2 Variables of independence

This paper's index of independence – on which the oversight systems are compared – is based on the construction of two profiles for each oversight system. While the *Organisational Profile* takes into account the organisational structures, the *Functional Profile* relates to the regulatory competences of the oversight authorities.<sup>28</sup> With the results of these profiles, it is then possible to create one index of independence that considers both the organisational and the functional independence equally. For each country the arithmetic mean of the organisational and functional profile is calculated in order to set up a ranking regarding the degree of material independence of the oversight systems.<sup>29</sup> Each profile is based on several variables and each variable is associated with several indicators, which are numerically coded on a scale of 0 (lowest level of independence) to 3 (highest level of independence).<sup>30</sup> It could reasonably be argued that the variables of the profiles could be weighted differently, for instance, by performing a qualitative assessment of their relative importance a priori. At this point in the study, each variable has been attributed with the same weight, thus, implicitly, the same relevance.<sup>31</sup>

The identification of the variables (i.e. the operationalisation of independence) is based on two pillars. First, it takes into account prior studies on independence of regulatory entities. Public policy primarily investigates the independence of regulatory agencies from political interferences. A measurement tool for independence has been developed for special cases, such as banks (Cukierman & Webb, 1995; Cukierman, Webb, & Nevapti, 1992), the telecommunications market (Edwards & Waverman, 2006; Tenbücken & Schneider, 2004) and courts (Hayo & Voigt, 2007; Smithey & Ishiyama, 2000). Other scholars have analysed the level of independence of regulatory agencies of various sectors within one country (Elgie & McMnamin, 2005) or among several countries (Gilardi, 2002, 2005; Hanretty & Koop, 2013). These studies all measure independence along multiple indicators (Table 11).

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Busuioc (2009) and Yesilkagit (2004).

<sup>28</sup> In some countries, several other entities are in charge of audit oversight. For instance, the Finnish audit oversight system is a two-tier system with the Auditing Board of the State, which is a government authority, and the Auditing Board of the Central Chamber of Commerce. Here the latter was taken as an analysis subject for organisational independence as it was specified in the questionnaire as the primarily responsible body for oversight matters.

<sup>29</sup> “Material” independence is thereby defined as true independence rather than rhetoric independence.

<sup>30</sup> This scale was used as the majority of variables had three indicators. In the case of four indicators, the scale was further differentiated (0.75 - 1.50 - 2.25 - 3.00).

<sup>31</sup> Gilardi points out that combining and weighing variables is unavoidably arbitrary. To cut this Gordian knot, he therefore attributes the same weight to each variable (Gilardi, 2002; also Tenbücken & Schneider, 2004).

**Table 11: Indices of statutory Independence**

Authors & date	Study focus	Dimensions of independence (number of indicators)
Cukierman et al. (1992)	Independence of banks from government	<ul style="list-style-type: none"> <li>▪ Chief executive officer (4)</li> <li>▪ Regulatory competences vis-à-vis the government (3)</li> <li>▪ Central bank objectives (1)</li> <li>▪ Limitations on lending to the government (8)</li> </ul>
Smithey and Ishiyama (2000)	Independence of courts from politicians	<ul style="list-style-type: none"> <li>▪ One dimension with six indicators: <ul style="list-style-type: none"> <li>• Number of actors involved in the appointment</li> <li>• Term length</li> <li>• Dismissal provisions</li> <li>• Organisational autonomy</li> <li>• Presence of a priori review</li> <li>• Decisions irreversible or not</li> </ul> </li> </ul>
Gilardi (2002)	Independence of various agencies from politicians	<ul style="list-style-type: none"> <li>▪ Agency head status (6)</li> <li>▪ Management board members' status (6)</li> <li>▪ Relationship with government and parliament (4)</li> <li>▪ Financial and organisational autonomy (4)</li> <li>▪ Regulatory competences (1)</li> </ul>
Schneider and Tenbücken (2004)	Independence of telecommunication regulators from governments	<ul style="list-style-type: none"> <li>▪ Organisational features (11)</li> <li>▪ Regulatory competences (12)</li> </ul>
Elgie and McMenamin (2005)	Independence of French agencies from politicians	<ul style="list-style-type: none"> <li>▪ Agency head (4)</li> <li>▪ Agency board member (4)</li> <li>▪ Regulatory competences (5)</li> </ul>
Edwards and Waverman (2006)	Independence of telecommunication regulators from governments	<ul style="list-style-type: none"> <li>▪ Powers of the agency (6)</li> <li>▪ Characteristics of the agency (6)</li> <li>▪ Member appointments and terms of office (3)</li> <li>▪ Resources of the agency (2)</li> <li>▪ Experience of the agency (1)</li> </ul>
Wonka and Rittberger (2010)	Independence of EU agencies from the European Commission, the European Parliament, and the European Council	<ul style="list-style-type: none"> <li>▪ Formal mandate of the agency (1)</li> <li>▪ Appointment of the head (8)</li> <li>▪ Appointment of the members (7)</li> <li>▪ Internal decision-making (11)</li> </ul>

To link public policy research to the specific field of audit regulation, the definition of the International Forum of Independent Audit Regulators (IFIAR) and the European Commission about the core principles of an “independent” audit oversight system has been taken into account as a second pillar for the identification for the relevant independence variables. The IFIAR was established in 2006 and is the central global platform of the audit regulatory framework, bringing together independent audit regulators from a total of 50 jurisdictions. According to its charter, the organisation seeks to promote effective independent audit oversight globally by developing and offering “core principles for independent audit regulators”. These principles are aimed at “fostering high quality audits and promoting public trust in the financial reporting process” (IFIAR 2014) and describe the responsibilities and powers of audit regulators, and ways of operating independently and objectively. The principles are meant to provide guidance to regulators’ governments, to establish an “effective” independent audit oversight

system. The 11 core principles are classified into three groups. While the first group includes principles on the structure of audit oversight, the second group focuses on the operations of audit regulators. The third group analyses the inspection process.<sup>32</sup>

By matching public policy research and the definition of audit oversight independence of the IFIAR and the European Union, the study's measurement validity can be secured.<sup>33</sup> The combination results in ten variables on which the measurement of the Organisational Profile is based, and five variables on which the Functional Profile of each oversight system is based (Table 2).

### *Organisational Profiles*

The analysis of the Organisational Profiles of the public oversight systems is based on a total of ten variables. Seven out of the ten variables are explicitly or implicitly stated in the IFIAR principles on independent audit oversight. Three have been additionally added based on prior literature on independence.<sup>34</sup> The variables measure the essential organisational features of the oversight boards and represent control relations between the accounting profession and the oversight board, such as the procedures foreseen for the appointment of the oversight board members and the oversight head, the existence or not of special cooling-off provisions, the employment status of the board members, and provisions on the terms of office. The latter is based on literature which argues that non-renewable and fixed-term mandates promote independence by eliminating the possibility that members exercise regulatory power strategically (Edwards & Waverman, 2006; Tenbücken & Schneider, 2004). They also measure the extent of influence of professional bodies on the nomination procedure and whether practitioners are involved in the governance of the board. Finally, the audit oversight system is analysed to determine whether it is organised as a single-sector or a multi-sector jurisdiction. According to the classic argument of capture theory, regulatees may gain influence over their regulator (Coen, 2005; Stigler, 1971). Scholars suggest that a multi-sector agency provides better protection from

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<sup>32</sup> Eldaly (2012) provides a very useful analysis of the 11 core principles and their key features of the IFIAR (Eldaly, 2012, pp. 117–124).

<sup>33</sup> Measurement validity is concerned with the question as to whether a variable measures what it is supposed to measure (King, Keohane, & Verba, 1994). As independence is a broad and widely used concept, it is important to keep in mind that the quality of measurement technique should be evaluated based on its relation between reality and its “systematised concept” (i.e. the construct defined for the purpose of the specific study). This means that the more complex and contested the background concept, in this case “independence”, the more important it is to distinguish issues of measurement from fundamental conceptual disputes. Therefore, the quality of this paper's operationalisation should not be assessed against any possible understanding of “independence”, but rather be evaluated against the concept of the specific research question addressed by this study. This understanding is borrowed from Adcock and Collier (2001) who argue that “rather than making sweeping claims about what the background concept ‘really’ means, scholars should present specific arguments, linked to the goals and context of their research, that justify their particular choices” (Adcock & Collier, 2001, p. 532).

<sup>34</sup> Literature does not offer a fixed number of variables for the reliability of the scale. However, the reliability is improved by the increasing the number of variables that can be theoretically defended as being representative of the concept (Merschrod, 1980). With regard to the subsequent POSAC analysis, optimal solutions are obtained with five to ten variables (Shye, 2009, p. 299). This is in line with the number of variables chosen in this study.

industry capture as interest groups compete against each other and thus reduce their organisational strength (Edwards & Waverman, 2006; Maggetti, 2007; Tenbücken & Schneider, 2004). Based on this argumentation, audit oversight systems embedded in a multi-sector regulator are coded as more independent. The variables “dismissal of board members” and “dismissal of authority head” have been omitted in the final analysis due to a lack of variance. The coding values for the Organisational Profiles of each oversight system are stated in Appendix 4.

### *Functional Profiles*

The Functional profiles measure the extent to which the audit oversight regulators depend on the audit profession for conducting the vital elements of the oversight system. Due to the high technical understanding that is needed in auditing, regulators have to balance between the need to cooperate with the audit profession and the necessary detachment, which is needed for an effective oversight system. Too much cooperation may result in an oversight authority being captured by the audit profession seeking to influence its decision, and in rules being applied too leniently or that the regulator loses its objectivity (i.e. a risk of capture) (Baldwin, Cave, & Lodge, 2012; Ottow, 2015). In other words, the interrelation between regulators and regulatees is characterised by the continual struggle to “balance between trust and distrust” (Ottow, 2015, p. 6). The analysis of functional profiles of the public oversight systems is based on a total of five variables. The first variable focuses on the registration of audit firms. The second and third variables relate to the mode of external quality assurance, which particularly affects the degree to which oversight systems achieve their goal of protecting the interests of investors and the public. This relates to common criticism that professions are unwilling or unable to discipline their members (Bedard, 2001; Suddaby, Cooper, & Greenwood, 2007). The fourth variable relates to the authority for disciplinary measures in case errors or material weaknesses were identified in the inspections and the publication of the report, which is the fifth variable (Table 3). The level of independence of the Functional Profiles is in particular determined whether the oversight authorities delegated tasks to national accountancy associations or national chambers of auditors. In these cases, the respective oversight authority is not directly involved in the day-to-day regulatory process, but strongly depends on the support of the accounting profession. These variables relate to core principles of professional self-regulation (Powell, 1985; Suddaby et al., 2007). In other words, the higher the level of functional independence of the particular oversight authorities, the more impaired is the national self-regulatory system (see e.g. R. L. Baker, Bealing Jr, Nelson, & Staley, 2006). The coding values for the Functional Profiles of each oversight system are stated in Appendix 5.<sup>35</sup>

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<sup>35</sup> As this is the first study on audit oversight boards, the column “prior studies” refers to prior studies that in general incorporated the competencies of regulators. These competencies differ in regard to the specific regulator.

## Coding for Organisational Independence

Coding system		Coding source		
Variables	Indicators	Coding	Principles of audit regulation	Prior studies
Form of financing of governing body	Fully financed by government subsidy	3.00		Edwards and Waverman (2006); Gilardi (2005, 2002); Tenbücken and Schneider (2004)
	Government subsidy (major part) and levy of audit firms	2.25	IFIAR Core Principle 2;	
	Levy of audit firms (major part) and government subsidy	1.50	EU Regulation No 537/2014 (22)	
	Levy of audit firms	0.75		
Employment status of head of governing body	Full-time	3.00		Cukierman et al. (1992); Gilardi (2005, 2002); Elge and McMenamin (2005)
	Part-time	2.00	IFIAR Core Principles 5 and 6	
	Honorary member	1.00		
Cooling-off requirement for head of governing body	Head was and is a non-practitioner	3.00		
	Cooling-off period between two and five years	2.00	IFIAR Core Principles 2, 5 and 6	
	No provision exists	1.00		
Employment status of board members of the governing body	Employed by the POB	3.00		Gilardi (2005, 2002); Elge and McMenamin (2005)
	Part-time	2.00	IFIAR Core Principles 5 and 6	
	Honorary member	1.00		
Appointment of board members under influence of the profession	No	3.00	IFIAR Core Principle 5;	Edwards and Waverman (2006); Elge and McMenamin (2005); Smithy and Ishiyama (2000); Tenbücken and Schneider (2004)
	Yes	1.00	EU Directive 2014/56/EU (18)	
	None	3.00		
	0%–14% of board members	2.25	IFIAR Core Principle 2;	
Number of practising auditors involved in the governing body	15%–29% of board members	1.50	EU Regulation No 537/2014 (22);	Gilardi (2002, 2005); Edwards and Waverman (2006)
	30%–49% of board members	0.75	EU Directive 2014/56/EU (18)	
	All members were and are non-practitioners	3.00		
Cooling-off requirement for members of the governing body	Cooling-off period between two and five years for all	2.25	IFIAR Core Principle 2;	
	Cooling-off period for 'majority' of board members	1.50	EU Regulation No 537/2014;	
	No provision	0.75	EU Directive 2014/56/EU (18)	
	Multi-sector jurisdictions	3.00		
Form of jurisdiction of oversight entity	Single-sector jurisdictions	1.00		Tenbücken and Schneider (2004); Edwards and Waverman (2006); Maggett (2007)
	>6	3.00		
Term of office for members of governing body	Four or five years	2.25		Smithy and Ishiyama (2000); Tenbücken and Schneider (2004); Elge and McMenamin (2005); Edwards and Waverman (2006)
	Two or three years	1.50		
	No fixed term	0.75		
Re-appointment provisions of board members	No	3.00		Smithy and Ishiyama (2000); Tenbücken and Schneider (2004); Elge and McMenamin (2005); Edwards and Waverman (2006)
	Yes, once	2.25		
	Yes, twice	1.50		
	No provision or indefinite	0.75		

## Coding for Functional Independence

Coding system		Coding source	
Variables	Indicators	Coding	Prior studies
	Principles of audit regulation		
Registration of audit firms	Professional Oversight Board	3.00	Cukierman et al. (1992); Gilardi (2005, 2002); Elgie and McMenamin (2005); Smithy and Ishiyama (2000); Edwards and Waverman (2006)
	National Chamber of Auditors/Accountants	2.00	
	Accounting association	1.00	
Responsibility of conducting inspections	Inspectors directly employed by the oversight board	3.00	Cukierman et al. (1992); Gilardi (2005, 2002); Elgie and McMenamin (2005); Smithy and Ishiyama (2000); Edwards and Waverman (2006)
	Inspectors employed by the accounting association	2.25	
	Combination of reviewers and employed inspectors	1.50	
	Peer reviewers	0.75	
Responsible authority of inspection reports	Professional Oversight Board	3.00	Cukierman et al. (1992); Gilardi (2005, 2002); Elgie and McMenamin (2005); Smithy and Ishiyama (2000); Edwards and Waverman (2006)
	National Chamber of Auditors/Accountants	2.00	
	Accounting association	1.00	
Operating authority of disciplinary measures	Professional Oversight Board	3.00	Cukierman et al. (1992); Gilardi (2005, 2002); Elgie and McMenamin (2005); Smithy and Ishiyama (2000); Edwards and Waverman (2006)
	National Chamber of Auditors/Accountants	2.00	
	Accounting association	1.00	
Publication of inspection results	Yes	3.00	Cukierman et al. (1992); Gilardi (2005, 2002); Elgie and McMenamin (2005); Smithy and Ishiyama (2000); Edwards and Waverman (2006)
	Only in the event of serious deficiencies	2.00	
	No	1.00	

### 2.2.3 Analysis and visualisation of independence

The results are analysed and visualised with a Partial Order Scalogram Analysis with Coordinates (POSAC).<sup>36</sup> POSAC is a specific form of multidimensional scalogram analysis that reduces the data of the objects from an N-dimensional space to a two dimensional space. As POSAC is a dimension reduction method, it can be compared with a Principal Component Analysis. However, while the latter tries to preserve distances, POSAC tries to preserve ordering (Bhat, 2007). Thus, the underlying assumption of POSAC is that the geometric representation of order relations among objects, rather than the mathematical expression of items' loadings on factors, may highlight patterns in the data that are not so apparent in factor analytic solutions. POSAC lists all profiles of the data set and represents these in a two-dimensional space by means of geometric distances on the basis of their structural similarity.

A partial order analysis begins with a number of criteria for differentiating an observed population basis; this is the so-called “facet theory”. Facet theory was originally used in the field of organisational research and psychology (Guttman & Greenbaum, 1998, p. 13). Recently, the method has gained attention in the field of comparative politics as it has been identified as a powerful method of structural and comparative analysis (DeRosa, D'Ambrosio, & Cohen, 2005; Schneider, 2001; Schneider, Fink, & Tenbücken, 2005; Taylor, 2002; Tenbücken & Schneider, 2004; Voigt, Welz, & Brüggemann, 2004).

Facet theory emerged out of Louis Guttman's conviction that research first has to conceptualise and define that which is being studied (Guttman & Greenbaum, 1998). The basic idea behind facet theory is that every analytical object can be decomposed into a certain number of dimensions (facets) and each dimension can be decomposed into ordered values (Tenbücken & Schneider, 2004). A combination of different facets is a “structuple”; in this case, the profile of one oversight system. Each oversight system can thus be defined by its specific ‘structuple’ (profile) based on scores for each variable. In other words, an audit oversight profile is a row of the data matrix, which, in the current coding scheme, can range from {1111111111} through to {3333333333} (ten dimensions of organizational profile which can take values from 1 to 3), with all combinations among these two extremes empirically possible.<sup>37</sup> The method's advantage is that it enables us to distinguish between objects that have different values on different facets and thus show different institutional configurations. This allows the comparison of various objects and enables us to structure a previously disorganised universe. From this perspective, an

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<sup>36</sup> For the analysis, the software SYSTAT, Version 12 was used.

<sup>37</sup> Tenbücken and Thiem (2004) show an introductory example of facet theory: Here, the analytical object person (public oversight systems in this study) is decomposed into personal characteristics (facets), such as age, height, physical strength or intelligence. Depending on their characteristic, the values 1, 2 and 3 are attributed to each facet. Hence, an object with a medium age (2), which is very tall (3), possesses medium physical strength (2) and only little intelligence (1) would end up the structuple (profile) {2321}.



oversight system is defined as a specific combination of organisational and institutional elements. POSAC adopts these principles and represents the resulting variation among profiles as points in the geometric space. With the scalogram analysis, all structuples (all profiles of the oversight systems) are then ordered and depicted as points in a two-dimensional space through a regioning process in which profiles with the same score on a struct are positioned closer together than profiles with different scores on that struct (Taylor, 2002; Tenbücken & Thiem, 2004). This means that similar profiles are close and dissimilar profiles are distant from each other.

Moreover, the two-dimensional space illustrates the degree of independence of the various systems. Profiles with the highest rank occupy the upper right-hand corner, those with the lowest rank, the left-hand corner (Guttman & Greenbaum, 1998). Based on the coding system, this means that the profiles with the lowest degree of independence are in the lower left-hand corner, while the profile with the highest degree of independence is located in the upper right-hand corner. In this way it is possible to measure the European oversight boards in a quantitative and comparative way.

## **2.3 Results**

### **2.3.1 Organisational Independence**

Comparing all 28 profiles along a multidimensional scale, the analysis generates the topography illustrated in Figure 1. The values of Organisational Independence of each oversight system are presented in Appendix 6.

Figure 1: Organisational Profile (Stress Level: 0,1)

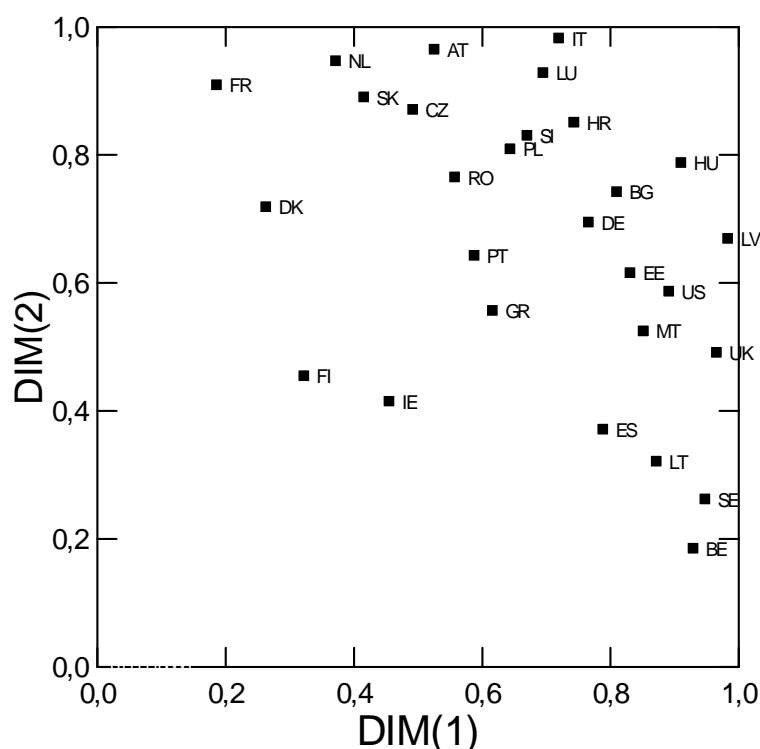


Figure 1 shows the POSAC for the organisational profiles of the audit oversight systems. In this case, the POSAC orders the oversight systems along ten dimensions, reduces the data and depicts them in a two-dimensional space. The result of the reduction of the ten dimensions to only two is DIM (1) and DIM (2). Thus, DIM (1) and DIM (2) are purely constructed dimensions which do not represent one particular dimension. They can be compared with the factors in a factor analysis that show a high factor loading. However, due to the reduction of ten dimensions to two, there is some error. The stress factor indicates that the percentage of the dimensions is not correctly represented after the reduction. A stress factor of  $<0.2$  is considered to be acceptable for the POSAC. Countries that lie closer to the lower left-hand corner have audit oversight systems with a low level of independence, whereas those systems closer to the upper right-hand corner possess a high level of independence. The Euclidean distance between each pair of oversight boards shows the systems' similarity based on the ten dimensions. Moreover, all of the countries that have the same distance to the diagonal have the same level of independence.

The analysis of the various interrelations between the accounting profession and the regulatory authority reveals a mixed picture of how independence was interpreted: although all of the European audit oversight bodies are formally independent from the accounting profession, there is not one single model to which all countries adhere. Countries lying closer to the upper right-hand corner show high levels of independence. Hence, Latvia, Luxembourg, Italy, and Hungary

are identified as possessing the most independent oversight systems in terms of organisational independence from the accounting profession and are gathered in the first group. The close positioning of the oversight systems of Luxembourg and Italy indicate similar institutional structures: they organise their audit oversight systems in the form of traditional regulatory agencies. Two indicators express the high organisational values of these countries in particular. First, one way of ensuring independence from the regulated industry is to maximise relational distance from the industry by excluding former employees of the accounting profession from being appointed as regulators, which is the case in these countries. Second, Italy and Luxembourg have multi-sector rather than single-sector agencies. As can be concluded from regulation literature, multi-sector agencies offer greater independence than single-sector agencies. They are more able to provide protection from industry capture, as interest groups have opposing effects and the agency has facilitated access to pooled resources, improving its information-processing abilities (Edwards & Waverman, 2006). Hungary and Latvia have set up the oversight boards within the government, as a permanent internal structure of the Ministry of Finance (Latvia) and the Ministry for National Economy (Hungary). Hence, members of the oversight board are civil servants and employed directly by the ministries.

Interestingly, Sweden shows that the organisation of the audit oversight system as a government authority does not necessarily result in high independence values. By 1973, in Sweden the supervision and licensing of auditors was transferred from the Stockholm Chamber of Commerce (private institution) to the State. It became one of the pioneers of quality controls when the Supervisory Board for Public Accountants (Revisorsnämnden) was established in 1995. Today, the Supervisory Board is a governmental authority under the Ministry of Justice and is governed by its director, who is appointed by the government. However, a closer look reveals that within its organisation the Supervisory Board has a separate decision-making body, the Oversight Board, which has decision authority in the field of disciplinary actions against individual auditors and audit firms. Additionally, the relatively low independence value is based on the lack of cooling-off requirements for the members of the Board and the involvement of practising auditors. This is in line with Jonnergard (2012), who draws attention to the country's opaque regulatory system, characterised by a strong regulatory intertwining between the state and the profession.<sup>38</sup>

Denmark presents a similar case. The official audit oversight authority is the Danish Business Authority (DBA), which is a regulatory agency under the Ministry of Business and Growth. However, the main responsible actor for quality assurance is the Danish Supervisory Authority

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<sup>38</sup> One example is the procedure in the event that the Supervisory Board reveals deficits when examining quality reports: Instead of taking action, it refers the matter back to the professional association for re-consideration (Jonnergard, 2012, p. 67).

on Auditing (DSAA). Although, the DSAA is an organisational entity within the DBA, its board consists of honorary members. The low independence value can furthermore be explained by the absence of cooling-off provisions and by the high number of accountants on the board: four out of nine members have to be approved auditors.

The low independence value of the PCAOB is another striking finding. This is primarily due to the specific SOX provisions regarding the composition of the Board. First, two out of five members involved in the governance of the Board have to be certified public accountants. Second, only the chairman has to meet the cooling-off provisions stated in the SOX. In particular, the SOX restriction of the number of Certified Public Accountants on the Board to two members is perceived as an appropriate safeguard to avoid the Board being dominated by the regulated parties (e.g. Palmrose, 2013, p. 778). Nevertheless this ratio is among the highest in terms of the involvement of accounting professionals, compared to the European provisions. Given that the Board is central to the way the PCAOB implements SOX provisions, one could, at least partially, question the role of the PCAOB as the globally accepted benchmark of an entirely independent regulator.

The British Financial Reporting Council (FRC) became responsible for audit regulation in 2004. Although the U.K. did not experience Enron-like accounting scandals, the FRC Board was a direct response to the developments in the U.S. (Eldaly, 2012), which is evidenced in relatively similar organisational structures, evidenced in the close positioning of the U.K. and the PCAOB in the topography illustrated in Figure 1. In contrast to other oversight authorities, here, only a majority of the overall 16 members of the Board must not be individuals who in the five years prior to appointment have been practising auditors. The average ranking in terms of organisational independence is mainly due to the fact that the profession funds half of the auditing and accounting costs of the FRC. This is in line with Eldaly (2012) who identified the dependence of the FRC's funding system on professional bodies as independence risk (Eldaly, 2012, p. 130).<sup>39</sup>

Finland and Ireland are the countries with the lowest values. By the mid-1990s, in Ireland the regulatory reforms altered the institutional arrangements of the country's self-regulatory system and established the Irish Auditing and Accounting Supervisory Authority (IAASA), described as "a unique event in the context of the main Irish professions" (Canning & O'Dwyer, 2013, p. 179). While at the time of establishment the institutional arrangements were more extensive than

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<sup>39</sup> The FRC frequently demanded to enhance its independence from those it regulates by arguing that "the independence of the FRC as oversight regulator for the audit profession is still governed by agreements with the profession that sometimes inappropriately limit its independence" (FRC, 2012, p. 11).

those of the majority of European countries<sup>40</sup>, the system has not kept pace with international and European regulatory developments (Canning & O'Dwyer, 2014, p. 25). As long ago as 1924, Finland decided that the supervision of the profession should be carried out by the Central Chamber of Commerce (Niemi & Sundgren, 2008, p. 80,96). Although critical voices have called for the removal of the oversight from the national Chamber to a pure governmental body, the Chamber has remained the primary responsible entity to this day.

### 2.3.2 Functional Independence

Comparing all 28 profiles along the multidimensional scale, the analysis shows the topography illustrated in Figure 2. The values of Functional Independence of each oversight system are presented in Appendix 7.

**Figure 2: Functional Profiles** (Stress Level: 0,1)

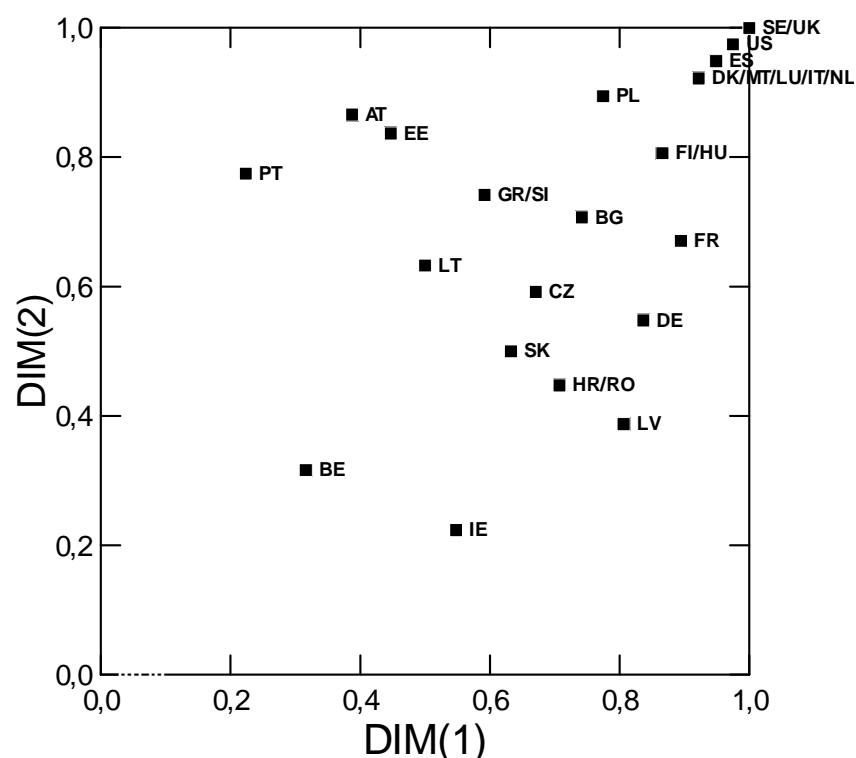


Figure 2 shows the POSAC for the functional profiles of the audit oversight systems. It shows less variation than the figure of the organisational profiles, thus indicating that the European audit oversight systems differ less significantly in terms of regulatory competences. Moreover, it reveals a fundamental difference between organisational and functional independence. While no single oversight system reaches the highest possible value concerning institutional independence, there are various countries with extremely high functional independence values (e.g. the FRC, the

<sup>40</sup> Canning and O'Dwyer (2013, p. 179) point out that one explicit aim of the regulatory reform was to establish an oversight board that is more independent and possesses greater regulatory competences than its U.K. counterpart.

Commissione Nazionale per le Società e la Borsa (CONSOB) in Italy, the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg and the Authority for the Financial Markets (AFM) in the Netherlands).

The two extreme outliers here are Belgium and again Ireland. In both countries, the primary responsibility for all quality assurance of statutory auditors resides with the accountancy bodies that organise the inspections and issue penalties in the case of deficiency reports. As in Ireland, Belgium integrated external entities, such as the High Council for Economic Professions and other disciplinary bodies, into its oversight system before European law required the establishment of independent regulation. Observers therefore argued that the “Belgian profession was at the leading edge” with respect to external quality assurance (Vanstraelen & Willekens, 2008, p. 36). However, the design of the system was made under influence of the profession (Vanstraelen & Willekens, 2008), which is evidenced in the analysis in terms of a very low degree of functional independence of the Belgian regulator. At this point, it is worth remembering that the analysis focus of this paper is on the external quality controls of audit firms with public interests clients. While some countries, such as the US, the UK, and Denmark distinguish considerably between audit firms with and without issuer clients, this regulatory gap does not exist in other countries. The low level of functional independence of the Belgian system might also explain why only one per cent of audit mandates relate to listed companies (Vanstraelen & Willekens, 2008, p. 19).

The Dutch system represents the counterexample, as the regulatory development took a very different course. Until 2006, no independent external oversight existed in the Dutch regulatory environment (Meuwissen & Wallage, 2008, p. 176). When, in 2006, the Authority for the Financial Markets (AFM) was declared as oversight body, the Dutch oversight system was transformed and—as in the U.S.—regulatory power was transferred from the professional bodies to a purely regulatory agency.

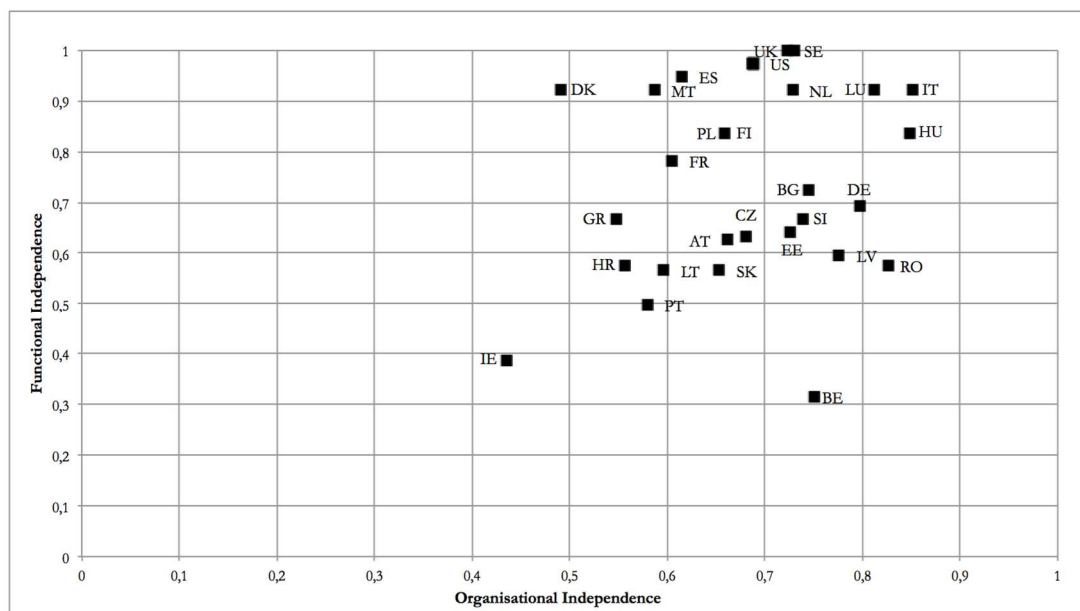
### 2.3.3 Material Independence

With these results, it is possible to create one index of independence that considers both organizational and functional independence equally. For each country, the arithmetic mean is calculated from the POSAC values of the Organizational and Functional profiles in order to set up a rank order regarding the degree of material independence of the oversight systems. The values of material independence of each audit oversight system are set out in Appendix 8.

For a graphical representation, the combined values are used to determine the positions of the systems on the y- and the x-axis of the diagram. The y-axis shows the combined values for the POSAC concerning the competences of the systems, the x-axis reveals the combined values for

the organisational structure. In this diagram, the oversight systems with the highest level of independence are located in the upper right-hand corner. The high variation—on both the y- and the x-axis—indicates that the oversight systems still differ significantly in terms of material independence.

**Figure 3: Material Independence of Audit Oversight Systems**



The great variance between the different degrees of independence among the countries becomes evident in the diagram. Countries with high independence values set up their oversight systems as administrative agencies (Hungary, Sweden) or as regulatory agencies (Luxembourg, Italy, the Netherlands).

The latter approach was put into practice by either adding audit oversight as an additional task to an already existing financial market supervisory authority, or by establishing a new authority—which was the case of the PCAOB in the U.S. The essential feature of regulatory agencies is that the prime and final responsibilities are combined as they are responsible for all immediate operating tasks of public oversight. Hence, these agencies combine legislative, executive, and judicial functions, i.e. they define rules, supervise them, and introduce sanctions if necessary. In addition, these agencies have their own powers and responsibilities given under public law, are organisationally separated from ministries, and are neither directly elected nor managed by

elected officials. Therefore they fulfil the criteria as an “independent regulatory agency” (Thatcher, 2002a, 2002b).<sup>41</sup>

Apart from Hungary and Sweden, the audit oversight systems in Denmark, Latvia, and Malta are also organised in the form of a regulatory authority equipped with its own resources and staff. These entities are organised as “governmental authorities” under the Ministry of Justice (Sweden), Ministry of Economic and Business Affairs (Denmark), and the Ministry for National Economy (Hungary), or belong to the internal structure of a ministry, as is the case in Latvia. Hence, this approach involves highly politicised bodies. However, as can be seen in Denmark, this does not necessarily result in regulatory structures without interference of the profession.

Low material independence values can be found in particular for oversight systems that are either institutionalised as a monitored peer-review system or are situated within a chamber system (as is the case, for example, in Belgium, Croatia, Czech Republic, Finland, France, Lithuania, and Poland).

A professional chamber is a corporation under public law that exercises some degree of regulatory authority over the accounting profession. In most of the countries these chambers are institutionalised in addition to other forms of government regulation, and the membership of statutory auditors is compulsory. At the same time, however, these chambers also function as traditional interest groups.<sup>42</sup> In these countries, a multiple-principles problem (Mattli & Büthe, 2005) arises, since the chambers, on the one hand, represent the interests of their members and, on the other hand, work as regulators on behalf of public interest. In these cases, audit oversight is conducted through a relatively weak council, commission, or committee, which holds the ultimate responsibility and which has the right to access any information on oversight matters and to participate in any oversight activity. In such a situation, the agent’s behaviour diverges from the public preference and moves closer to the private principal, the more the agent depends upon the private principal for the provision of expertise and technical support. The close interrelation with, and dependence on, the accounting profession therefore might jeopardise the regulators’ service for public interest.

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<sup>41</sup> Independent regulatory agencies can be observed in many economic fields. Interestingly, they are generally seen as result of a process of “reregulation”, which refers to a process in which European governments have been forced to change their traditional modes of governance due to increasing international competition and financial integration within the European Union. Political actors have started to delegate powers away from government departments to independent regulatory agencies (Majone, 1997, p. 199; Thatcher, 2002a; Vogel, 2003). This development has been observed in various markets, such as telecommunication, energy, and the media (Gilardi, 2002; Tenbücken & Schneider, 2004). Hence, from the reregulation angle, regulatory agencies are the material features of a development away from direct government regulation towards a more pluralist and liberal understanding of regulation.

<sup>42</sup> The German Chamber of Public Accountants, for instance, unambiguously mentions the “upholding of the interests and positions of the profession vis-à-vis the public and policymakers as one of its key duties” (Wirtschaftsprüferkammer (WPK), 2014).



## 2.4 Conclusion and future research

Within the last decade, the regulation of statutory audit firms has changed significantly. By analysing the statutory provisions that describe the composition and the competences of audit oversight boards, this paper contributes empirically and methodologically to the on-going debate on audit regulation.

The methodological aim was to develop a framework to measure the degree of independence of the PCAOB and recently established oversight bodies in the European Union. To this end, this paper offers a detailed operationalisation of audit oversight independence, leading eventually to a single index of material independence. The impact of formal independence on regulatory effectiveness (Krapohl, 2004) and on behavioural independence (Gehring & Krapohl, 2007) should not be overestimated. Nevertheless, the empirical and methodological contribution of this study is a first and necessary step for further comparative audit oversight research, as legal represent the “starting point” (Busuioc, 2009, p. 603) for further comparative audit oversight research that aims at investigating how these formal rules have been evolved in regulatory practice. The results of this study can therefore be used for future research about the effectiveness of audit regulation. Carson et al. (2013), for example, found that the use of government inspectors did not affect audit quality compared to the use of peer reviewers. As they do not consider the overall oversight structure in which inspectors operate, the results of this study should therefore be used as a basis for elaborating on the relationship between audit regulation and audit quality in more detail.

The empirical aim of this study was to shed light on the independence from the accounting profession of the various audit oversight authorities. In 2009, PCAOB Chairman Mark Olson explained that “approximately 27 countries have established independent audit oversight bodies that are responsible for audit firms operating in their jurisdictions” (Olson, 2009). Although all countries encounter similar pressures to establish public oversight systems, this study has revealed that “independence” has been translated into rather different regulatory outcomes. Whereas all countries claim to possess formal independent oversight systems, there is a visible gap between countries with comparatively strong independent oversight authorities, such as Italy and Luxembourg, and countries in which accounting bodies still maintain far-reaching regulatory influence, such as Ireland and Belgium. Hence, despite the fact that regulatory convergence has intensified with time, the in-depth analysis of the oversight structures reveals significant differences in terms of their institutional design and composition, as European member states have established oversight systems with various organisational structures and have often delegated very different regulatory competences to them. Through the strong interrelation between oversight entities and the accounting profession found in various countries, regulators

and accountants form what Meidinger (1987, p. 365) defined as a “regulatory community”, in which members “frequently influence each other, act with reference to each other, and desire each other’s respect”. Through this, a specific mode of regulatory capture, labelled as “social capture” (Davidoff Solomon, 2010) or “cultural capture” (Kwak, 2014), could arise. The concept goes beyond traditional material self-interest explanations, as the regulated industry is able to shape policy outcomes through mechanisms other than material incentives or rational debate. As a result, regulators “may believe they are doing their best, but their worldview is affected by the people they interact with” (Davidoff Solomon, 2010).

By representing initial insights about the current mode of audit regulation, this study is a necessary starting point in comparative audit oversight research. At the same time, it indicates future research questions to address. One limitation of this study is that it does not differentiate between different segments of the accounting profession. Others have highlighted how large and globally operating accounting firms have started to disconnect themselves from the majority of local audit firms by following their own strategic and regulatory agenda (Cooper & Robson, 2006; Covalleski, Dirsmith, & Rittenberg, 2003; Suddaby et al., 2007). As anecdotal evidence from data used in this study indicates, particular representatives of large accounting firms are involved in oversight affairs—in the governance of the oversight authority and in the organisation and implementation of audit inspections. Future research has therefore to focus on whether the participation of different segments of the profession in regulatory affairs is representative or unrepresentative, and the ensuing possible side effects.

Further research should address the causes and consequences of significant variation of audit oversight structures. This is particularly important for the cases that deviate extremely, which have been identified in this study. The analysis shows that some of the countries that implemented their oversight systems before the PCAOB came into existence, such as Ireland, Belgium, and Denmark, still possess public institutions that are close to the profession and have not left their chosen regulatory path. Further research could therefore elaborate on how relevant actors were able to secure this earlier mode of regulation and how these sectoral and national patterns intervene with European regulatory harmonisation efforts (Yesilkagit & Christensen, 2010). More in-depth analytical case studies are required to identify the factors and motives shaping audit oversight arrangements. This is particularly important for those countries in which a strong interrelation between the oversight authorities and the accounting profession has been identified. Future research has to identify the ways and mechanisms that have enabled this specific understanding of regulation to remain accepted by the regulatory community of statutory audit oversight, while being widely contested by the public and policy makers.

## 2.5 Appendices

### Appendix 1: History of audit oversight regulation in the European Union

The first provisions on European audit regulation were introduced with the Fourth Directive (78/660/EEC) in 1978. The Directive required companies to have their annual accounts “audited by one or more persons authorised by national law to audit accounts” (European Council, 1978 Article 5.1 (a)). In 1983, the Seventh Directive (83/349/EEC) extended the audit requirement to consolidated accounts. One year later, the Eighth Directive (84/253/EEC) dealt specifically with the educational and training prerequisites necessary to become a statutory auditor. Although these three Directives caused most of the member states to modify their regulations in order to comply with the legislative requirements, regulatory harmonisation in general remained at a low level (R. C. Baker et al., 2001, p. 764). As the European framework remained silent about audit oversight requirements, powerful independent oversight entities did not exist. In the few countries with external quality controls, the system was organised within the profession as a peer review system.

In the 1990s, regulation regained speed and especially the European regulatory framework for financial reporting and auditing “changed dramatically” (Maijoor & Vanstraelen, 2012, p. 118). Questions about the regulation of the regulators started to arise when the critical role of auditors in various corporate scandals reinforced the demand for a common and tighter regulatory framework (Humphrey & Moizer, 2008, p. 20). In 1996, the European Commission issued a Green Paper titled “The Role, the Position and the Liability of the Statutory Auditor within the European Union”, in which the nonexistence of external quality assurance mechanism in various countries was perceived as “a handicap for the Single Market and in the international context” (European Commission, 1996)<sup>43</sup>. One year later, in 1997, the financial crisis in Southeast Asian economies eventually highlighted the importance of ensuring the reliability of audited financial reports, and the accounting profession came under pressure to prove that it was capable of meeting the greater demands of the world’s capital markets. As a direct response, the European Commission founded the “Committee on Auditing” in 1998, to develop a common view on auditing matters including the discussion about the implementation of quality assurance systems in each member state (European Commission, 1998). The Committee consisted of government experts and representatives from the accounting profession. However, it was especially the accounting profession that delivered much of the input for the Committee’s deliberations (Van Hulle, 2004), and representatives left no doubts that the external quality assurance should be organised in the form of peer reviews. Frank Harding, the former President of the International Federation of Accountants (IFAC), for instance, acknowledged that the accounting profession

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<sup>43</sup> A green paper is a tentative government report and consultation document of policy proposals for stimulating discussions on given topics at the European level without any commitment to action.

“is being challenged” to demonstrate that it is competent to fulfil its traditional self-regulatory role in the public interest, but he made clear that “experience has demonstrated that [...] regulation of the profession works best where it is delegated by government to the profession itself” (Harding, 2000, p. 596).

The outcome of the Committee’s debates was the Recommendation on “Quality Assurance for the Statutory Auditor in the EU”, issued in November 2000, in which external quality controls were framed as “fundamental for ensuring good audit quality” (European Commission, 2000).<sup>44</sup> Nevertheless, the Commission made it clear that “Quality assurance is the *profession’s* principal means of assuring the public” (European Commission, 2000, p. 3). It stated:

“Both peer review and monitoring are acceptable methodologies for quality assurance [...]. Monitoring and peer review are considered as methodologies of equal stature” (European Commission, 2000, p. 3).

Moreover, public oversight boards were attributed a rather passive role: their main tasks were to “ensure” and to “plan” the quality assurance mechanisms and to “evaluate” the review results, rather than to function as an authority with the possibility of making direct inspections or taking disciplinary measures. In general, the Recommendation’s character was shaped through the belief in the principle of subsidiarity. The different regulatory histories of the countries, the particular requirements of their financial markets, and their general cost considerations would make different regulatory frameworks not only unavoidable but also favourable. Only two years later, however, the regulatory paradigm shift in the U.S. marked the starting point of a period of various regulatory reforms in the European Union, as the nonbinding nature of the Recommendation from 2000 would not avoid extraterritorial U.S. inspections in Europe (Eberle & Lauter, 2011; Humphrey et al., 2011). Answers to this problem had to be found at the European level: in the 1990s, financial matters were still solved under bilateral agreements between the U.S. and European member states, and it was increasingly the European Commission that took the leading role in debates on financial matters. In particular, the EU–U.S. Financial Markets Regulatory Dialogue discussed regulatory issues of mutual interest, such as the application of the SOX regulation to foreign companies (Ilmonen, 2012, p. 149; Posner & Véron, 2010, p. 402). The developing Parmalat fiasco and other European financial scandals were perceived as contemporary proof that the European regulatory framework (mainly based on the 8<sup>th</sup> Directive from 1984) no longer met the requirements of the global financial markets. But while the SOX was discussed and passed in only a few months in the U.S., regulatory changes in Europe took place rather slowly.

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<sup>44</sup> A Recommendation is expected to be applied by member states, but it does not have as much weight as a directive.

It took until 2006 for the European Commission to formally replace the former 8<sup>th</sup> Directive with the Statutory Audit Directive (European Parliament and the Council of the European Union, 2006). The Directive obliged member states to implement a public oversight system independently from the accounting profession and made it mandatory for statutory audit firms to be subject to an external quality assurance review. However, although the Directive defined the “independent” public oversight board as the ultimate authority, it allowed professional bodies to remain directly responsible for the registration, external quality controls, and disciplinary measures of statutory audit firms. This legislative leeway was used by most of the member states and the majority installed a committee or a commission to “oversee” the accounting profession, rather than to place these tasks into a regulatory agency. To foster harmonisation among European member states without using its regulatory power, the Commission established the Audit Regulatory Committee (AuRC) and the European Group of Auditors’ Oversight Bodies (EGAOB).<sup>45</sup>

Following the adoption of the Directive, the debate on the regulation of auditors continued, dominated in particular by the transatlantic relationship between the PCAOB and the European member states, and the lack of convergence among the European systems. In March 2007, Internal Market and Services Commissioner Charlie McCreevy and PCAOB Chairman Mark Olson agreed to launch roadmap discussions to “move towards inspections of audit firms carried out by an independent and rigorous home-country public oversight authority” by 2009, which would enable a system of mutual recognition between the U.S. and European audit regulators (European Commission, 2007). Therefore, it became necessary for the European oversight systems to move closer to the PCAOB structures, especially by cutting the systems’ dependencies on the accounting profession (see for example the speeches of Goelzer, 2004; Ross, 2004). The pressure for action was increased at the end of 2007, when the PCAOB drafted a policy statement that defined complete independence as the “essential criteria” for determining whether the Board could rely on a non-U.S. oversight system to conduct inspections of PCAOB-registered non-U.S. audit firms (PCAOB, 2007; Ross, 2004).

In 2008 the increasing pressure through the PCAOB caused the European Commission to issue the Recommendation: “On external quality assurance for statutory auditors and audit firms auditing public interest entities”. According to the legal text, inspections of audit firms with issuer clients should no longer be conducted by practising auditors and the organisation of the oversight bodies should cut its affiliations with the profession. At the same time, however, the Recommendation reiterated elements of the traditional EU model by allowing for the delegation of tasks to professional bodies and for the participation of practitioners in reviews as “experts”

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<sup>45</sup> The AuRC was established in accordance with the “comitology” procedure. The committees are forums for discussion, consisting of representatives from member states and are chaired by the Commission. They enable the Commission to establish dialogue with national administrations before adopting and implementing measures.

(Eberle & Lauter, 2011). Thus, the recommendation remained a compromise between the calls of the profession and member states for flexible and diverse oversight structures, and the Commission's aspiration to set up entirely independent oversight systems.

Surprisingly, the financial crisis of 2008 then interrupted rather than accelerated the discussion on audit regulation in Europe. The crisis did not seem to have much effect on the reputation of the audit profession. European auditors did not find themselves in the immediate firing line, with the blame mainly being placed on credit rating agencies, bankers, and financial regulators (Humphrey et al., 2011, p. 436). This changed when McCreevy, commissioner for internal market and services, who himself was a chartered accountant and known for his liberal market views, was preceded by Michael Barnier in 2010. Barnier, a former foreign minister of France without an accounting background, caused concern among the profession as to whether he would be as supportive of the profession as McCreevy had been (Humphrey et al., 2011). In fact, shortly after his appointment, Barnier announced the publication of a Green Paper, focusing on the role of audit firms:

“I am convinced that it is the right time to launch a real debate at European level on the subject of audit. This conviction is reinforced by the questions recently raised in the context of the audit of the accounts of the American bank Lehman Brothers” (European Commission, 2010).

The Green Paper was launched in 2010 and was one part of the Commission's holistic strategy to stabilise the financial markets. The paper contained a wide variety of possible provisions for the further development of public audit oversight. For instance, the paper proposed the transformation of the EGAOB into a so-called “Lamfalussy Level 3 Committee” or the establishment of a new European Supervisory Authority, to reach convergence in the application of rules and ensure a common approach to inspections of audit firms among European member states.<sup>46</sup> Finally, after intensive debates, the European Commission, the European Parliament, and the Council reached an agreement and adopted the “Directive on statutory audits of annual accounts and consolidated accounts” (2014/56/EU, 2014a) and the “Regulation on specific requirements regarding statutory audit of public-interest entities” (537/2014, 2014b) in April 2014. The latter contains additional requirements that relate exclusively to the statutory audits of Public-Interest Entities (PIEs) in addition to the ones stated in the Directive.<sup>47</sup>

Under the new regulatory umbrella, all statutory audit firms have to be subject to oversight by formally independent entities. They have to be governed by non-practitioners who possess

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<sup>46</sup> This kind of committee already exists in the areas of securities (Committee of European Securities Regulators, CESR), insurance (Committee of European Insurance and Occupational Pensions Supervisors, CEIOPS), and banking (Committee of European Banking, CEBS).

<sup>47</sup> The Directive needs to be transposed by the member states into their national legislation by June 2016. Although the Regulation formally entered into force immediately (i.e. in June 2014), most provisions will be applicable with the implementation of the Directive.

thorough expertise and knowledge in the relevant areas. Unlike in earlier debates, a sharp distinction was made between the regulation of audit firms of listed companies and of audit firms of unlisted companies. For audits without issuer clients, the Directive left European member states the option to delegate the organisation and execution of quality reviews, investigations, and sanctions to professional bodies or other authorities (Directive 2014/56/EU, Article 32 (4b)).<sup>48</sup>

This regulatory leeway was closed for the audit firms of PIEs regarding external quality controls, which cannot be delegated to professional bodies. Through this, Brussels differentiates for the first time the regulatory requirements between audit firms with and without issuer clients. Tasks related to sanctions and measures can still be delegated, but only to bodies independent from the profession (Regulation 537/2014, Article 24). The Regulation refers to quality assurance reviews as “inspections”, whereby an “inspector” is defined as someone who is contracted by the competent authority without being a practising statutory auditor and without being associated with a statutory audit firm. The Regulation further specifies that all persons involved in the governance must not be affiliated with an audit firm during their involvement, nor have been so in the three previous years. However, an option was maintained, from the Directive of 2006, which allows the national authorities to contract experts and accounting practitioners for certain oversight tasks, including assurance review, investigations, and disciplinary matters (Directive, Article 32 (3); Regulation, Article 26 (5)).

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<sup>48</sup> To be precise, the 2014 Directive, in contrast to 2006 Directive, explicitly allows the member states to “delegate or allow the competent authority to delegate any of its tasks to other authorities or bodies designated or otherwise authorised by law to carry out such tasks” (Article 32), whilst the directive from 2006 did not have any provisions on this. The Directive requires a cooling-off period of three years between reviewers and reviewed firm, and introduces a risk-based approach to determine the frequency of reviews, which still have to be conducted at least every six years (Directive 2014/56/EU 2014a).

## Appendix 2: Legal sources

Austria
<ul style="list-style-type: none"> <li>▪ Abschlussprüfungs-Qualitätssicherungsgesetz (A-QSG)</li> <li>▪ Abschlussprüfungs-Qualitätssicherungsrichtlinie (A-QRL)</li> </ul>
Belgium
<ul style="list-style-type: none"> <li>▪ Royal Decree of 21 April 2007 transposing provisions of Directive 2006/43/EC</li> <li>▪ Royal Decree of 25 April 2007 amending Belgium's Company Law with a view to the transposition of provisions of Directive 2006/43/EC</li> <li>▪ Law of 8 June 2008</li> </ul>
Bulgaria
<ul style="list-style-type: none"> <li>▪ Independent Financial Audit Act</li> <li>▪ Regulation for the Activity of the Commission for Public Oversight of Statutory Auditors</li> </ul>
Croatia
<ul style="list-style-type: none"> <li>▪ Audit Act Amendments (enacted by the Croatian parliament at its session of 21 November 2008)</li> </ul>
Czech Republic
<ul style="list-style-type: none"> <li>▪ Collection of Laws No. 93/2009 ACT, dated 26 March 2009, on auditors, and amending certain other legislation (the Auditors' Act)</li> </ul>
Denmark
<ul style="list-style-type: none"> <li>▪ Section 32 of the Danish Act on Approved Auditors and Audit Firms</li> </ul>
Estonia
<ul style="list-style-type: none"> <li>▪ Auditors Activities Act (passed 27 January 2010)</li> </ul>
Finland
<ul style="list-style-type: none"> <li>▪ Auditing Act (459/2007)</li> <li>▪ Chamber of Commerce Act (878/2002)</li> </ul>
France
<ul style="list-style-type: none"> <li>▪ Code de commerce</li> <li>▪ Code de déontologie</li> <li>▪ Ordonnance du 8 décembre 2008 transposant la huitième directive européenne relative aux commissaires aux comptes</li> </ul>
Germany
<ul style="list-style-type: none"> <li>▪ Wirtschaftsprüferordnung (zuletzt geändert 31.08.2013)</li> <li>▪ Geschäftsordnung der APAK (Fassung vom 9.11.2009)</li> <li>▪ Abschlussprüferaufsichtsgesetz (APAG)</li> <li>▪ Berufsaufsichtsreformgesetz (BAREfG)</li> </ul>
Greece
<ul style="list-style-type: none"> <li>▪ Law 3148/2003</li> <li>▪ Law 3693/2008</li> </ul>
Hungary
<ul style="list-style-type: none"> <li>▪ Act LXXV of 2007 on the Chamber of Hungarian Auditors, the Activities of Auditors, and on the Public Oversight of Auditors</li> </ul>
Ireland
<ul style="list-style-type: none"> <li>▪ Companies (Auditing And Accounting) Act 2003</li> </ul>
Italy
<ul style="list-style-type: none"> <li>▪ Legislative Decree no. 58 of 24 February 1998: Consolidated Law on Financial Intermediation, pursuant to Articles 8 and 21 of Law 52 of 6 February 1996 (as amended by Italian Legislative Decrees No. 44 and No. 53 of 4 March 2014)</li> <li>▪ Legislative Decree No. 39 of 27 January 2010: implementation of Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Directives 78/660/EEC and 83/349/EEC and repealing Directive 84/253/EEC1</li> <li>▪ Consob Regulation no. 11971 of 14 May 1999: implementing the provisions on issuers of Legislative Decree 58 of 24 February 1998 (as amended by Consob resolution No. 18671 of 8 October 2013)</li> </ul>



Latvia
<ul style="list-style-type: none"> <li>▪ Law on Sworn Auditors</li> <li>▪ Regulation of the Cabinet of Ministers No 525 of June 8, 2004 on procedures by which applications and other documents for the taking of Sworn Auditor Qualification Examination and for Receipt of Commercial Company of Sworn Auditors' Licence shall be submitted</li> <li>▪ Regulation of the Cabinet of Ministers No 547 of December 27, 2001 on the minimum liability amount of civil liability insurance for a sworn auditor—a self-employed person or an individual merchant—and for a commercial company of sworn auditors</li> <li>▪ Regulation of the Cabinet of Ministers No 536 of June 17, 2009 on regulations regarding an inspection of compliance with the quality control requirements of audit services</li> <li>Regulations of the Cabinet of Ministers No 537 of June 17, 2009 on regulations regarding the sample form of the registration application for a third country auditor or third country commercial company of auditors, and the sample form for an opinion regarding the compliance of a third country auditor or third country commercial company of auditors to registration conditions, and procedures for preparation and sending of an opinion</li> </ul>
Lithuania
<ul style="list-style-type: none"> <li>▪ Law of the Republic of Lithuania on Audit</li> </ul>
Luxembourg
<ul style="list-style-type: none"> <li>▪ Loi du 18 décembre 2009 relative à la profession de l'audit</li> <li>▪ Règlement grand-ducal du 18 décembre 2009 déterminant les conditions de reconnaissance de prestataires d'autres Etats membres prévues à l'article 7 de la loi du 18 décembre 2009 relative à la profession de l'audit</li> <li>▪ Règlement grand-ducal du 15 février 2010 portant organisation de la formation continue des réviseurs d'entreprises et réviseurs d'entreprises agréés</li> <li>▪ Règlement grand-ducal du 9 juillet 2013 déterminant les conditions de qualification professionnelle des réviseurs d'entreprises en exécution de la loi du 18 décembre 2009 relative à la profession de l'audit</li> <li>▪ Règlement grand-ducal du 28 octobre 2013 relatif aux taxes à percevoir par la Commission de surveillance du secteur financier</li> </ul>
Malta
<ul style="list-style-type: none"> <li>▪ Accountancy Profession Act, CAP281</li> <li>▪ Accountancy Profession Regulations, 2010</li> <li>▪ Accountancy Profession (Provision of Accountancy Services on a Temporary and Occasional Basis) Regulations, 2010</li> <li>▪ Accountancy Profession (Accounting and Auditing Standards) Regulations, 2009</li> <li>▪ Directive 4, Quality Assurance, 2009</li> <li>▪ Companies Act, CAP386</li> </ul>
Netherlands
<ul style="list-style-type: none"> <li>▪ Audit Firms Supervision Act</li> <li>▪ Decree on the supervision of audit firms</li> </ul>
Portugal
<ul style="list-style-type: none"> <li>▪ Regulamento do CNSA relativo à supervisão do Controlo de qualidade da Ordem dos Revisores Oficiais de Contas</li> <li>▪ Decreto-Lei 225/2008, de 20 de Novembro Criação do Conselho Nacional de Supervisão de Auditoria</li> <li>▪ Decreto-Lei 224/2008, de 20 de Novembro Alteração ao Estatuto da Ordem dos Revisores Oficiais de Contas</li> <li>▪ Regulamento da CMVM n.º 6/2000</li> </ul>
Poland
<ul style="list-style-type: none"> <li>▪ Act of 07 May 2009 on statutory auditors and their self-government, entities authorised to audit financial statements and public oversight</li> </ul>
Romania
<ul style="list-style-type: none"> <li>▪ Government emergency ordinance regarding the statutory audit of annual financial statements and consolidated financial statements</li> </ul>
Slovakia
<ul style="list-style-type: none"> <li>▪ Act No. 540/2007</li> <li>▪ Act No. 504/2009</li> <li>▪ Act No. 136/2010</li> </ul>
Slovenia
<ul style="list-style-type: none"> <li>▪ Auditing Act (Official Gazette RS No. 65/08, ZRev-2)</li> </ul>

<b>Spain</b>
<ul style="list-style-type: none"><li>▪ Royal Decree 302/1989, of 17 March</li><li>▪ Royal Decree 1517/2011, of 31 October</li><li>▪ Royal Legislative Decree 1/2011, of 1 July</li></ul>
<b>Sweden</b>
<ul style="list-style-type: none"><li>▪ Revisorslagen (2001:883)</li><li>▪ Revisorsförordningen (1995:665)</li><li>▪ Revisorsnämndens föreskrifter</li></ul>
<b>United Kingdom</b>
<ul style="list-style-type: none"><li>▪ Companies Act 2006</li></ul>
<b>United States</b>
<ul style="list-style-type: none"><li>▪ The Sarbanes-Oxley Act 2002</li></ul>

## Appendix 3: National oversight authorities and funding structure

Country	Name of authority	Funding structure	Budget
Austria	Austrian Auditors Supervisory Authority	State budget	Not public
Belgium	High Council for Economic Professions	Fees from audit profession	€400,000 (2013)
Bulgaria	Commission for Public Oversight of Statutory Auditors (CPOSA)	State budget	€631,077 (2013)
Czech Republic	Audit Public Oversight Council	State budget (possibility to increase income by fines)	Not public
Croatia	Audit Public Oversight Committee (APOC)	State budget	€53,000 (2013)
Denmark	Danish Supervisory Authority on Auditing (DSAA)	Fees from audit profession	€2.5 mn (2013)
Estonia	Auditors Activities Oversight Council (AAOC)	State budget	€200,000 (2013)
Finland	Auditing Board of the Central Chamber of Commerce (AB3C)	Fees from audit profession	€1.75 mn (2013)
France	Haut Conseil du Commissariat aux Comptes (H3C)	Fees from audit profession	€8.8 mn (2012)
Germany	Auditor Oversight Commission (AOC)	Fees from audit profession	€5.2 mn (2012)
Greece	Hellenic Accounting and Auditing Standards Oversight	Fees from audit profession	Not public
Hungary	Auditors' Public Oversight Committee (APOC)	State budget and fees from audit profession	Not public
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)	State budget and fees from a audit profession	€128 mn (2013)
Ireland	Irish Auditing & Accounting Supervisory Authority	State budget (40%) and accountancy bodies (60%)	€2 mn (2012)
Latvia	The Authority of Audit and Accounting	State budget	Not public
Lithuania	The Authority of Auditing and Accounting (3A)	State budget	€460,000 (2011)
Luxembourg	Commission de Surveillance du Secteur Financier (CSSF)	State budget (90%), fees from audit profession (10%)	€51 mn; 5.1 mn for audit oversight (2012)
Malta	Quality Assurance Oversight Committee (QAOC)	State budget (50%), fees from audit profession (50%)	Not public
Netherlands	Netherlands Authority for the Financial Markets ((AFM)	State budget (33%), audit profession (60%)	€77.7 mn (2012)
Poland	Audit Oversight Commission	State budget (80%), audit profession (20%)	€342,989 (2012)
Portugal	National Audit Oversight Board (CNSA)	-	No formal budget
Romania	Council for the Public Oversight of the Activity of the Statutory Audit	State budget (40%), audit profession (60%)	Not public
Slovakia	Auditing Oversight Authority (UDVA)	State budget (33%), PIE, and audit profession (66%)	Not public
Slovenia	Agency for Public Oversight of Auditing	State budget (main proportion), and audit profession	€353,500 (2010)
Spain	Accounting and Auditing Institute (ICAC)	Fees from audit profession and publication revenues	€6.9 mn (2012)
Sweden	Supervisory Board of Public Accountants	Fees from audit firms	€3.5 mn (2012)
United Kingdom	Financial Reporting Council (FRC)	Audit profession, listed companies, and state budget	€31.7 mn (2013)
United States	Public Company Accounting Oversight Board (PCAOB)	Fees from listed companies	€190 mn (2014)

## Appendix 4: Coding for Organisational Independence

	ff	fj	esh	coh	esbm	ipba	pgp	cobm	to	abmr
AT	3.00	1.00	1.00	1.00	1.00	3.00	3.00	0.75	3.00	0.75
BE	1.00	1.00	3.00	2.00	3.00	3.00	3.00	2.25	0.75	0.75
BG	3.00	1.00	3.00	2.00	3.00	1.00	1.50	1.50	2.25	1.50
HR	3.00	1.00	1.00	1.00	3.00	3.00	2.25	1.50	2.25	1.50
CZ	2.25	1.00	1.00	1.00	3.00	3.00	1.50	0.75	3.00	0.75
DK	0.75	1.00	1.00	1.00	1.00	3.00	0.75	0.75	2.25	0.75
EE	3.00	1.00	1.00	2.00	1.00	1.00	1.50	2.25	2.25	0.75
FI	0.75	1.00	1.00	1.00	1.00	1.00	1.50	0.75	1.50	0.75
FR	0.75	1.00	3.00	1.00	1.00	1.00	1.50	0.75	3.00	0.75
DE	0.75	1.00	1.00	2.00	1.00	3.00	3.00	2.25	2.25	3.00
GR	1.50	1.00	1.00	1.00	1.00	1.00	2.25	0.75	1.50	0.75
HU	3.00	3.00	3.00	1.00	3.00	3.00	3.00	2.25	1.88	1.88
IE	1.50	1.00	1.00	1.00	1.00	1.00	0.75	0.75	1.88	0.75
IT	2.25	3.00	3.00	1.00	3.00	3.00	3.00	0.75	3.00	3.00
LV	3.00	1.00	3.00	2.00	3.00	3.00	3.00	2.25	1.88	1.88
LT	3.00	1.00	1.00	2.00	1.00	1.00	0.75	1.50	1.50	0.75
LU	2.25	3.00	3.00	1.00	3.00	3.00	3.00	0.75	3.00	0.75
MT	1.85	1.00	1.00	2.00	1.00	1.00	0.75	2.25	1.50	0.75
NL	1.50	3.00	3.00	1.00	3.00	3.00	0.75	1.50	2.25	0.75
PT	2.25	1.00	1.00	1.00	3.00	1.00	1.50	0.75	0.75	0.75
PL	2.25	1.00	1.00	2.00	1.00	3.00	1.50	1.50	2.25	0.75
RO	1.50	1.00	1.00	1.00	1.00	1.00	1.50	0.75	1.50	1.50
SK	1.50	1.00	1.00	1.00	1.00	3.00	0.75	2.25	2.25	1.50
SI	2.25	1.00	3.00	2.00	1.00	1.00	3.00	2.25	3.00	0.75
ES	0.75	1.00	3.00	1.00	1.00	3.00	3.00	0.75	0.75	0.75
SE	0.75	3.00	3.00	3.00	2.00	3.00	1.50	0.75	1.50	0.75
UK	1.50	1.00	2.00	3.00	2.00	3.00	3.00	1.50	1.50	0.75
U.S.	3.00	1.00	3.00	3.00	3.00	3.00	0.75	0.75	2.25	1.50

ff	Form of financing
fj	Form of jurisdiction
esh	Employment status of head
coh	Cooling-off requirement for head
esbm	Employment status of board members
ipba	Nomination and/or appointment under influence of professional body
pgp	Practitioners involved in the governance of the board
cobm	Cooling-off requirement for board members
to	Term of office
abmr	Appointment of board members renewable

## Appendix 5: Coding for Functional Independence

	rpie	ipie	arpie	admpie	ppie
AT	3.00	0.75	3.00	3.00	0.75
BE	1.00	1.50	1.00	1.00	0.75
BG	1.00	3.00	3.00	3.00	0.75
HR	2.00	2.25	2.00	2.00	0.75
CZ	2.00	2.25	3.00	2.00	0.75
DK	3.00	3.00	3.00	3.00	0.75
EE	3.00	1.50	1.00	3.00	0.75
FI	2.00	3.00	3.00	3.00	0.75
FR	3.00	3.00	3.00	2.00	0.75
DE	2.00	3.00	3.00	2.00	0.75
GR	1.00	2.25	3.00	3.00	0.75
HU	2.00	3.00	3.00	3.00	0.75
IE	1.00	2.25	1.00	1.00	0.75
IT	3.00	3.00	3.00	3.00	0.75
LV	1.00	3.00	3.00	1.00	0.75
LT	2.00	0.75	3.00	2.00	0.75
LU	3.00	3.00	3.00	3.00	0.75
MT	3.00	3.00	3.00	3.00	0.75
NL	3.00	3.00	3.00	3.00	0.75
PT	1.00	0.75	3.00	3.00	0.75
PL	3.00	2.25	3.00	3.00	0.75
RO	2.00	2.25	2.00	2.00	0.75
SK	2.00	1.50	2.00	2.00	0.75
SI	1.00	2.25	3.00	3.00	0.75
ES	3.00	3.00	3.00	3.00	1.50
SE	3.00	3.00	3.00	3.00	3.00
UK	3.00	3.00	3.00	3.00	3.00
US	3.00	3.00	3.00	3.00	2.25

rpie Registration of audit firms with PIE clients

ipie Responsibility of inspections of audit firms with PIE clients

arpie Responsible authority of inspection reports of audit firms with PIE clients

admpie Operating authority of disciplinary measures for audit firms with PIE clients

ppie Publication of inspection results of audit firms with PIE clients

## Appendix 6: Values of Organisational Independence

<b>Countries</b>	<b>Profile value</b>
IT	0.85
HU	0.85
LV	0.83
LU	0.81
BG	0.80
HR	0.78
BE	0.75
DE	0.75
SI	0.74
UK	0.73
NL	0.73
AT	0.73
SE	0.72
US	0.69
CZ	0.68
EE	0.66
PL	0.66
SK	0.65
ES	0.62
FR	0.61
LT	0.60
MT	0.59
PT	0.58
RO	0.56
GR	0.55
DK	0.49
IE	0.44
FI	0.39

## Appendix 7: Values of Functional Independence

<b>Countries</b>	<b>Profile value</b>
SE	1.00
UK	1.00
US	0.98
ES	0.95
DK	0.92
MT	0.92
LU	0.92
IT	0.92
NL	0.92
PL	0.83
FI	0.84
HU	0.84
FR	0.78
DE	0.69
BG	0.72
SI	0.67
GR	0.67
AT	0.63
CZ	0.63
EE	0.64
HR	0.58
RO	0.58
LV	0.60
SK	0.57
LT	0.57
PT	0.50
IE	0.39
BE	0.32

## Appendix 8: Ranking of Material Independence

Ranking	Country	Organisational independence	Functional independence	Material independence
1	IT	0.85	0.92	0.89
2	LU	0.81	0.92	0.87
3	UK	0.73	1.00	0.87
4	SE	0.72	1.00	0.86
5	HU	0.85	0.84	0.84
6	US	0.69	0.98	0.83
7	NL	0.73	0.92	0.83
8	ES	0.62	0.95	0.78
9	MT	0.59	0.92	0.75
10	FI	0.66	0.84	0.75
11	PL	0.66	0.83	0.75
12	DE	0.80	0.69	0.74
13	BG	0.75	0.72	0.73
14	DK	0.49	0.92	0.71
15	SI	0.74	0.67	0.70
16	RO	0.83	0.58	0.70
17	FR	0.61	0.78	0.69
18	LV	0.78	0.60	0.69
19	EE	0.73	0.64	0.68
20	CZ	0.68	0.63	0.66
21	AT	0.66	0.63	0.64
22	SK	0.65	0.57	0.61
23	GR	0.55	0.67	0.61
24	LT	0.60	0.57	0.58
25	HR	0.56	0.58	0.57
26	PT	0.58	0.50	0.54
27	BE	0.75	0.32	0.53
28	IE	0.44	0.39	0.41

Note: the independence levels are calculated as the sums of the values of the organisational and functional independence values. The higher the value in the table, the higher the level of agency independence from influence of the accounting profession. All values used for the calculation of independence levels are ordinal so that the values cannot be compared with each other on a metric base. It would therefore be wrong to conclude that the CSSF in Luxembourg, for instance, is almost *twice* as independent as the oversight system in Belgium. The values merely serve to rank the various audit oversight systems from the most to the least independent.



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“It seems doubtful whether quality control systems can prevent members of the profession from engaging in malpractice. The pursuit of a free profession is, in the end, an attitude. The latter can only to a certain degree be enforced with the aid of organisational procedures.”

(Niehus, 1985, p. 299)

## Chapter 3

### **Maintaining, disrupting and destroying: (un)intended consequences of parallel institutional works in a local context.**

#### **Abstract**

This study analyses the introduction of the public audit oversight system in Germany. While in the U.S. the professional self-regulatory system was replaced by government oversight in a matter of months, the German regulatory system underwent multiple symbolic adjustments and incremental changes over the course of more than a decade. This study draws attention to the reasons and mechanisms that explain why the introduction of public oversight mechanisms in Germany was greeted with such intense and protracted reluctance. By mobilizing the concept of institutional work, this longitudinal case study shows how the auditing profession managed, with the aid of a process of institutional de-coupling, to adjust to external pressures (e.g. the establishment of a system of oversight that was independent of the profession) without relinquishing either its dominant role or the system of self-regulation. It demonstrates that new institutional rules cannot be established unless the frameworks that precede them are deinstitutionalized. Discussing how the self-regulatory tradition was disrupted by severe intra-professional conflicts, the paper sheds light on the unintended consequences of multifarious modes of institutional work.<sup>49</sup>

**Keywords:** audit regulation, audit oversight, institutional work, institutional decoupling

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### 3.1 Introduction

Traditionally, the auditing profession has itself been responsible for ensuring compliance with standards and accounting practices within the framework of professional self-regulation. Serious accounting scandals in the past, however, have brought the profession's self-regulatory ability under scrutiny. In the U.S., the period of self-regulation came to an end when the Sarbanes-Oxley Act replaced the U.S. AICPA peer review system, with direct inspections implemented under the PCAOB (Casterella, Jensen, & Knechel, 2009; Daugherty & Pitman, 2009).<sup>50</sup> The U.S. paradigm shift triggered a global regulatory wave through which formally "independent" public audit oversight systems were established to monitor and ensure the legitimacy of financial auditing (Canning & O'Dwyer, 2013; Caramanis, Dedoulis, & Leventis, 2015; Hazgui & Gendron, 2015; Malsch & Gendron, 2011). In this way, audit oversight developed into a basic mechanism for tackling perennial problems in corporate financial reporting (Caramanis et al., 2015, p. 12) and into one of the key elements of a contemporary dogma that promotes the diffusion of accounting and auditing standards to both foster and demonstrate global financial stability (Caramanis et al., 2015). Comprehensive and universal standards and global codes of conduct are, in this context, overseen and enforced by formal and informal regulatory institutions (Bengtsson, 2011; Humphrey, Loft, & Woods, 2009; Perry & Nölke, 2005). By mobilizing the concept of institutional work, this study shows how initially the German auditing profession managed, with the aid of a process of institutional decoupling, to adjust to external pressures without relinquishing its dominant role within the regulatory context, though later intra-professional rivalries increasingly undermined the profession's self-regulatory ability.

While other European countries, such as Spain or the UK, were quick to adopt an independent monitoring system (Gabor, 2005; Marks & Schmidt, 1998), in the case of Germany the idea of establishing public oversight mechanisms was greeted with a protracted and persistent reluctance. The intention of this study is therefore to address the following questions. How did the auditing profession impact the implementation of public oversight? What forms of institutional work took place to ensure, facilitate or prompt this development? How and why did the regulatory reform shift the balance of power within the organizational field?

The German case is representative of both institutional continuity and institutional change, demonstrating how different actors are intertwined within the organizational field. The fluid German context is particularly suitable for the concept of Institutional Work, as in this specific context actors are more likely to be fully aware of – and become engaged in – acts of institutional agency (Muzio, Brock, & Suddaby, 2013, p. 709). In this way, Institutional Work

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<sup>50</sup> Please see Appendix 9 for a list of abbreviations.



abandons the neo-institutional assumption that actors embedded in institutional contexts lack agency. The concept offers a way to develop a deeper understanding of institutional processes as being both fluid and uncertain, and it helps to account for variation within institutional processes, which is a central concern of current institutional research (Battilana, Leca, & Boxenbaum, 2009; Lawrence, Suddaby, & Leca, 2011; Lounsbury, 2008; Malsch & Gendron, 2013). Scholars such as Lawrence and others (Lawrence & Suddaby, 2006; Lawrence, Suddaby, & Leca, 2009) have already developed a useful taxonomy of institutional work, which associates specific types of institutional work to institutional outcomes: institutional change, maintenance or disruption.

The rereading of the introduction and development of external quality control mechanisms and public oversight elements highlight a case of institutional work articulated around two key struggles, which are both interrelated and distinct at the same time. The first struggle emerged as a result of the attempt by the “auditing establishment” to preserve the profession's self-regulatory model with the help of a wave of regulatory reforms between 2004 and 2010. The second involves the emergence of a new actor, which successfully disrupted the traditional role and functionality of the established actors. By demonstrating the unintended outcomes of power, mobilization and disruption, the main theoretical contribution made by this study is to flesh out a deeper understanding of both the intended and the unintended dynamics of institutional work.

This analysis aims to adopt a locally embedded perspective that is sensitive to the political and economic context in which the regulatory intervention took place. In examining audit regulation, it posits the institutions as constituting the outcomes of the interactions between actors who are themselves positioned within a structure of politico-economic relations that is “simultaneously united and divided by internal contractions, tensions and struggles” (Puxty, Willmott, & Lowe, 1987, p. 282). With a view to linking the accountancy profession's micro-level actions, and its interaction with both its members and the state, to the macro-level dynamics of institutional change, the analysis draws from both document analysis and qualitative interviews conducted with experts in the field, including relevant actors within the German audit oversight system and European political actors.

In this way, the study seeks to contribute to a field of literature that analyses the processes through which professional audit regulation is shaped, developed and formulated. This is achieved in three ways:

First, the study offers a contribution to the literature on audit and professional regulation. Although the establishment of audit oversight bodies has been the subject of increasing

scrutiny (Blavoukos, Caramanis, & Dedoulis, 2013; Canning & O'Dwyer, 2013; Caramanis et al., 2015; Hazgui & Gendron, 2015; Malsch & Gendron, 2011), research on the processes through which new regulatory arrangements are interpreted in different national contexts remains both limited and contradictory. While Malsch and Gendron (2011) identify for the Canadian case a "form of allegiance" between the largest accounting firms and the oversight body and conclude that self-regulatory logic is more influential than might have been anticipated, Canning and O'Dwyer (2013) find only limited evidence of agreement between the regulators and the regulated in their analysis of the Canadian oversight board's establishment.

Second, the paper represents a response to recent calls for studies focused on small auditors (Ramirez, Stringfellow, & Maclean, 2015). Although others have already noted the sustained segmentation of the accounting profession (Caramanis, 2005; Richardson, 1987, 1989; Yee, 2012), literature on audit regulation has a tendency to remain focused on the centrifugal force and influence exerted by larger firms (Arnold, 2005; Greenwood & Suddaby, 2006; Humphrey et al., 2009). This paper challenges the dominance of large audit firms by shifting the focus away from powerful, centrally positioned actors to those on the margins of the organizational field and by demonstrating the impact that small auditors can have on audit regulation in the institutional setting.

Third and last, the paper aims to make a contribution to developing a coherent theoretical framework for institutional work, a field which has been previously described as an "umbrella concept and a rallying point" (Hwang & Colyvas, 2011, p. 62). As such, aside from the empirical findings presented, the theoretical contribution made by this study lies in its use of the concept of institutional work within a highly regulatory context at times of crisis and uncertainty. In particular, the paper seeks to extend the usage of the concept of institutional work by identifying the modes of institutional work aimed at institutional maintenance and disruption, which is something that, unlike research into the process of institutional creation, has received relatively little scholarly attention (Lawrence et al., 2009). In particular, a rereading of the case highlights the impact of the use made by actors of rhetoric in their efforts to affect the institutional order, and it demonstrates the extent to which institutions require constant "work". (Zilber, 2007, p. 1038), which is to say that it envisages institutional work as an ongoing effort. In addition, the study illustrates how institutional work can produce unanticipated institutions in unintended ways, among other things, "disrupting those institutions or creating ones very different from those originally conceived of by the actors involved" (Lawrence et al., 2009, p. 10). This study thus demonstrates how, on the one hand, the established actors tried to preserve the institutionalized model of audit regulation. On the other hand, however, it shows how the attempt made by small audit firms to disrupt the traditional dominance exercised by the large accounting firms eventually resulted in an unintended disruption of the profession's self-

regulatory institution, which triggered political actors to take a more active role, and might mark the start of a process of a de-professionalization of the German audit profession. It thus responds to calls for the role of power to be analysed and for work to be done on the role played by a series of various simultaneous, linked and unlinked dimensions of institutional work in sustaining the dynamics of institutional change (Malsch & Gendron, 2013).

In order to engage in this discussion, this article is structured as follows: in the next section, the research methods employed are explained. Subsequently, the theoretical framing of the study is outlined. The following sections discuss the development of the German audit oversight system and its theoretical interpretation. Lastly, concluding remarks and comments are presented.

### 3.2 Research method

The analysis aims to adopt a locally embedded perspective that is sensitive to the political and economic context in which the regulatory intervention took place. On the basis of a longitudinal case study (Stake, 1995), an analysis is undertaken into the interplay between, on the one hand, global influences and pressures and, on the other, local socio-political characteristics and the institutions that have conditioned how the German system of oversight has evolved at the state level. To gain a profound understanding of the chain of events, the analysis is based on a variety of data sources and triangulation research methodology (Denzin, 2009; Jick, 1979; Lincoln & Guba, 1985). The data sources include a whole number of publically available archival materials: all of the public pronouncements and presentations made by the POB and the APAK since their respective foundation, all of the press releases emanating from the relevant actors over the period studied, the official proceedings from public hearings associated with legislative procedures, articles in professional journals, and media reports commenting on local regulatory changes.

Although the German parliament is the decisive legislative organ, draft legislation is primarily discussed, prepared and formulated within the ministerial bureaucracy and in close cooperation with the relevant associations (Rudzio, 2011, p. 76). As the regulation of the audit profession has not been the subject of controversial debate in the Federal German Parliament, the analysis has consequently laid the emphasis on the minutes of the technical committee (e.g. from public hearings) and on the comment letters submitted by distinct organizations from the auditing profession to the Federal Ministry for Economic Affairs and Energy. Of particular importance for the analysis is, moreover, the journal of the Chamber of Auditors (the “WPK Magazin”, previously “Wirtschaftsprüferkammer – Mitteilungen”), which is regularly sent to all the members of the profession and the members’ emails sent by the second professional association, which were collected and analysed.<sup>51</sup> Minutes from meetings of the Chamber of Public

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<sup>51</sup> The publicly available sources are available on request.

Accountants' Executive Board are not published. However, various minutes were provided to the author.

The written evidence is supplemented by semi-structured face-to-face interviews with 22 key actors involved in audit regulation (Table 12).<sup>52</sup> As the impact exerted by individual auditors on regulatory matters is limited, the interviews focused on representatives of professional interest groups, on the Big Four's departments for regulatory matters and on the relevant government agencies. Accordingly, the interviewees were not randomly selected, but were instead chosen on the basis of their involvement in the organizational field. The interviews were conducted between March 2014 and September 2015 and lasted between 35 and 200 minutes, with an average length of 60 minutes. Depending on the interviewee's personal knowledge and background, the interviews covered a series of issues related to how the audit oversight system has evolved in Germany. While the first interviews were used to evaluate how apt the theoretical assumptions were and to circumscribe the research questions, the later interviews were used to obtain answers on detailed issues. With the permission of the participants, all but nine interviews (marked with an \*) were digitally recorded. All interviewees were assured that their responses would be kept strictly confidential.<sup>53</sup>

For the analysis, all recorded interviews were transcribed and analysed with AtlasTi software. Following Gioia (2013), the coding is based on a three-step process. To gain both an in-depth understanding of the empirical material and a synthesis of the various issues raised by interviewees, the respondent direct quotes were grouped into first-order concepts (i.e. an analysis using informant-centric terms and codes).<sup>54</sup> At the second level of analysis, key links and patterns (second-order concepts) within the different data sources were identified (i.e., an analysis using researcher-centric concepts, themes, and dimensions). In the course of focusing on, and dealing with, second-order concepts, it emerged that the various forms of institutional work related to institutional creation, institutional maintenance or institutional disruption were a relevant way to make sense of the data. To reinforce the reliability of the study, a large number of interviewees were provided with an overview of the research results (Lincoln & Guba, 1985).

The study shares the limitations inherent in any qualitative methodology.

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<sup>52</sup> The following actors and organizations declined to be interviewed: Deloitte, various members of the German parliament, former policy advisors of the Ministry and the Deutsche Schutzvereinigung für Wertpapierbesitz (DSW), which is the largest association for private investors in Germany. The PCAOB rejected the interview request by arguing that answering appropriately would require its disclosing confidential information, which would violate its confidentiality restrictions.

<sup>53</sup> After consultation with the interviewees, various quotes were allowed to add to the thesis. Appendix 12, Appendix 13, and Appendix 14 show examples of the coding process, for both interview data and other sources.

<sup>54</sup> Gioia et al.'s 1st- and 2nd-order labelling is based on Van Maanen (1979).

**Table 12: Interview details<sup>55</sup>**

Name	Date	Occupation(s) at date of interview
<b>Political Sphere</b>		
Policy Officer*	02/2015	Policy Officer at European political institution
Political Actor	02/2015	Former Member of the European Parliament and Chair of Committee on Legal Affairs
Policy Officer*	02/2015	Policy Officer at European political institution
Policy Officer	02/2015	Policy Officer at the Federal Government
Gisela Hammers-Strizek	02/2015	Retired, former head of section at the Federal Ministry of Economic Affairs and Energy responsible for the regulation of the auditing profession
Richard Pitterle	02/2015	Member of the German Parliament for Die LINKE, initiator of the brief parliamentary enquiry on matters pertaining to German audit oversight
<b>Regulator</b>		
APAK Commissioner*	03/2014	-
APAK Commissioner*	09/2015	.
APAK Commissioner*	02/2015	-
Tim Volkmanm	02/2015	Managing Director of the APAK (since 2005)
Rudolf Steckel*	09/2013	Chairman of the Austrian Auditor Supervisory Authority (ASA)
<b>Audit Profession</b>		
Andrea Bruckner	02/2015	BDO Audit partner, Board of Directors of the IDW, Member of the WPK Advisory Board
Klaus-Hermann Dyck	02/2015	EY Audit partner
Michael Gschrei	02/2015	President and Founder of Wp.net, former WPK President (2011-2012)
Peter Maxl*	02/2015	Managing Directors of the Chamber of Auditors
Klaus-Peter Naumann	03/2015	President of the IDW
Wienand Schruuff	02/2015	KPMG Management Board Member, Chairman of the KPMG Global Regulatory Group, Member of the IFAC Board, Member of the WPK Board
Ulrich Skirk	02/2015	EY, Audit partner, WPK Board Member
Dieter Ulrich*	06/2015	Retired, former WPK President (2005-2008) and Audit partner
Reiner J. Veidt*	02/2015	Managing Directors of the Chamber of Auditors
<b>Others</b>		
Georg Giersberg	02/2015	Journalist, various articles on the German accounting profession and audit oversight development
Reiner Quick	06/2015	Professor of Audit at the Darmstadt Technical University

<sup>55</sup> In order to preserve interviewees' anonymity, the exact positions and departments of various interviewees are not mentioned.

### 3.3 Theoretical Framing

#### 3.3.1 Agency in Institutional Theory

Institutional work has its roots in neo-institutional thinking. Economic, social and political actions are embedded in larger institutional schemes. Institutions comprise all “regulative, normative and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life” (Scott, 2008, p. 48). Early neo-institutionalist scholars emphasize institutional stability and change, both emerging despite, rather than because of, intentional action. Institutions were perceived to be templates for action, cognition, and emotion, and the identification of the mechanisms through which institutions constrained and determined the behaviour of actors was at the centre of neo-institutional studies (DiMaggio, 1988; DiMaggio & Powell, 1991). This cultural-sociological notion of “institutionalization” locates structures and practices beyond the reach of interests and politics. Hence, intentionality and the role, played by collective actions appeared to be incompatible with the traditional conceptualization of institutional theory. Sociological-institutional perspectives had “a hard time incorporating notions of conflict and power, and they (were) not particularly helpful in talking about change” (Thelen, 1999, p. 387; similar Scott, 2008, p. 77). Over the years, however, scholars have increasingly begun to turn their attention to the way actors actively engage in processes of institutional creation, maintenance, disruption and change (Lawrence et al., 2011, p. 53; Scott, 2008, p. 77).

DiMaggio (1988), DiMaggio and Powell (1991) and Oliver (1991, 1992) were among the first to rebut criticisms that accused institutional theory of assuming organizational passivity and of ignoring the notion of power and strategy (for example in Covalleski & Dirsmith, 1988; Fligstein, 2001, p. 111; Marti & Mair, 2009; Powell, 1985). DiMaggio (1988) attempted to combine a theory of agency with institutional theory. Introducing the concept of “institutional entrepreneurship”, (1988, p. 14), DiMaggio argued that some social actors were better at producing desired social outcomes than were others; he thus brought the notion of power and strategy back into neo-institutional thinking. Oliver (1991) discussed and systematized strategic reactions that organizations employ in direct response to institutional pressure and factors that predict when these alternative strategies will occur. She argued that organizations were not only able to respond, but also to deinstitutionalize, something that she defined as the process in which the legitimacy of an established or institutionalized practice erodes or discontinues.

These studies marked a shift in institutional researchers’ perceptions of how both individual and collective actors exert influence on institutions. By reversing the causality, they transformed institutions from explanatory factors into dependent variables and passive actors into “creators, maintenance workers, and destroyers of institutions” (Hwang & Colyvas, 2011, p. 63). As a

result, other scholars showed how institutional theory can, in fact, accommodate interest-seeking and active organizational action when actors respond to institutional pressures and aim at influencing their institutional contexts (Battilana et al., 2009; Beckert, 2010; Cooney, 2007; Fligstein, 1997; Greenwood & Suddaby, 2006; Hoffman, 1999; Maguire, Hardy, & Lawrence, 2004; Rao, Morrill, & Zald, 2000). These studies have shown how actors are able to emancipate themselves, at least partially, from the influence and pressure of existing institutions. In order, however, to overcome the “somewhat stylized representations of the relationships among actors, agency, and institutions” (Lawrence et al., 2011, p. 3), Lawrence and Suddaby (2006) developed the concept of “institutional work”.<sup>56</sup>

The concept highlights how and why actors work to “interpret, translate, transpose, edit, and recombine institutions, and how those actions lead to unintended adaptations, mutations, and other institutional consequences” (Lawrence et al., 2011, p. 55). While DiMaggio situated the “institutional entrepreneur” in the context of emerging institutions, institutional work extends the theoretical and empirical agenda to the rest of institutions’ life cycle, including persistence, deinstitutionalization and reinstitutionalization (Hwang & Colyvas, 2011, p. 62).<sup>57</sup> With its emphasis on the action of actors within institutional theory, the concept is characterized by

“neither determinism nor heroism and is potentially sensitive to both the oppressiveness of social, cultural, and material structures, and the potential for emancipation from some of those structures some of the time” (Lawrence et al., 2011, p. 56).

Institutionalist scholars suggest that institutional work is accomplished through the coordinated and uncoordinated efforts of various actors (Lawrence et al., 2011, p. 55). The latter are located in what neo-institutionalist scholars refer to as “organizational fields” (DiMaggio & Powell, 1983, 1991; Fligstein, 2001) or “societal sectors” (Scott & Meyer, 1992, p. 108). These conceptualizations refer to a community of organizations which partake of a common system of meanings and whose participants interact more frequently with one another than with actors outside the field (Scott, 2008). The concept is central to institutional theory because it is perceived as intermediate level between actors and their socio-economic contexts, through which socially constructed practices and expectations become continuously disseminated and reproduced (Greenwood, Hinings, & Suddaby, 2002).

This study will focus, in particular, on the governance system, which is a relational feature at the field level (Scott, 2008, p. 185). It describes all the arrangements which support the regularized

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<sup>56</sup> The term of “institutional work” can also be found in earlier works, for instance, in DiMaggio (1988).

<sup>57</sup> In this way, the concept responds to calls to link institutional and network approaches (or critical approaches) so as to overcome the perceived theoretical and ideological segmentation dividing them (Beckert, 2010; Cooper, Ezzamel, & Willmott, 2008; also DiMaggio, 1988; Fligstein & Dauter, 2007). Network analysts perceive fields to be compositions of specific structures of social networks, including hierarchies and power differences, which impact economic outcomes (Granovetter, 1985).

monitoring of the actions undertaken by one set of actors by another and combines all those actors who employ coercive or normative controls over activities and actors within the field. Actors with this function are public regulatory bodies, trade associations, unions, professional associations and judicial systems (Scott, 2008, p. 186; see also Fligstein, 1991, p. 314).

### 3.3.2 Modes of Institutional Work

Lawrence and Suddaby (2006) identified three modes of institutional work: work that maintains, work that disrupts and work that creates institutions.

#### *Institutional Work to create institutions*

The practices associated with creating institutions constitute the category of institutional work that has been most extensively examined in the literature (Lawrence et al., 2011, p. 8). Lawrence and Suddaby (2006) identified ten forms of institutional work associated with creating institutions.

**Table 13: Creating Institutions**

<b>Modes</b>	<b>Definition</b>	<b>Key mechanism</b>
Advocacy	The mobilization of political and regulatory support through direct and deliberate methods of social suasion.	Creation of Institutions through political work in which actors reconstruct rules, property rights and boundaries that define access to material resources.
Defining	The construction of rule systems that confer status or that identity or define membership boundaries or that create status hierarchies within a field.	
Vesting	The creation of rule structures that confer property rights.	
Constructing identities	Defining the relationship between an actor and the field in which that actor operates.	Creation of Institutions through actions in which actors' belief systems are reconfigured.
Changing normative associations	Recreating the connections between sets of practices and the moral and cultural foundations for those practices.	
Constructing normative networks	Constructing inter-organizational connections through which practices become normatively sanctioned and which form the relevant peer group with respect to compliance, monitoring and evaluation.	
Mimicry	Associating new practices with existing sets of taken-for-granted practices, technologies and rules in order to ease their adoption.	Creation of Institutions through actions designed to alter abstract categorizations in which the boundaries of meaning systems are altered.
Theorizing Educating	Developing and specifying abstract categories and elaborating chains of cause and effect.	
Constructing normative networks	Educating actors in the skills and knowledge necessary to support the new institution.	



*Institutional Work to maintain institutions*

In contrast to the institutional work related to the creation of institutions, less is known about the about the processes of maintaining institutions (Scott, 2001, p. 110). Lawrence and Suddaby (2006) identified six types of institutional work (Table 14) which maintain institutions by “supporting, repairing or recreating the social mechanisms that ensure compliance” (Lawrence & Suddaby, 2006, p. 230).

**Table 14: Maintaining Institutions**

<b>Modes</b>	<b>Definition</b>	<b>Key mechanism</b>
Enabling work	Creating rules that facilitate, supplement and support institutions, such as the creation of authorizing agents or diverting resources.	Maintenance of institutions by ensuring adherence to a rule system.
Policing	Ensuring compliance through enforcement, auditing and monitoring.	
Detering	Establishing coercive barriers to institutional change.	
Mythologizing	Preserving the normative underpinnings of an institution by creating and sustaining myths regarding its history.	Maintenance of institutions by reproducing existing norms and belief systems.
Valorizing and demonizing	Providing for public consumption positive and negative examples that illustrates the normative foundations of an institution.	

A related type of institutional work is the notion of “Dirty Work”, which aims to preserve institutions with the aid of strategic decoupling (Hirsch & Bermiss, 2009). It refers to a specific type of institutional work that “entails the actions undertaken by actors searching for ways to carry over norms from the previous regime into the construction of the new institutional order” (Hirsch & Bermiss, 2009, p. 263). This means that policies are adopted in order to conform to external expectations with regard to formally stated mechanisms and operational procedures, even though, in practice, the old rationales survive in practice (Bromley & Powell, 2012; Scott, 2008). In other words, a strategic process by which formal policies are decoupled from actual practices (Bromley & Powell, 2012; J. W. Meyer & Rowan, 1977). In fact, research has shown that the implementation of externally triggered reforms in accounting regulation is often associated with “shallow” reforms or with “a mere facade” of reforms at the national level (Blavoukos et al., 2013, p. 153; Power, 1999), with the result that material regulatory changes are minimized, postponed or even averted (Caramanis et al., 2015; Humphrey, Turley, & Moizer, 1992; Malsch & Gendron, 2011).

*Institutional Work to disrupt Institutions*

While institutional theory was once primarily regarded as a theory of stability and similarity, the notion of change has increasingly gained attention (Beckert, 2010; Greenwood & Hinings, 1996; Mahoney & Thelen, 2010). This shift in attention has occurred because the organizational field is not a static concept. The multiple constituents compete over the definition of issues and the form of institutions that will guide organizational action and behaviour. Most of the time, these actors are furnished with opposing perspectives, rather than with a common rhetoric, and these are exchanged through channels of dialogue and debate and represent the centre of a field (Hoffman, 1999, p. 352). The ability of one of the constituents to capture the rules of the field, by, for instance, inducing the state to introduce particular rules for the field, depends first and foremost on the organization's resources and on its dependency relations and network relations (Fligstein, 1991, p. 314). Nevertheless, the field remains stable as long as its pivotal actors share the same understanding and agree on a particular definition of their field and as long all members benefit from the institutionalized, stable rules (Fligstein, 1991).

Institutional change is therefore restricted as long as something erodes the mechanisms of reproduction that generate institutional continuity (Beyer, 2010, p. 4; Pierson, 2000). From this perspective, the argument that an institutional pattern is "locked in" (Mahoney, 2000, p. 515) or has "maintained its equilibrium" (Caramanis et al., 2015, p. 27) can therefore be unmasked as a metaphor for the on-going effectiveness of a stabilisation mechanism. That means that each and every continuity-ensuring mechanism offers opportunities for the termination of path-dependent development or for the abandonment of a chosen path. Actors driving this process will be actors whose interests are not served by existing institutional arrangements, and consequently, work to disrupt the extant set of institutions (Lawrence & Suddaby, 2006, p. 235).

Lawrence and Suddaby identify four forms of institutional work aimed at disrupting existing institutions (Table 5). Activities to disrupt institutional structures are largely discursive and relate to what Lamont and Molnar (2002) have described as "boundary work". Hence, "actors appear to disrupt institutions primarily by redefining, re-categorizing, reconfiguring, abstracting, problematizing and, generally, manipulating the social and symbolic boundaries that constitute institutions" (Lawrence & Suddaby, 2006, p. 238).

**Table 15: Disrupting Institutions**

Modes	Definition	Key Mechanism
Disconnecting sanctions	Working through state apparatus to disconnect rewards and sanctions from some set of practices, technologies or rules.	Disrupting institutions by attacking or undermining the mechanisms that induce members to comply with institutions.
Disassociating moral foundations	Disassociating the practice, rule or technology from its moral foundations, as appropriate within a specific cultural context.	
Undermining assumptions and beliefs	Decreasing the perceived risks of innovation and differentiation by undermining core assumptions and beliefs.	

Both institutional maintenance and institutional disruption constitute a political process that reflects the interests and power of organized actors within the field (DiMaggio, 1988; Fligstein, 1997; Maguire et al., 2004). A process of institutional change or evolution can be triggered by disruptive, endogenous events. These “shocks” (Zucker, 1988, p. 23) or “jolts” (Greenwood & Suddaby, 2006; A. D. Meyer, 1982) can take the form of technological disruptions, social upheaval or regulatory change (Greenwood & Suddaby, 2006). They can trigger the entry of new actors or changes in organizational interdependencies (Barnett & Carroll, 1993) and power structures (Brint & Karabel, 1991; Greenwood & Hinings, 1996; Oliver, 1991). If, in this process of institutional evolution or “deinstitutionalization” (Greenwood et al., 2002, p. 60), the dominant actors do not agree on a particular definition of their field, the field becomes unstable and organizational fields become “arenas of power relations” (Brint & Karabel, 1991, p. 355; similar DiMaggio & Powell, 1991). Such

“changes in power relations hold the key to creating the openings in which new scripts (or scripts previously only on the margins of an organizational field) can become more central” (Thelen, 2003, p. 217).

In other words, they have the capacity to end what has become locked in institutional inertia.

The next section introduces the relevant actors and outlines the politico-economic context of the politics of German auditing.

### 3.4 Setting the stage

#### 3.4.1 Actors of the German field of auditing

The politics of auditing in Germany were traditionally considered to be a consensual procedure between the legislator and the auditing profession - one determined by the latter and discussed without much public debate (Ordelheide, 1999). The institutional arrangements governing audit regulation in Germany are based on the country's strong tradition of societal corporatism (Schmitter, 1974). Corporatism is as a system of interest intermediation, or, in line with Schmitter's definition, "a particular modal or ideal-typical institutional arrangement for linking the interests of civil society, as organised in associations, with the decision-taking structures of the state" (Schmitter, 1974, p. 86). As a result of the governance and administration being delegated to certain peak interest groups, various actors are involved in the politico-economic context of regulation in Germany (Puxty et al., 1987; Rudzio, 2011).<sup>58</sup> The particular corporatist framework of audit regulation was institutionalized in 1961. After World War Two, the country's division into four occupied zones triggered more than ten years of controversial debates over how the auditing profession should be organised and what its role vis-à-vis the government should be. The debates ended in 1961 with the Law Regulating the Profession of German Public Auditors (WPO). The law made two entities, the Institute of Public Auditors in Germany (IDW) and the Federal Chamber of Public Accountants (WPK), responsible for organizing and regulating the accounting profession.

A body such as the Federal Chamber of Public Accountants is in Germany a "joint venture" between the state and the profession (Will, 2010) and is one of the decisive pillars of the corporatist political framework. The WPK is a public corporation ("Körperschaft des öffentlichen Rechts") that is formally overseen by the Federal Ministry of Economics.<sup>59</sup> The duties of the WPK include, in particular, its responsibility to organise the standardized, countrywide audit examination and the quality assurance procedure. In addition, the Chamber is responsible both for registering public accountants and audit firms and for striking them off the register, and it is responsible for disciplinary oversight (§ 57 WPO). Membership to the WPK is obligatory for all public accountants and audit firms. The governing body of the WPK consists of working auditors who are selected by the audit profession. To describe the WPK as a "state-designed" organization (Puxty et al., 1987, p. 288) is thus misleading, as this ignores the degree of

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<sup>58</sup> The corporatist approach to integrating interest groups is an essential element of the German model of capitalism. In addition to the corporatist arrangements between the state and integrated interest associations, Germany's "Rhine Capitalism" is characterized by long-term commitments and social and by a striving to find an economic consensus (Amable, 2003; Hall & Soskice, 2001). In contrast to liberal market economies, in which competitive market arrangements are much more prevalent, policy outcomes are thus more the result of discussions within and between interest groups, rather than being determined by state guidance or market principles.

<sup>59</sup> The German chamber tradition was born in the 19th century, when Western countries' economies were subject to major transitions. While most Romanic countries incorporated the necessary competences into their civil service structures, Prussia transferred these tasks to the relevant profession (Hendler, 2002, pp. 10, 12).

direct control exercised in the WPK by the profession.

The IDW was established as early as 1929 as fusion of several professional associations to strengthen the profession's influence on the debates over introducing statutory audit. After the war, the IDW became the mouthpiece used by the profession to advising on, or lobby for, particular accounting and auditing policies (Dykhhoorn & Sinning, 1992, p. 84; Vieten, 1995, p. 488). Today, the IDW is still responsible for the technical work ("Facharbeit") done by the profession, providing technical guidance on accounting and auditing matters and offering educational and training seminars (Coenenberg, Haller, & Marten, 1999; Gietzmann & Quick, 1998). It can thus be seen as a "parallel authority" representing the German auditing profession (Puxty et al., 1987, p. 284)<sup>60</sup>, not so much in the sense that it issues specific regulations, but more in the sense that it adjudicates or advises on fundamental principles. As a consequence of the "profession's cosy relationship with the Chamber" (Dykhhoorn & Sinning, 1992, p. 86), the WPK is frequently described as a quasi self-regulatory body for the profession (Vieten, 1995, p. 507), which tended to play the role of the accounting profession's advocate, rather than its overseer (Dykhhoorn & Sinning, 1992, p. 85).<sup>61</sup> This was reinforced by the close ties and cooperation between the IDW and the WPK. The interdependence was manifested in the fact that the two organizations used the same facilities, that public accountants simultaneously served on committees of both organizations and that they were occasionally headed by the same general manager (Markus, 1996, p. 153). As a result, the "monitoring function of the two organizations became practically inseparable and indiscernible" (Harston, 1993, p. 156).

In line with corporatist traditions, the Federal Ministry traditionally maintained a certain distance to the profession. Its supervisory function vis-à-vis the WPK is demonstrated primarily by the fact that the ministry's formal approval is necessary before changes or amendments can be made to the WPK's constitution. In combination with the intermediate role played by the WPK, the auditing profession operated without any substantial interference by regulators, nor was the general public really aware of its activities (Niehus, 2000; Quick, Mertens, Blij, & Hassink, 1998). This is, in particular, the case when the quality of audit services might be at risk. Professional proceedings are discussed and decided within the Chamber of Auditors, without the results being disclosed. Likewise, court judgements that are directly concerned with fraudulent financial

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<sup>60</sup> Dykhhoorn and Sinning (1992), for instance, revealed how the German codified auditing standards were entirely the outcome of works within the IDW (Dykhhoorn & Sinning, 1992, p. 84).

<sup>61</sup> The Chamber itself describes one of its main responsibilities as upholding "the interests and positions of the profession vis-à-vis the public and policymakers as well as [fulfilling] the role of the WPK as a point of contact for its members" (WPK 2014). For a general discussion about the intermediary role played by German Chambers as advocacy groups, on the one hand, and as an organization with public authority, on the other hand, see Sack and Schroeder (2008) and Streeck and Schmitter (1985).

reporting are rare events in Germany (Wulf, 2005).<sup>62</sup>

Apart from the WPK, the IDW and the Ministry, the group of large audit firms represent the fourth “actor” in the regulatory field. Traditionally, it was this particular segment of the auditing profession that defined the interests of the profession through its influence on the intra-organizational structures of both the WPK and the IDW. The influence exerted by large accounting firms within the IDW is primarily based on their disproportionate involvement in the IDW’s technical committees. The main Technical Committee of the IDW (“Hauptfachausschuss”), for instance, consists predominantly of Big Four representatives, while small auditors are absent. In addition, the Big Four are frequently estimated to provide more than half of the Institute’s membership fees (Lenz, 2014). The dominance of large accounting firms within the WPK, was traditionally ensured through the traditional electoral system. The President and the Management Board, which is elected through regular ballots held by the profession, exercise the decision-making authority of the WPK. Until 2010, it was only those members who attended the Chamber’s general meeting who were able to vote. In addition, it was possible for a member attending the meeting to exercise the proxy votes of up-to six absent members. As large accounting firms were able systematically to collect absent colleagues proxies to vote at the general meetings, the system ensured that the big firms were able to retain their control over the WPK (Sack, 2011, p. 150). Hence, background meetings among the large accounting firms determined who became president of the chamber and “it was an open secret that the election winner had already been chosen before the election took place” (Interviewee, audit profession).

#### 3.4.2 National audit practices under international pressures

From the 1970s, Germany developed into an advanced capitalist economy, and its strong industrial export orientation resulted in its being strongly intertwined with international financial markets (Hilger, 2003, 2008). The internationalization of the German audit firms has thus been a direct response to their clients becoming increasingly embedded in the globalized economy (Coenenberg et al., 1999, p. 379). To remain competitive, German auditors had to set themselves up on an international basis. As a result, a wave of mergers with both domestic German and U.S. audit firms took place in the course of the 1980s, and by the beginning of the 1990s, all of the large German audit firms had signed cooperation agreements with U.S. based accounting firms

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<sup>62</sup> The German accounting enforcement authority is the Financial Reporting Enforcement Panel (FREP). The FREP directly examines the financial reports of listed companies in Germany and publishes error findings in the Federal Gazette. Although its annual reports indicate material errors are identified in one out of four of its assessments (2010: 25 %, 2011: 26 %, 2012: 16 %, 2013: 11 %, 2014: 13 %), the link to the audit firms remains unknown, as the WPK does not publicly reveal whether these cases have resulted in supervisory procedures against the these firms’ auditors.

(Ganster, 2000, p. 91; Markus, 1996, p. 163).<sup>63</sup>

This trend was accompanied and reinforced by the transformation of the country's traditional financial system; an institutional shift that started from the 1990s. Traditionally, capital markets had played a limited role in the German "bank-oriented" or "insider" model – in contrast to the "shareholder" or "outsider" model of capitalism (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1998; Leuz & Wüstemann, 2003; Lütz, 2000). Key providers of funds, such as banks, had little need for public financial information, as their position in the corporate governance structure provided them with privileged access to financial information. As a consequence of banks holding large, long-term equity stakes in companies, and as a consequence of their concomitant representation on those companies' supervisory boards, "a concern with external financial reporting has been missing" (Willmott, Puxty, Robson, Cooper, & Lowe, 1992, p. 43). Through this web of interrelationships, banks had far-reaching monitoring opportunities, which may provide at least a partial explanation for why the need for additional external control was felt to be relatively low (Quick, 2005, p. 338). When in the 1980s, the Eight Directive then disentangled the banks' influence on audit firms, the latter successfully lobbied against the introduction of external quality controls (Quick, 2005, p. 338; Vieten, 1995, p. 492). The role played by accounting in the German model was less to deliver publicly relevant information than to "facilitate relationship-based financing [...] by limiting the claims of outside shareholders to dividends, which protects creditors and promotes internal financing" (Leuz & Wüstemann, 2003). While the system was remarkably stable for decades, it slowly but steadily shifted towards the more liberal Anglo-Saxon model of capitalism from the early 1990s onwards (Amable, 2003; Höpner, 2001; O'Brien, 2005).

Throughout the 1990s, Germany "was running persistently and unsustainably high unemployment rates, economic growth was anaemic, and the integration of the former East Germany had stalled badly and triggered a severe recession" (Cioffi, 2002, p. 358). In addition, a series of serious corporate scandals had erupted in the course of the mid-1990s, which indicated that there were systemic problems with Germany's "insider"-based corporate governance regime. The traditional German financial model, based on strong banks, poor financial disclosure, underdeveloped securities markets, low levels of equity finance and corporate governance geared to the interests of the controlling shareholders and the creditor banks "had begun to look anachronistic" (Cioffi, 2002, p. 358).

The institutional transformation was further fuelled when the country became a net capital importer, as a direct response to the country's reunification and the subsequent immense volume

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<sup>63</sup> Markus (1996, pp. 156–167) provides a thorough review of the mergers of German audit firms with national and international audit firms.

of funding needed by its economy. The country's capital imports began to exceed its capital exports, and the German economy could no longer rely on its traditional sources of finance (Leuz & Wüstemann, 2003; Nowak, 2001). Companies increasingly began to internationalize their investor base, and the role played by Anglo-American investors rose dramatically in the 1990s (Höpner, 2001, p. 14). More and more of the largest German companies began to reorient themselves towards a more Anglo-American style of behaviour, with its greater shareholder orientation (Glaum, 2000; Jackson, 2001; Jürgens, Naumann, & Rupp, 2000). Quite apart from anything else, they had to comply with international accounting rules if they wanted to be listed on foreign stock exchanges. As Anglo-Saxon institutional investors made special demands on corporate governance, German firms also faced calls for more reliable public information to be provided in the German financial market (Nowak, 2001). Consequently, new laws and reforms were passed with a view to encouraging a more "shareholder-friendly" corporate governance system and making it more feasible for German businesses to raise capital in the global equity markets (Nowak, 2001). For instance, the Securities Act 1994, aimed to improve the informational quality of annual reports. Another milestone was the Raising of Equity Relief Act that was passed in 1998, following pressure from multinational corporations (Nowak, 2001). The act permitted listed corporations to apply IAS as a real substitute for national accounting standards, making Germany one of the first European countries to make this possible.

In the same year, the highly damaging collapse of a number of major companies triggered intensive debates over the narrow scope of the traditional statutory audit (Heck, 2006; Lenz, 2011; Martens & Pauly, 2000). The revelations that accompanied these corporate bankruptcies triggered debate over the Corporation Control and Transparency Act (KonTrag), which was designed to further improve German financial reporting and corporate governance (Eierle, 2005, p. 292). The act diminished the power of the banks, curbing rent-seeking by corporate insiders, and shifted power to the supervisory board by requiring that in future the external auditor be hired by the supervisory board. In the course of the preparation of the act, the interministerial working group proposed implementing external quality controls for the accounting profession (Hammers-Strizek & Dannenbring, 1999, p. 19).

External quality controls and public oversight emerged as a policy issue in Europe in the mid-1990s, when the lack of harmonized quality controls among the EU Member States was identified as an impediment to the Single Market functioning effectively (European Commission, 1996). In 1998, in the same year in which the KonTrag was debated, the International Federation of Accountants recommended for the first time the introduction of mandatory external quality controls (IFAC, 1998, p. 6). However, during the legislative process the accounting profession made it very clear that, in its view, questions relating to quality controls should be solved by and within the profession itself (Marks & Schmidt, 1998, p. 976). In the end, statutory provisions on



external quality controls were removed from the KonTraG, as the introduction of external quality assurance was (still) seen as being primarily the job of the profession (Hammers-Strizek & Dannenbring, 1999, article from the head of section at the Federal Ministry responsible for audit regulation). Hence, Germany remained among the very few Western economies, both in Europe and at a global level, that did not establish any form of external audit quality assurance controls or public oversight structures (FEE 1998; Marks & Schmidt, 1998, p. 980; Niehus, 1994).

To sum up, two vital features characterize the context in which this analysis is undertaken. First, starting from the 1990s, Germany's economic and financial structures were aligned to the Anglo-Saxon model of capitalism in an effort to facilitate and support the use of capital markets. This macro-institutional shift directly impacted the accounting and auditing arena. The demand for reliable, public financial reporting information burgeoned, increasing the role played by financial auditing. This dynamic environment encountered the relatively stable field of audit regulation. The second feature, therefore, relates to the institutionalized understanding of audit regulation, characterized by the audit profession's strong position vis-à-vis the political arena and by the dominant intra-professional position of the big audit firms.

### **3.5 Case narrative: Institutional Works in the politics of auditing**

This section presents the results of the analysis. It is divided into three stages in which distinct modes of institutional work can be identified and traces the regulatory transition over the period from 1998 to 2014.<sup>64</sup> Based on the different dimensions of institutional work outlined in the theoretical section, the following sections reconsider a major institutional shift in the field of the German audit profession. To explain this transformation, which did not occur in a sequential or progressive manner, institutional work is articulated along two interrelated struggles. The first struggle, divided into stage 1 und stage 2, is the attempt of the large audit firms, the Institute and the Ministry to secure the traditional mode of professional self-regulation. The second fight, which is a direct outcome of the first one, is the struggle of small auditors to disrupt the dominant actors.

#### **3.5.1 Institutional maintenance**

As outlined in the previous section, the German auditing framework operated without external quality controls or public oversight mechanisms until the late 1990s. In 1997, the system came under pressure from international developments, when the U.S. NASDAQ Stock Market changed its listing requirements. The new provisions stipulated that listed companies could only be audited by audit firms whose quality control systems had been externally monitored. With the

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<sup>64</sup> Appendix 11: The time line of events in the establishment of the POB and APAK presents the time line of major events in the history of POB and APAK.

deadline for implementation set for February 1998, large German audit firms put the IDW under pressure to campaign for the introduction of external quality controls as quickly as possible. Otherwise, these audit firms stood to lose their revenues from auditing companies listed on the U.S. stock market. Through their international networks, big German audit firms already underwent peer reviews, but the new stock exchange requirements made a formal German external quality control system necessary. Following internal debates within the IDW, which resulted in a first proposal being put forward to introduce a peer review system, a technical committee on “Quality Assurance” was established between the WPK and the IDW in order to explore how the international audit firms’ need for external quality controls could be realized (WPK President Hense in WPK, 1998a, p. 47, 1999d).

The debates revealed that the WPK and the IDW were striving for different regulatory models (WPK President Hense in WPK, 1998b, p. 224). The IDW, whose priorities were rooted in its global orientation, favoured a system as close as possible to the U.S. AICPA peer review system. The WPK took a rather critical stance to the establishment of an external quality control system, as it felt this would run counter to its understanding of a free profession. Hence, in the intra-professional debates, the WPK strove to limit, as far as it could, the scope of the IDW’s notions on the design, organization and implementation of a German system. Contrary to the IDW’s initial proposal, the WPK managed to ensure that review results were not made publicly available and that peer reviewers were selected and commissioned autonomously by the audit firms. The original suggestion by the IDW also proposed to encompass the entire organizational procedures of an audit firm, whereas the WPK argued that the scope of the review should be limited to just those parts of the firm associated with audit engagements. In spite of these modifications, the IDW prevailed successfully in the intra-professional negotiations, and in November 1998 the committee officially announced that it would be proposing the establishment of a peer review system, taking the U.S. system as its regulatory benchmark (Committee Chairman Volck in WPK, 1999a).

After the IDW’s and WPK’s management had reached a compromise, it was important that the auditing profession, in particular the local members of the profession without international links, be convinced of the merits of such a system. To this end, WPK board members frequently pointed out that discussions at a European level indicated that the European Commission would (in response to the U.S. developments) soon issue legal requirements governing external quality controls, which, once issued, would make it impossible for a system tailored to the specific needs of German auditing to be established.

“If we [the profession] want to avoid the issue [external quality reviews] being initiated and organized by the legislator, we have to be prepared to tackle this question ourselves.”  
(WPK-President Hense 1998a, 224)

This created a perception in the profession that something had to be done. In March 1999, the WPK management board voted unanimously to introduce a peer review system under the formal supervision of a Public Oversight Board (POB). As such amendments required a so-called WPO-Novelle, the WPK and IDW approached the Federal Ministry for Economic Affairs and Energy (BMWi) and called for a legislative initiative (WPK, 1999a, WPK, 1999b).<sup>65</sup>

The following legislative process was based on the close coordination of the WPK, the IDW and the Ministry (WPK-President Wah in WPK, 2001). As the notion of external quality controls was unknown to the Ministry, the latter depended on the international networks maintained by the big audit firms to “open the door” for it to make contact with the U.S. AICPA and the SEC (interview with the head of section responsible at that time). In November 1999, policy advisors of the BMWi, and representatives of the WPK and the IDW together visited the AICPA headquarters. The AICPA and KPMG explained the U.S. review system and, in particular, stressed the system’s ability to bolster confidence in financial auditing (WPK, 1999c). Shortly after, in April 2000, the Ministry issued its bill for an Act to Amend Auditing Regulations (WPOÄG) (Federal Government, 2000). The bill almost entirely mirrored the proposal made by the IDW and WPK. Hence, in the following debates over the bill, IDW and WPK demanded only marginal changes.

Initially objections to the introduction of the POB were made by both the WPK and the IDW (WPK, 1999a). However, it soon came to be regarded as a necessary means for achieving public acceptance, and as a way to “demonstrate the system’s efficiency” to the public (WPK, 1999b, p. 95). Likewise, the justification given for the Act stated that

“Experts the [POB] have to be integrated in order to guarantee the credibility of the system [...] and they have to be personalities who are not only known to the public but who also enjoy an excellent reputation for integrity.” (Federal Government, 2000)

It was of particular importance to the WPK that the POB would work on an honorary basis, as the slightest perception of its being a “regulator” had to be avoided (WPK-President Wahl in WPK, 2000b). Hence, in much the same way as its U.S. counterpart,<sup>66</sup> the German POB was made up of five members from outside of the profession, who were bound strictly to observe the confidentiality of its deliberations. Although the Ministry formally appointed the members, it was the profession, above all the IDW, which approached and eventually proposed possible candidates. However, in informal discussions, the profession experienced difficulties in recruiting members for the Public Oversight Board, and so the field of potential candidates had to be

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<sup>65</sup> A “WPO-Novelle” describes regulatory amendments or changes to the WPO (Law Regulating the Profession of German Public Auditors) and can only be passed by the Federal Parliament.

<sup>66</sup> The U.S. POB was created in 1977 as an independent, private sector body charged with overseeing and reporting on the AICPA’s peer review system (§ 2000.01 SECPS). The five board members represented a spectrum of business, professional, regulatory, and legislative experience.

extended. To this end, in the course of discussions on the bill, the WPK and IDW, speaking for the profession, demanded that the formal prerequisites for POB members be changed (WPK and IDW, 2000). Whereas the draft specified that members had to have a “legal background”, this was changed to the broader category of “academic background” (WPK 2000a, p. 113). Eventually in December 2000, the Act was passed by parliament (Deutscher Bundestag, 2000), without triggering controversial debates (WPK-President Wahl in WPK, 2001). It introduced a mandatory peer review system for all statutory auditors and established the POB to oversee the system.

From the theoretical perspective, the two models of institutional work can be identified for the first stage: Mythologizing and Enabling Work. Both models are linked to attempts to preserve and maintain the existing institutional logics (Lawrence & Suddaby, 2006). “Mythologizing” refers to the way in which actors work to preserve the normative underpinnings of institutions by mythologizing their history (Lawrence & Suddaby, 2006). Mythologizing was used in a rhetorical way to legitimize material regulatory interventions being made unnecessary, and it centred on two main pillars on which the German auditing understanding had traditionally been based on: the perceived high hurdles to becoming a statutory auditor, on the one hand, and on the strong belief in the neo-corporatist Chamber system, on the other hand.

The first line of argument departs from the (perceived) high quality of the education received by German statutory auditors, which relates to the theoretical knowledge examined, the minimum required amount of practical experience, and the different ways of entering the auditing profession. Although various European Directives had been passed as far back as the 1980s to harmonize the education and vocational training systems among European Member States, the educational systems in the various European Member States still differed considerably in the 1990s (Margerison & Moizer, 1996, p. 29). Compared with other educational systems in Europe, audit education in Germany has been considered to be at the leading edge, and the demands made on the education of professionals were regarded as being “some of the toughest in the world” (Coenenberg et al., 1999, p. 386). For such a myth to be created and sustained, it has to have a “story” and has to be repeatedly brought to the public arena (Lawrence & Suddaby, 2006). The argument was frequently used and emphasized in official statements and in interviews in the media with representatives of the profession. In this context, the German statutory auditor was contrasted to the educational path taken by CPAs in the U.S., where the peer review system was seen as necessary tool to balance the “fast and superficial” educational system (Interviewee). From this understanding, the label “statutory auditor” was seen as a hallmark of quality, which, it was argued, made ex-post assessments in the form of external quality controls superfluous. The mythologization of the perceived high quality of audit services resulted in the audit profession initially being highly critical of quality checks and oversight elements. When the U.S. capital

market exerted pressure on the German system, the glorification of the “German statutory auditor” was one factor that ruled out any sort of material regulatory interventions. It is closely linked to the second argument, which refers to the strong belief, rooted in socio-political factors, in the German Chamber system. When the debate on quality assurance entered the professional arena, articles and statements in professional journals frequently declared it to be impossible that a government authority or independent regulatory agency, representing merely the “liberal design” of a profession-organized system such as that used in the U.S., could match the effectiveness of the German Chamber tradition (Dörner, 1999, p. 199; Lindgens-Strache, 1997; Ludewig, 2001, p. 2; Marks & Schmidt, 1998; Schmidt, 1997; WPK-President Hense in WPK, 1998a). Maintaining the traditional division of responsibilities between the state and profession was also in the interests of the Ministry, which rejected governmental solutions, seeing them as being overly bureaucratic and too costly. Moreover, the Ministry made it clear that responsibility for quality assurance had to be given to the profession, if only because auditing was so technical and complex (Hammers-Strizek, 1999, p. 913). The mythologization of both the quality of statutory auditors and the neo-corporatist organization between the state and the profession secured that notion of self-regulation by ruling out any sort of radical regulatory intervention right from the very beginning.<sup>67</sup> Even more, it was the impetus behind the specific design of the POB and peer review system that strengthened rather than weakened the profession’s position, which refers to the second model of institutional work that can be identified.

Enabling work refers to the introduction or creation of rules, institutional arrangements and actors that facilitate, supplement and support institutions in order to ensure institutional survival (Lawrence & Suddaby, 2006, p. 230). In the case of the German oversight system, enabling work refers to the particular design of the peer review system and the POB: Although quality controls and public oversight boards are elements that are associated with a certain dilution and scrutiny of the profession’s self-regulatory ability, they were designed in a way that actually strengthened the profession’s traditional system. As the auditing profession strongly rejected the introduction of any sort of quality assurance mechanisms, the IDW and WPK had to find a compromise, which would meet international requirements, on the one hand, but would not question the institutionalized understanding of a self-regulated profession, on the other. The latter was important for the general acceptance of the auditing profession, and was eventually made possible because the auditing profession “installed some safeguards into this review system.” (Interviewee).

The strongest safeguard was a “firewall” which prevented peer review findings being used in disciplinary court procedures against the audit firm. To this end, the disciplinary system and the

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<sup>67</sup> Similar rhetorics were used in the debates in the 1980s and early 1990s concerning the implementation of a peer review system (Niehus, 1980, 1982, 1985, 1994, 1995; R. Schmidt, 1995).

quality control system within the WPK were separated when the peer review system was introduced (Sahner, Schulte-Groß, & Clauß, 2001, p. 15). For the organization and evaluation of the peer review results, a Special Commission was founded within the WPK (Niehus, 2000, p. 1136). The Commission consisted of members of the profession who were all registered as external reviewers. It assessed all peer review reports and decided what corrective actions should be taken in the event of errors in the firms' internal control system being identified. The firewall was a vital aspect for the profession:

“We had to discuss the issue of what the consequences would be in the event of the review result being negative. What would we do in such a case? It was not intended to publish this.” (Interview with Wienand Schruff)

In order to guarantee the firewall and ensure that the WPK's internal department for disciplinary actions and department for quality controls remained separated, the WPK hired a second managing director. From now on, the WPK was led and organized by two managing directors. The firewall was explained on the basis of the privilege against self-incrimination (“*nemo tenetur principle*”). It stood in sharp contrast to the recommendations made for the U.S. system, the recommendations of the IFAC (IFAC, 1999) and the European Commissions' Recommendation “On quality assurance for the statutory audit in the European union: minimum requirements”, which was issued in 2000 (European Commission, 2000). Although, the Recommendation explicitly demanded that negative results from external quality controls should trigger sanction proceedings, the IDW frequently emphasized that “all international requirements had been fully met” by the German system (e.g. IDW, 2002, p. 12).

The firewall was explicitly referred to in the official justification for the law (Federal Government, 2000). As Lawrence and Suddaby point out, the state and the professions often work together to maintain existing institutions (Lawrence & Suddaby, 2006, p. 236). In fact, this first stage was characterized by the joint efforts made by the WPK, IDW and the Ministry to preserve the self-regulatory system of the profession. The justification for the law explained the legislative initiative with “international developments” rather than with any perceived shortcomings in national audit quality, which explains why the objective of the system was not to reveal the grounds a registered auditor being struck off (Federal Government, 2000). This understanding of the system was also voiced by the then Policy Advisor, who argued that “the introduction of quality controls should not be the equivalent of a dragnet investigation of the profession” (Hammers-Strizek, 1999, p. 913).

The alliance between the profession and the Ministry is also evidenced in the creation of the POB as a new actor to ensure the existing institutional script. Beyond the profession's boundaries, the POB was established to signal and reaffirm the system's legitimacy. Within the

system, the fact that the POB operated on an honorary basis prevented concrete, individual review outcomes being in its focus (Interviewee). Moreover, as the profession itself took the lead organising the POB's members, the chosen members shared a liberal understanding and agreed on the “ability and usefulness of the profession to regulate itself” (Interviewee). The combination of the shared politico-economic understanding and the honorary nature of the work has ensured that the POB has had no occasion to use its powers to overrule the decisions of the Quality Control Commission. On the contrary, in joint meetings with the Commission, review results have been presented and possible consequences discussed to such effect that the relationship between the Quality Control Commission and the WPK warmed swiftly (Interview, WPK General Managers).

As a result of the strong, mythologized belief in the high quality of statutory auditors' education and the effectiveness of the German Chamber system, new rules (external quality controls) and actors (POB) were implemented in a way that did not limit, but instead strengthened the profession's self-regulatory capacities, thereby ensuring the survival of the self-regulatory institution. It also solidified the relationship between the dominant actors, the WPK and the IDW. In the late 1990s, unsolved questions regarding the general division of responsibilities and competencies did cause tensions between the IDW and the WPK. The President of the WPK therefore stressed the need for harmony to be maintained in order to “increase our (the accounting profession's) political clout”, and the successful work on the peer review system, evidenced in joint statements on the course of the debate over the governments' draft (IDW and WPK, 2000), was used as an example of what could be achieved if forces were united (WPK President Wahl in WPK, 2000c). This enabled the profession to exert influence outside its national boundaries: On behalf of the Ministry, the WPK attended the European Committee on Auditing. Thanks to its political power, it was able to ensure that peer review and monitoring were defined as “equivalent” by the European Recommendation of 2000 (WPK 1999, p. 238).<sup>68</sup>

### 3.5.2 Institutional decoupling

In 2002, the collapse of Enron and WorldCom significantly changed the regulatory environment in a matter of months. When in July 2002 the U.S. self-regulatory system was replaced by government inspections under the new established PCAOB, the German peer review system lost its regulatory benchmark overnight. The PCAOB was equipped with a set of comprehensive information rights, which granted inspectors access to confidential documents from audit firms and their clients (PCAOB, 2004). As a result of this, the regulatory shift had a direct impact on German enterprises. It soon became apparent that the PCAOB's sphere of influence would go

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<sup>68</sup> According to the text, quality assurance was the *profession's* principal means of reassuring the public, therefore both considered were deemed to be methodologies of “equal stature” (European Commission, 2000, p. 3).

beyond its national borders, as Sections 102(a) and 106 of the Sarbanes-Oxley Act and PCAOB Rule 2100 required all non-U.S. audit firms to be registered at the PCAOB and thus subject to PCAOB inspections. This was particularly crucial for German companies as, at the time, German audit firms involved in statutory audits of firms listed in the U.S., were the second largest group of foreign auditors (WPK, 2004b, 2005b, p. 8). The PCAOB's extensive inspection powers made German companies worry about economic and industrial espionage (Engelen, 2005, p. 32).<sup>69</sup>

As a result, in the months subsequent to the establishment of the PCAOB, the alliance of the IDW, WPK and the Ministry made joint efforts to lobby against the obligatory registration of non-U.S. audit firms with the PCAOB (WPK 2002, p. 298). In addition, the WPK and IDW attempted to directly convince the SEC and PCAOB to renounce its inspection rights (WPK 2002, p. 292) and publicly criticized the regulatory powers of the PCAOB (WPK 2002, pp. 292, 297, WPK 2003a, WPK 2005c, p. 25). The German efforts were supported by the European Commission, which negotiated over the duty to register with the SEC (Engelen, 2005). However, arguing that U.S. investors demanded high-quality audits from firms listed on U.S. exchanges, regardless of their location, the PCAOB was adamant that its international inspections represented one of its top priorities and it was accordingly unwilling to renounce them (PCAOB, 2003). After the PCAOB extended the deadline for registration twice more, first to April 2003, then to July 2003, the PCAOB made it unambiguously clear on October 28, 2003 that registration would remain necessary (PCAOB 2003; WPK President von Treuberg in WPK, 2003b). The only way to avoid PCAOB inspection would be the recognition by the PCAOB of the German oversight system as an "equivalent" system (PCAOB Chairman Goelzer, 2004).

At first, the profession's strategy, as evidenced in press releases and joint statements (WPK and IDW, 2002), was based on the argument that the very design of the current peer review system, as assessed by the POB, would make regulatory changes to gain recognition by the PCAOB unnecessary.

"The requirements of the public and of SOX are already met by the German system."  
(WPK statement in WPK, 2002)

"It can be concluded that the German system of professional oversight and external quality assurance already guarantee an independent and comprehensive oversight of the profession." (IDW statement in IDW, 2002)

To further emphasise the independent, public oversight elements in the German system, the Ministry issued the 5<sup>th</sup> WPO-Novelle in 2003, granting the POB members the right to attend meetings of the WPK's management board, which was seen as a significant enhancement of the public element in the German oversight system (Manfred Schmidt & Kaiser, 2003, p. 163), as the

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<sup>69</sup> The Federation of German Industries (BDI) had already in August 2002 organized an information meeting for all listed German companies in order to discuss the consequences of the PCAOB's establishment (WPK, 2002).



newly granted right of attendance would sufficiently guarantee the “public interest” (former Parliamentary State Secretary Schlauch, 2003). To further reinforce the system’s effectiveness, from 2005 on audit firms were not allowed to choose their reviewers autonomously, but rather had to propose three reviewers to the Quality Control Commission and then engage one reviewer who had not been rejected by the Commission.<sup>70</sup>

Nevertheless it soon became apparent that more material regulatory modifications were inevitable, since, parallel to the German national debates, the European Commission was working on a reform of the 8<sup>th</sup> EU Directive from 1984. After the transatlantic negotiations on the registration of foreign audit firms with the PCAOB had failed, it became clear to both the profession and the Ministry that the new Directive would include regulatory provisions, which the German system would not be able to fulfil; the POB had to be given a more relevant role in the German regulatory context.

Informal discussions between the Ministry and the profession (in particular the IDW) resulted in a first draft on the Law on “The further development of oversight over statutory auditors” (APAG), being issued in July 2004 (BMWA, 2004). The main component was the transformation of the POB into the Auditor Oversight Commission (APAK). While the POB’s oversight was limited to the external quality reviews, the draft granted the APAK ultimate responsibility and decision-making power over all matters administered by the WPK, such as the quality assurance system, disciplinary investigations, professional exams and registrations of auditors (BMWA, 2004). The final draft of the act did not contain material changes and was not discussed in the parliament to any great extent, as it had been accepted unanimously in the parliamentary committee (WPK President von Treuberg in WPK, 2005b). The German parliament passed the act on December 3, and the APAK came into force in January 2005<sup>71</sup> (Deutscher Bundestag, 2004g).

The APAK was composed of ten honorary members. All the members of the POB became members of the APAK. Technical and human resources were provided by the WPK. The only direct support for the APAK consisted of a secretary, which was felt to be necessary to communicate with international oversight entities abroad and to boost its acceptance and recognition (APAK Chairman Röhricht in WPK, 2007b). The first chairman of the APAK was Volker Röhricht, who was already member of the POB. He had been associated with the profession from the early 1990s, as he had served as a member of the examination boards for the statutory auditors exams and was known for his liberal attitude to regulation.

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<sup>70</sup> In later years, it came out that in the majority of cases, only one reviewer was proposed to the Commission, which was not rejected by the Commission.

<sup>71</sup> The European Directive was eventually passed in October 2005 (2006/43/EG).

In discussions with European oversight authorities, Röhricht soon realized that his European counterparts viewed the German system with sceptical frowns.<sup>72</sup> The final evidence that the POB's transformation into the APAK would still not be enough to meet international standards was then brought by a PCAOB visit in February 2006. While the PCAOB welcomed the transformation of the POB into the APAK, it pointed out that in the absence of an inspection system, it would not be possible for it to recognize the German oversight system as equivalent (Warming-Rasmussen, 2006; WPK 2006a). In particular, the fact that inspections were still not part of the German oversight system and that the Commissioners were working on an honorary basis was viewed critically by the PCAOB.

“With the [establishment of the APAK], we [the accounting profession] thought that we would not only fulfil the new EU Directive, which at this point was still evolving, but also fulfil the expectations of the U.S. with regard to a proper oversight system. In the meantime, we have received signals that this might not be the case.” (WPK-President in WPK, 2006b)

For this reason, another regulatory amendment was prepared. The first draft of the 7<sup>th</sup> WPO-Novelle, the Law on Professional Oversight Reform (BARefG), was published in March 2006 (Federal Government, 2006). Its main component was the introduction of inspections for audit firms with clients of public interest (§§ 61a Satz 2 Nr. 1, 62b WPO). As the risk of PCAOB inspections was still omnipresent, it was a crucial issue for the WPK to have the legislation passed as quickly as possible (WPK Ulrich in WPK, 2007c).

“We promised the Americans an equal system by 2007 in order to avoid PCAOB inspections in German audit firms.” (WPK President Ulrich in WPK, 2006c)

“Our international firms need an equivalent to the U.S. oversight regulations.” (WPK President Ulrich in WPK, 2007d)

Without having been debated either in the Federal Council (Bundesrat, 2006) or in Parliament (Deutscher Bundestag, 2007), the legislation was eventually passed in September 2007, thus introducing inspections to the German audit oversight system. Nevertheless, the still strong organizational interrelationships between the APAK and the WPK continued to be a problem.

In May 2008, the European Commission issued a Recommendation on external quality assurance for statutory auditors and audit firms auditing public interest entities (European Commission, 2008), which laid down the criteria for an effective oversight system. To meet the independence criteria, the profession, the IDW, WPK and the APAK started to focus on the legal status of the APAK, and two legal opinions (Fachgutachten) were commissioned on this issue. According to

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<sup>72</sup> These discussions took place at meetings of “European Group of Auditors’ Oversight Bodies” (EGAOB). The EGAOB was established by the European Commission to coordinate the establishment of the oversight systems in the European Union. The preparatory meetings took place on 29.04.2005, 13.07.2005, and 12.12.2005, followed by a first meeting on 09.02.2006.

the legal opinions, the APAK could continue to serve as a supervisory entity and fulfil the responsibilities of the European Recommendation by changing the chronological order of various procedures between the WPK and APAK. In particular, it would become necessary for the inspections reports to be submitted first to the APAK and then to the WPK's "Professional Oversight" department, something that was still done the other way round at this time (WPK 2009b, WPK 2010a). The debates between the IDW, WPK and APAK continued during 2009.

As formal independence was still not assured, the PCAOB still did not recognize the German system as equivalent, and the fear of extraterritorial inspections was omnipresent. The discussions between the PCAOB and the APAK were characterized by informal discussions between Röhricht and the PCAOB's Board Member Niemeier, who frequently demanded that the APAK's formal independence be strengthened by means of further legal reforms. The pressure to rectify the APAK's organizational dependence on the WPK increased after the PCAOB's formally announced that it would conduct its first extraterritorial inspections by the end of 2009 (PCAOB 2009). The WPK and two of the Big Four firms that would have been affected immediately contacted the APAK and the BMWi and demanded that the debate over how the APAK was to develop finally be brought to a conclusion (WPK President Pfitzer in WPK, 2009a). Together, talks were held on how to enhance the German oversight board's formal independence. With a view to reaching agreement on a common proposal, a meeting between the APAK, IDW and WPK took place in December 2009 (WPK Pfitzer in WPK, 2009c). Consensus was reached in December 2009, and on January 20, 2010 the President of the WPK, the chairmen of the APAK, and the President of the IDW's approached the BMWi to present the new proposals (APAK, 2011; WPK 2010b). However, these discussions were suddenly disrupted when the European Commission announced its intention to issue a Green Paper on audit regulation in autumn 2010.<sup>73</sup> This brought German discussions to a halt since the BMWi wanted to await the outcome of the Green Paper before changing the regulatory framework once again (Oberrecht, 2011). This line was supported by the WPK, which, following discussions with the management board, decided to stop further deliberations over the oversight structure and instead await the results of the Green Paper.

To sum, for the auditing establishment, key issue raised by the international embedding of big audit firms and their clients was to formally introduce a public oversight elements, while maintaining the traditional mode of professional autonomy. From a theoretical perspective, in the course of the transformation from the POB to the APAK and in the course of the APAKs' further development, similar modes of institutional work to those seen in the first period can be identified. In particular, by means of a whole series of regulations, new rules and provisions were

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<sup>73</sup> The Green Paper was triggered when, in the wake of the financial crisis, the regulation of the auditing profession came into the global spotlight (e.g. ACCA, 2010; FSA and FRC, 2010; IFAC, 2010).

introduced with the explicit goal of ensuring the institutional survival of the self-regulatory system. However, while institutional maintenance had been relatively easy to accomplish in the first stage, pressures from both the PCAOB and the European Commission now posed a challenge for the actors. Again, as was the case when the peer review system and the POB were established, the WPK and the IDW had to find a compromise between the IDW's need to possess an internationally accepted oversight system and the WPK's critical attitude to any alteration in the way the profession was organized and regulated.

Although endowed with rather weak powers, the APAK nevertheless represented a new actor and triggered debates on the roles, tasks and general understanding of the WPK.<sup>74</sup> While there was a concurrent interest on the part of the IDW and the industry to create – formally –, with the APAK, a counterpart to the American PCAOB (IDW, 2004a, 2004c), the WPK tried to limit the powers of the new actor as far as possible, perceiving it to be a “frontal attack on its own existence” (Interviewee). This is evidenced in the discussions in the course of the APAK's establishment. The WPK demanded that the APAK follow a rather “general oversight approach” without focusing on particular cases (WPK, 2004a, 2004c). Moreover, it argued that the profession should be directly involved in the governance of the APAK (Deutscher Bundestag, 2004f). As formal independence was of particular importance for the IDW, this was adamantly rejected by the IDW.

“For a system that is based on strong cooperation with a professional organization, which is the case in Germany, one can hardly argue that the necessary expertise could not be guaranteed unless the profession is directly involved [in the organization of the APAK], as this is precisely what is guaranteed through the cooperation [...]. It would be a very good argument in public debate to refer to the fact that the oversight authority consists exclusively of non-professionals.” (Naumann, 2004)

Both the establishment and the further development of the APAK were therefore characterized by the on-going desire to find a balance between maintaining the institutional system, on the one hand, and finding international acceptance, on the other. To this end, a form of institutional decoupling of formal policies from actual practices had become necessary (Meyer & Rowan, 1977). Policies were adopted with a view to conforming to external expectations regarding formally stated mechanisms and operational procedures, even though, in practice, the old rationales were preserved (Bromley & Powell, 2012; Scott, 2008). As applied to institutional work, Hirsch and Bermiss (2009) have argued that the process of decoupling is particularly applicable for the institutional maintenance (Hirsch & Bermiss, 2009). While a loosely coupled organization was frequently framed as an unintended management failure or the gradual equilibrium to an organizational system that is exposed to contradictory institutional logics (e.g.

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<sup>74</sup> The marginal role played by the POB is further evidenced by the fact that the POB did not actively play a role when it was transformed into the APAK.

Brunsson, 2003; Weick & Orton, 1990), Hirsch & Bermiss (2009) point out that a loosely coupled system can be the result of careful strategic design by institutional actors. Likewise, Bromley and Powell (2012) state that decoupling can often be reduced to the self-interest of powerful actors (Bromley & Powell, 2012, p. 11). Especially during a period of change and deinstitutionalization, such strategic decoupling enables actors to more “creatively navigate” within their organizational fields (Hirsch & Bermiss, 2009; Oliver, 1991).

Decoupling was facilitated through the passive role played by the Ministry. Although officially the POB was replaced by the APAK, the latter resulted more from a transformation of the POB. The APAG Act was formulated in general, vague terms, thereby leaving it to the profession to fill it with life. For instance, as the Act did not contain concrete independent requirements with regard to the members of the APAK, all POB members were nominated for the APAK without having to submit formal applications, which made it possible for the profession to “secure continuity through the transferal of the POB members into the APAK Commission” (Regulator). The Act neither defined the APAK’s role as an intermediary between the Chamber and the Ministry, nor did it specify its personal and organizational capacities.<sup>75</sup> This resulted in the APAK, from its beginning, being involved in the intra-organizational structures of the Chamber, which in the first months even organized the APAK’s email correspondence. The APAK Chairman commented on the lack of any organizational substructure at a meeting with the Chamber: “Well, I might need my own secretary and an assistant who coordinates my activities” (Interviewee). In contrast, at the time the APAK was established, the PCAOB had an annual budget of 137m U.S. dollars and had more than 400 employees (WPK 2005a, p. 21).

Since the power and resources of the APAK were both limited and unspecified, all oversight matters very much resided within the profession itself.<sup>76</sup> The first inspectors were recruited from the big accounting firms and employed directly by the WPK. As some of the APAK Commissioners did not possess special knowledge on specific auditing aspects, a certified accountant was hired who would “translate” the inspection results to the Commissioners. Above all, the APAK Commission was still working on a honorary basis, which made a deep and critical engagement with review and inspection results impossible and limited the APAK’s influence on superficial, procedural aspects. For instance, the APAK criticized the fact that various peer review reports were not assessed by the Chamber on a timely basis (APAK, 2008). Decoupling between formal and de facto oversight resulted in the initial doubts harboured by parts of the

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<sup>75</sup> When the draft of the APAK was discussed in the parliamentary committee, only one comment referred to the lack of technical and personal support provided to the APAK (Deutscher Bundestag, 2004b).

<sup>76</sup> The vague legislation caused also debates within the APAK, primarily caused by Schmidt, who was the head of section at the Federal Ministry of Economic Affairs, and primarily responsible for the Act that established the APAK. After his departure from the Ministry, he became a APAK Commissioner in 2008. The debates centred on the fact that various aspects of the Act that established the APAK was implemented differently than intended by the former legislator.

profession over the establishment of the APAK, swiftly disappearing (WPK 2008c, p. 4). As with the previous relationship between the POB and the Chamber, the first years were characterised by close cooperation between the profession and the APAK. In its annual reports between 2005 and 2010, the APAK confirmed that the Chamber's organization and assessment of the inspections was both appropriate and efficacious, nor did it challenge the outcome of a single one of the latter's oversight proceedings (APAK, 2006, 2007, 2008, 2010, 2011).

The APAK's monthly meetings were also attended by the WPK-President and managing directors (WPK President Ulrich in WPK, 2007a), and the then WPK-President publicly announced that: "It might sound strange when the overseen says that he is being treated well. However, the collaboration is really positive" (WPK President Ulrich in WPK, 2007a). In this way, a sort of alliance between the profession and the APAK emerged (Malsch & Gendron, 2011), both of whom worked together with the object of being deemed equivalent to the U.S. PCAOB.<sup>77</sup>

"He [he APAK Chairman] again and again returned from international meetings and said: I have just managed to sell our system." (Interviewee)

By enhancing the formal independence of the APAK from the Chamber, the alliance between APAK and profession worked on the basis of the old system's surviving at an institutional level.

"Who gets the documents first, who signs first [...]. The Chamber did not resist that [the changes to enhance formal independence]. There was no passion about these things." (Interviewee)

The IDW was aware that the interweaving of the oversight structures with the WPK was viewed critically on the international stage. The recognition of the German system therefore depended heavily on how the role played by the WPK was understood. For this reason, it became important that the WPK should be perceived not as a second, pure interest group representing the profession, but as an entity acting on behalf of the public authorities. While it was the WPK's perception that both aspects would belong to its inherent area of responsibilities (WPK, 2004a), it was the WPK's original role and function within the neo-corporatist framework that the IDW emphasized in its official statements and in public hearings (e.g. IDW President Naumann in a public hearing of the parliamentary committee 2004).

### 3.5.3 Institutional disruption

In the shadow of the attempts made by the IDW and WPK to ensure the institutional survival of professional self-regulation, a new actor entered the stage when small auditors began to organize

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<sup>77</sup> International acceptance was stated in the APAK's annual report to constitute the primary goal of its international activities (APAK, 2008).

themselves. When the peer review system was introduced in 2000, it was important for the profession and the Ministry to have one and the same system in place for all statutory auditors in order to prevent the profession being divided into a “first class” of auditors with peer reviews and a second class of auditors without these (Federal Government, 2000, p. 24). To this end, the procedures and requirements demanded by the peer review system were designed identically across all auditors. Small audit firms without companies of public interest among their clients were given until the end of 2005 to prepare for their first review, while large audit firms had to pass their reviews directly. By the end of 2002, all of the 142 reviews, conducted both at large and at a number of medium-sized firms, had proceeded successfully (Kommission für Qualitätskontrolle, 2002).<sup>78</sup> However, in contrast to large accounting firms, the vast majority of small auditors possessed neither the technical skills nor the financial and human capabilities required for a peer review process. When the deadline for small auditors was reached in 2006, a “shock wave” was triggered in the small auditors segment of the profession, as they realized that they would not be able to meet the review requirements (Gschrei, 2009, p. 5).<sup>79</sup> As a result, at least one third of small auditors left the audit market.<sup>80</sup>

The opportunities for small auditors to demand reforms were limited, nor did the intra-organizational institutional setting provide access for small auditors to the regulatory arena: while large audit firms dominated the internal structures of the IDW, it was the specific electoral system of the WPK, outlined above, that prevented small auditors from participating in the politics of auditing. As the intra-professional opportunities to reform the system seemed to be blocked, a group of small auditors went to the Administrative Court (Verwaltungsgericht) to challenge the “undemocratic electoral system” after the WPK’s general elections of 2002. Wp.net’s main objective was the introduction of a postal vote, which would have made it easier for small auditors to participate in the general elections. However, the Court opposed regulatory interventions, arguing that the design of the electoral system did in fact enable all auditors to participate in the elections and ruling that reforms had to be discussed within the profession (WPK, 2008b). In response to their perceived legal and professional discrimination, a group of small- and medium sized auditors established the Association for Medium-sized Auditing (wp.net) in 2005 (wp.net, 2005). For the first time since the auditing profession had been institutionalized in 1961, a second professional association had entered the arena.

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<sup>78</sup> In 133 reviews were unqualified, and nine qualified.

<sup>79</sup> The overwhelming majority of small audit firms postponed their first review until the deadline was reached. The annual reports from the Commission for Quality Controls indicate that in 2003 107 reviews (Kommission für Qualitätskontrolle, 2004) and in the year 2004 500 reviews (Kommission für Qualitätskontrolle, 2005) were conducted, with the number increasing significantly to 2600 review report in 2005 (Kommission für Qualitätskontrolle, 2006).

<sup>80</sup> It is difficult to determine the precise number of audit firms that left the audit market. While the WPK and IDW estimate that around 25 % left the audit market, 70 % left the audit market according to Wp.net.

The first President of Wp.net was its founder Michael Gschrei. He immediately positioned wp.net against the dominant actors of the field: The first members newsletters were composed of a series of intense personal attacks against the WPK and IDW, the WPK's general elections of 2005 were challenged and successful demands were made to be heard in public hearings, when oversight changes were discussed in the parliamentary committee (wp.net, 2006a). Nevertheless, the number of new members remained at a distinctly low level in the first three years, and regional meetings had to be cancelled due to the marginal number of participants (wp.net, 2006a, 2007b). In addition, at the end of 2007, the Administrative Court dismissed the association's challenge to the WPK election of 2005 (wp.net, 2008a). As the old electoral system remained in place, the group of large auditors won the WPK's general elections in 2008 (WPK, 2008a).

As small auditors were still stalemated within the intra-professional arena and as support from the judiciary had not been forthcoming, wp.net intensified its own political lobbying activities. In 2009, wp.net sent its journal, in which the WPK's "antiquated and anti-democratic" electoral system was described (Gschrei, 2009, p. 30) to all the members of the German Parliament (wp.net, 2009b). Eventually, in April 2010, representatives of Wp.net, the IDW and the WPK were invited by the Ministry to discuss possible electoral reforms. The WPK and IDW insisted that they could see no need for reforms, since the electoral system, they argued, already fulfilled democratic criteria. However, the Ministry was put under pressure, as it was easy for wp.net to communicate and convey the shortcomings displayed by a political system to the members of the German parliament:

"I think it was clear to everyone that the electoral system had to be changed: it was necessary to make postal votes possible, only being able to vote if you attended the meeting no longer conformed with modern expectations." (Interviewee, Political Actor)

The Ministry agreed to change the WPK's electoral system by introducing the postal vote. The German parliament passed the amendments to the WPO in October 2010 (Bundesgesetzblatt, 2010), and in January 2011, and the Chamber changed the relevant articles in its own statutes (WPK, 2011b). As the next general elections, scheduled for June 2011, were imminent, wp.net intensified its attacks on the IDW and WPK. In particular, it benefited from its collaboration with a blog on auditing called "PRIMUS", which enjoyed a nationwide readership. Since 2005, PRIMUS had used insider information to attack the IDW, the WPK and the Big Four in general. As personal links existed between wp.net and PRIMUS, the latter had access to confidential documents and minutes, which it published on its blog.<sup>81</sup> The mobilization of the small auditors was indirectly facilitated by the debates on the European level. The Green Book on the role of audit firms in the financial crisis, released by European Commissioner Barnier in 2010 (European

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<sup>81</sup> It is not possible to "measure" quantitatively the blog's impact. However, the fact that all interview partners referred autonomously to the PRIMUS blog, is a strong indicator for the blog's impact and coverage within but also outside the audit profession. It relaunched its website in August 2015 and it is not accessible through [www.wpwatch.de](http://www.wpwatch.de).



Commission, 2010), provided wp.net with ammunition in its attempt to position small auditors against the Big Four by casting doubt on the latter's professional legitimacy:

“Had the statutory auditors (Big Four) warned about the risks on the banks' balance sheets, the financial crisis might have been avoided.” (wp.net, 2010b)

The mobilization of small- and medium-sized auditors increased the election turnout at the 2011 election to 50 percent, and the wp.net's slate of candidates won the majority of the votes (WPK, 2011c). Under the majority voting system, all 51 seats on the Management Board went exclusively to wp.net representatives, and Gschrei, the President of wp.net became the new President of the WPK. For the first time, the composition of the WPKs' Management Board did not just turn out differently to what had been forecast – the board had actually come under the control of the small auditors. The election victory was expected neither by the established actors nor by the wp.net (Gschrei, 2011; WPK President Pfitzer in WPK, 2011d). The Big Four were “shocked” (Big Four interviewee):

“To be honest, we [the Big Four] did not do much [to prepare for the election], we completely underestimated the situation. This all went completely wrong.” (Wienand Schruoff, KMPG)

In his inaugural speech, the new President of the Chamber immediately made it clear that the impact of the IDW on the politics of auditing had to be rolled back, as the latter would in future be “one among several professional associations” (WPK President Gschrei in WPK, 2011a). In press interviews, he publically supported the majority of the regulatory reforms that had been put on the political agenda by the European Commission's Green Book of 2010 (e.g. in *Börsen-Zeitung* from 29.11.2011 2011). This public support on the part of the national Chamber for the introduction of mandatory audit rotation and a rigid separation of auditing from consulting services was targeted directly against the core of the Big Four's business models. In a direct response, the new President was attacked by the Big Four audit firms, which announced that they would take legal action if the Chamber continued to work against the “general and genuine interests of the profession”. Letters to the WPK's President were sent by EY, PWC and KMPG, with copies being sent directly to the Ministry. In this way, the long-established coalition in the ranks of the audit establishment between the WPK, the IDW and the large audit firms was broken up.

To sum up, the peer review system, which had primarily been introduced in order to preserve large audit firms' competitiveness on the international playing field, became a serious problem for small audit firms in the local context. The “perfect marketing tool for the profession” (Interview, IDW) highlighted the gap between different parts of the profession and pushed small auditors out of the auditing market. Others have argued that a “peer reviews strengthens the logic of

confidence by unifying the accounting profession around the symbols of peer review” (Fogarty, 1996, p. 260). In this case, however, it was the triggering moment for institutional disruption by the small auditors.

The possibility of institutions being disrupted by the work of actors has been highlighted in institutional theory by several scholars (Greenwood & Hinings, 1996; Greenwood et al., 2002; Holm, 1995; Maguire et al., 2004). From prior studies on the dynamics of organizational fields, it is known that actors whose interests are not in line with the existing institutions work, when possible, to disrupt the existing logic (Abbott, 1988; DiMaggio & Powell, 1991). Implementing change, however, that breaks with existing institutions is challenging (Battilana et al., 2009, p. 78). When professions work to disrupt institutions, they are often observed to do this by challenging the prevailing regulatory structure (Abbott, 1988). Based on this observation, Lawrence and Suddaby (2006) argue that in most of these cases, institutional disruption takes place through the judiciary, as the latter is capable of directly invalidating previously powerful institutions (Lawrence & Suddaby, 2006, p. 236). In fact, the first attempts made by small auditors were aimed at challenging the Chamber’s electoral system, as this was identified as constituting the stabilizing mechanism that ensured the dominance of the establishment. However, the judiciary refused to support the small auditors, as the electoral system could not be challenged successfully on legal grounds.

The only way for wp.net to disrupt the dominance of the establishment was by mobilizing the traditionally silent majority of small auditors. As the definition of a clear identity is of central importance when one is mobilizing others within a field that is characterized by high levels of institutionalization (Rao et al., 2000), a vital success factor for wp.net was its explicit positioning against the IDW and WPK from the very beginning. The formation and development of wp.net is thus an example of what others (e.g. Mahoney, 2000) have identified as typical reasons for deviation from an institutional system that is itself stuck in inertia: An opposing group which had initially been at the periphery of the organizational field emerged and positioned itself in relation to the “institutional defender” (Battilana et al., 2009; similar Malsch & Gendron, 2013, p. 876), eventually disrupting the latter’s dominance by challenging the prevailing institutional foundations.

The disruption of the establishment’s dominance was based on the solidarity that existed among small auditors and on the articulation of a vision for the divergent change that it was promoting. The vision that was created by wp.net was the participation of small auditors in the politics of auditing and a new establishment, which would serve the interest of the whole profession. Having developed a vision, wp.net had to convince small auditors of the need for change and mobilize them behind it. Wp.net had to decrease the perceived risk of dissenting by undermining

the core assumptions and beliefs in the organizational field (Lawrence & Suddaby, 2006). This was done above all with the aid of a specific use of rhetoric that can be observed in the emails sent to its members (Table 16).

Table 16: The rhetorics used by wp.net for institutional disruption<sup>82</sup>

Target	Story	Examples
Big 4	“The Big Four are not part of the profession any longer.”	<ul style="list-style-type: none"> <li>▪ “The auditors of banks would have been able to avoid the financial crisis and the global economic crisis [...]. However, in audits of systematic banks, such as the HRE [Hypo Real Estate], ‘political opinions’ were provided rather than true opinions, as according to the HGB.” (wp.net, 2009b, p. 3)</li> <li>▪ “Some of the high-flyers of the ‘Neuen Markt’ only made magic revenues on paper, but our amazing auditors blessed everything.” (wp.net, 2005)</li> <li>▪ “He who consults, cannot audit.. Who does not understand this principle, should try it out. The ‘elite auditors’ prove this although despite their truehearted affirmations. [...] In 2006, KPMG received from its 20 DAX clients 321 Mio. € audit fees and on top of this additional 119 Mio consultancy fees.” (wp.net, 2008b, p. 7)</li> </ul>
	“The Big Four take our clients.”	<ul style="list-style-type: none"> <li>▪ “Through Sarbanes Oxley, the large ones in our field had to retreat from their past lucrative benefices. They will, therefore, increasingly and with aggressive methods target the audits of medium sized companies.” (wp.net, 2005)</li> <li>▪ “With the introduction of inspections, the brutal bloodletting also started in the segment of the ‘elite class’. With disproportionate measures, the banishment of small audit firms with public interest began.” (Gschrei, 2015, p. 22)</li> </ul>
IDW	“The structures of the IDW are dominated by Big Four.”	<ul style="list-style-type: none"> <li>▪ “The quality control system which was passed by the Federal Parliament and which designed by the IDW and WPK is amazing. It did not improve the audit quality of bank auditors [Big 4], but expelled 75 % of audit firms out of the audit market.” (wp.net, 2009a, p. 13)</li> <li>▪ “Although the EU-Directive does not require a Commission for Quality Control [...], it was, however, created by the German legislator under the leadership of the WPK and IDW, which threw around 70 % of small auditors and 90 % of sworn auditors out of the audit market” (wp.net, 2008b, p. 6)</li> <li>▪ “Some in the Chamber and, in particular the IDW, feel as they would be the Ludwig XIV: ‘L’État, c’est moi!’” (wp.net, 2010d)</li> </ul>
Ministry	“The legal initiatives are against small auditors.”	<ul style="list-style-type: none"> <li>▪ “The quality controls were designed for the Big 4 and not for the 5000 small auditors.” (wp.net, 2006c)</li> <li>▪ “Why did the Ministry translate the “Quality Assurance REVIEW” in the Directive of 2016 with “Quality control ASSESSMENT” [germ. Prüfung] and not with “Quality Review”? The result: With the support of the IDW, U.S. SOX was handed over to the German auditors.” (wp.net, 2014b)</li> </ul>
WPK	“The WPK is captured by the interest of Big 4 and IDW”	<ul style="list-style-type: none"> <li>▪ “We have known for years, that it is a nice habit of the WPK, that the name of the next WPK president is clear years in advanced” (wp.net, 2007a, p. 9)</li> <li>▪ “The WPK and the big ones are very much afraid of the post vote, like the devil hates holy water.” (wp.net, 2007a, p. 9)</li> <li>▪ “Until today, the majority of the management board of the WPK consists of honorary officials or employees from the IDW.” (Gschrei, 2009, p. 6)</li> <li>▪ “The two “Chief-Professor”s [IDW-Naumann and Chamber President Pfitzer] now demonstrate to the public and the legal supervision, how no single paper fits in between IDW and WPK. A common letterhead!!! It can not be more obvious.” (wp.net, 2009d)</li> </ul>
	“The rights of small auditors have to be protected.”	<ul style="list-style-type: none"> <li>▪ “The WPK breaks fundamental electoral principles.” (wp.net, 2009a, p. 12)</li> <li>▪ “In our next journal, Germany will learn that it was wp.net and its members who fought for this fundamental right.” (wp.net, 2010c)</li> <li>▪ “We wanted democracy to enter the Chamber and we wanted a Chamber that works in the interest of everyone. That was more important to us than personal benefits.” (wp.net, 2014d)</li> <li>▪ “We can announce the holy news to our members,, that after 50 years of darkness, democracy will enter the Chamber in 2011.” (wp.net, 2010a)</li> <li>▪ Without diluting, we work in the interest of the small and medium sized auditors. Without being pretentious, it can be said that in 20 years before our establishment, interests of small and medium sized auditors were not de facto represented.” (wp.net, 2006b)</li> </ul>
APAK	“The APAK is captured by the Big 4.”	<ul style="list-style-type: none"> <li>▪ “The APAK-Commissioners took the PCAOB as a role model, but somehow strangely completely forgot that the PCAOB has very strict independent rule.” (wp.net, 2013)</li> <li>▪ “That is just bold or done in bad faith! The ‘Holy Trinity’ of IDW, WPK and APAK added even the logo of the Minister of Economic Affairs and the ‘IDW/Chamber state supervision’ is ready. This bias problem damages the APAK’s reputation!” (wp.net, 2010d)</li> <li>▪ “The whole organization of the inspections is done by the Chamber through the employment of worn-out, former Big 4 auditors.” (wp.net, 2009b).</li> <li>▪ “In the first year of the inspections, the small audit firms with public interest clients were inspected and not the Big 4 auditors, although they have to be inspected annually; the small ones only every three years.” □ (wp.net, 2009c)</li> </ul>

<sup>82</sup> Total number of member wp.net letters: 2005 (1); 2006 (5); 2007 (5); 2008 (8); 2009 (9); 2010 (16); 2011 (12); 2012 (15); 2013 (20); 2014 (20).

The use of discourse was vital for the success of wp.net, as narration is a potent tool for sense-making and in the ongoing construction of reality (Zilber, 2007, pp. 1038, 1047). The “rhetorical strategies” (Suddaby & Greenwood, 2005) applied to legitimate the institutional change sought by wp.net aimed to undermine the moral underpinnings of the audit establishment by communicating how and why an adoption of the articulated vision would improve the situation for small auditors (Fligstein, 1997; Holm, 1995; Suddaby & Greenwood, 2005). To this end, the use of “institutional vocabulary” (Suddaby & Greenwood, 2005) was necessary. By frequently making reference to a “free profession”, “the core values of a profession” or “commercialization”, wp.net linked its rhetoric to familiar templates, while at the same time demonstrating the need for change, as the underlying contradictions inherent in the established system were exposed. The rhetorical identification of contradictions inherent in the prevailing logic, and their constant repetition, were the means by which the institutional shift was achieved (Suddaby & Greenwood, 2005, p. 59).

Of similar importance for the success of the institutional work was the development of “stories”, which, as identified by others, can play a vital role in the processes of institutional change (Zilber, 2007). Through storytelling, past events were linked to easily understandable quasi-causal connections, and fixed roles were attributed to the actors in the organizational field. The stories called for changes in the institutional order and for a new balance of power within the politics of auditing, casting the role of “heroes” to small auditors and the role of “villains” (Morrill & Owen-Smith, 2002) to the establishment and charting a sequence of past events that were connected up in such a way as to form a plot.

At the same time, the IDW and WPK were hampered in their attempts to defend their dominant positions, as they could not publically work as “institutional defenders” (DiMaggio, 1988): the IDW’s legitimacy was based on the premise that it was working in the profession’s overall interests, which restricted the IDW’s opportunities to counter the ongoing attacks by the new actor:

“Wp.net has an advantage compared to us [the IDW]: We perceive ourselves as representing the whole profession [...]. If I, as Wp.net, only represent a fringe group, then I can raise my voice more loudly, as I do not have to show consideration to everyone.”  
(Naumann, IDW)

This became more evident when the small auditors successfully lobbied for the electoral system to be changed in 2010. Although it was clear that the IDW opposed electoral reforms, it was unable to officially oppose reforms, and official statements only “welcomed” reforms while strongly emphasising that their “detailed drafting” should be left to the profession (IDW, 2010). In addition, it was also rhetorically hampered in the Green Book debates, which enabled wp.net to craft its vision that institutional changes needed to be implemented. While wp.net was able to

clearly identify and support various proposals, the IDW first rejected the European initiatives on the whole (IDW, 2011), and it later remained silent on aspects that would lead to changes in the audit-client relationships (e.g. through joint audits) (IDW, 2012). The WPK was similarly unable to react, as it is formally committed to neutrality (WPO § 57 II Nr. 6). Hence, the WPK and IDW ignored the harsh and often personal attacks. It was not until 2010 that the first official statement was issued in the WPK-magazine responding to some of the various attacks made by the wp.net in the preceding months (WPK 2010c, p. 16). As a result of the WPK's inability to react directly to wp.net, the latter was eventually able to push through the electoral reforms.

While the number of wp.net members remained low in the first years, solidarism increased after the applied rhetoric used by wp.net succeeded in creating a sense of discrimination among small auditors, on the one hand, and in attacking the IDW for no longer working in the interests of the public, on the other. The advent of the new player undermined the institutionalized assumptions and belief that the IDW was serving the needs of one profession. The disassociation of the moral foundations was achieved through a combination of mobilized political energy and appeals to the “higher ideals” of the profession. The institutional work that was pursued by wp.net, and that was founded on solidarism and claims to equal rights in the way the profession was organized ultimately proved successful. The 2011 election outcome turned the traditional understanding and organization of the profession upside down:

“At a single blow, everything [the traditional mode of professional organization] disappeared. That was a shock for everyone.” (Interviewee IDW President Naumann)

### **3.6 Epilogue: institutional destruction?**

Professions have been identified as being particularly influential, as they influence other actors by diffusing expertise and norms in the field (Greenwood et al., 2002; Suddaby & Viale, 2011). Professions possess what scholars define as “formal authority” (Battilana et al., 2009) or “institutional capital” (Oliver, 1997). This describes the rights or capacities of actors to engage directly in creating, maintaining or disrupting institutions and to mobilize other actors to build a coalition to that end. As a result of the allegiance between the “accounting establishment” (e.g. professional institute and largest accounting firms) and the Ministry, the oversight authority was working on a honorary basis and was provided with limited power and resources, which was not scrutinized much by the oversight commission itself. While at first sight the profession's autonomy appeared to be threatened by the establishment of the APAK, and while the IDW frequently emphasised how “strongly” the APAK intervened in the self-administrative structures of the profession (IDW, 2014), in practice the APAK had been culturally captured by the auditing establishment, which resulted in the boundaries between overseer and overseen becoming blurred (similar Malsch & Gendron, 2011). Hence, at this first stage, with the aid of

multiple “cosmetics of response” (Power, 1993, p. 199), the audit establishment added rules and organizational structures to the oversight system in order to preserve the traditional mode of professional self-regulation.

To this end, it was vital to preserve the perception that we were talking about a “profession”, as the “self-regulation of professions is intrinsically connected to the legitimacy of the profession” (Fogarty, Zucca, Meonske, & Kirch, 1997, p. 168). Professionalism refers to the attempt by the audit profession to publicly promote the perception of its being an effective “guardian of the public good” (Robson, Willmott, Cooper, & Puxty, 1994, p. 531). As outlined above, the rhetoric of wp.net maintained the notion that we were dealing with a profession, which supports the idea that institutional change is not possible without maintaining certain institutions that make possible the desire for such a change (Malsch & Gendron, 2013, p. 873). Hence, from this perspective, the takeover of the Chamber by small auditors is an example of Thelens’s (2003) “institutional conversion”, which relates to a situation in which the change of actor constellation fundamentally transforms the character of an institution – without the actors involved calling the institution itself into question (Thelen, 2003). However, a question that remains open at the present moment is whether wp.net, while it has successfully disrupted the dominance of the establishment, might not at the same time have unintentionally opened up the status of the occupation as a “profession” to scrutiny.

**Table 17: Multifarious modes of Institutional Work**

Actors	Institutional Work	Mechanisms
IDW, WPK, Ministry	<b>Maintaining:</b> the profession’s self-regulation institution	<p>Mythologizing: Preserving the normative underpinnings of the institution by the</p> <ul style="list-style-type: none"> <li>▪ use of rhetorics to demonstrate the high quality of statutory auditors’ education.</li> <li>▪ use of rhetorics to demonstrate the effectiveness of the German neo-corporatist Chamber system.</li> </ul> <hr/> <p>Enabling Work: Creating rules that supplement and support institutions:</p> <ul style="list-style-type: none"> <li>▪ Introduction of a peer review system.</li> <li>▪ Introduction of a Public Oversight Board.</li> </ul>
IDW, WPK, APAK	<b>Maintaining:</b> the profession’s self-regulation institution	<p>Mythologizing: Preserving the normative underpinnings of the institution by the</p> <ul style="list-style-type: none"> <li>▪ use of rhetorics to demonstrate the effectiveness of the German neo-corporatist Chamber system.</li> </ul> <hr/> <p>Preserving the institution by strategic decoupling:</p> <ul style="list-style-type: none"> <li>▪ Establishment of the APAK.</li> <li>▪ Various regulatory amendments with a focus of formal independence.</li> </ul>
wp.net	<b>Disruption:</b> the institutional dominance of the establishment	<p>Disruption by undermining the moral underpinnings of the audit establishment by the</p> <ul style="list-style-type: none"> <li>▪ use of rhetorics that mobilize small auditors around wp.net.</li> <li>▪ use of rhetorics to create a sense of solidarity.</li> <li>▪ use of stories and myth to underpin the legitimacy of the establishment.</li> </ul>

The intra-professional battles may have depleted the professional institutional capital (Oliver, 1997), and the institutional work to preserve the self-regulatory institution through strategic decoupling (Hirsch & Bermiss, 2009) may have become difficult. In particular, in the course of the elections in 2011 the profession became highly politicized, and, the eventual takeover of wp.net in 2011 was viewed critically by the Ministry, which doubted whether wp.net would have the skills needed to lead the Chamber (WPK President Gschrei in WPK, 2011a). The conflicts intensified once more when the debates on the European Directive governing the statutory audits of annual accounts and consolidated accounts (EU Directive 2014a), and the Regulation on specific requirements regarding the statutory audit of public-interest entities (EU Regulation 2014b) added additional fuel to the flames. Wp.net supported the regulations' objective to break the Big Four's market power, (wp.net, 2014a, 2014c) and apodictically demanded that the Big Four's impact on the APAK be removed by transferring the APAK's responsibilities to the Federal Financial Supervisory Authority (BaFin) (wp.net, 2014c). Tension between the establishment and wp.net grew further when the APAK annual reports revealed more errors and omissions than in previous years and, in particular, accused small and medium-sized audit firms of employing unsatisfactory auditing practices (APAK, 2013, 2014). This triggered once again heavy attacks from wp.net, which accused the APAK of not possessing sufficient expertise (Gschrei, 2014). In turn, the IDW publically defended the APAK from these "attacks", emphasizing the latter's vital role as it "protected not only the audit profession, but also the German economy from coming under the sway of foreign regulators (IDW, 2014, p. 2). The vehemence with which this conflict was waged in public drew the attention of both the media and the public.<sup>83</sup>

“We have conflicts in other free professions as well. But this level of dispute, this level of conflict, in part very personal [...] this is completely unknown.” (Political Actor)

The debates for the first time- resulted in various press articles being published which informed the public about the regulatory developments within the profession (Becker, 2014a, for instance 2014b; Giersberg, 2014). In addition, these conflicts led to two parliamentary questions in 2014, in which the organization of the audit profession, the intertwining of the Big Four with the APAK and the intra-professional conflicts were addressed and critically scrutinized (Deutscher Bundestag, 2014a, 2014b).<sup>84</sup> Thus, it could be argued that political awareness was raised not by a perceived insufficient audit quality, or by the role of the audit firms during the financial crisis, but instead by the intra-professional conflicts, which increasingly turned the spotlight onto questions

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<sup>83</sup> One important factor that made the conflicts visible to the public was the fact the Gschrei resigned as WPK president in March 2012 in the wake of internal conflicts. However, he was still member of the Chamber's Management Board. In the following months, confidential information from meetings of the management board were communicated, via the PRIMUS blog, to the public.

<sup>84</sup> The inquiry was made by the leftwing party DIE LINKE, and consisted of 51 questions concerning the German audit oversight system, the role of the Big 4 during the financial crisis, the procedure of appointment for the APAK and the caused and impact of the intra-professional rivalries.



about the status of statutory auditors as a profession and about its ability to regulate itself, which was particularly perceived by the audit establishment.

“Of course, the standing of the profession is negatively impacted if different segments of the profession express different opinions in public.” (Interview IDW President Naumann)

“The intra-professional conflicts have been and still are a risk for the self-administration of the profession.” (Interviewee, audit profession)

Bromley and Powell (2012) emphasise that some policies, initially established as window dressing, have the potential to evolve into a meaningful aspect of regular activities (Bromley & Powell, 2012). At this point, it is too early to draw conclusions about the outcome of the intra-professional conflicts and their impact on audit regulation in Germany. However, the debates in the course of the European Directive and Regulation from 2014 indicate that the Ministry is likely to play a more active role. Although the IDW, the WPK and the APAK all argued that the APAK’s core design should be maintained, the new oversight entity will be integrated into the Federal Office of Economics and Export Control (BAFA), without maintaining the Commissions model of the APAK. In addition, the peer review system’s firewall will be removed, which will allow the use of review reports in proceedings against an auditor (BMBWi, 2015). Whether this results in a process of “re-coupling”, i.e. to the establishment of a powerful agency, is a question that has to be left open for future research.

### **3.7 Conclusion**

This study has examined the establishment and development of the German audit oversight system from 2000 to 2014. To frame the analysis, the paper has mobilized Lawrence’s and Suddaby’s synthesis of various modes of institutional work.

The paper contributes to the literature in three ways.

First, this study has demonstrated how external pressures were initially internalized by the established actors in such a way as to make it possible for the traditional self-regulatory system essentially to maintain its *ex ante* equilibrium, and substantive reforms were not considered a priority. Prior studies have challenged the suitability of exogenous-induced change modelled on the Anglo-American mode of regulation (Arnold, 2012; Wade, 2007). Due to politico-economic factors, the implementation of audit oversight boards is associated with significant gaps between the intended purposes and the actual regulatory outcomes, not only in political-economic systems characterised by traditional reform incapacity problems and state ineffectiveness (Blavoukos et al., 2013; Caramanis et al., 2015), but also in contexts characterised by functioning institutional traditions (Malsch & Gendron, 2011). This study supports these prior findings by demonstrating

the difficulties of establishing new frameworks that are disassociated from the deinstitutionalized “older” scripts and legacies. In Germany, the legacies were derived from the belief that the auditing profession was able to regulate itself, a belief which is interlinked with the country’s chamber system. On this account, the auditing profession and the political actors forged a strategic alliance, with the goal of preserving the reputation of the German financial sphere on the international stage, rather than establishing an independent and powerful audit oversight regulator.

Second, in response to recent calls made in prior research (Ramirez et al., 2015), this study has highlighted the reciprocal relationship between audit regulation and small practitioners. Initially, the main driver behind the establishment of the German audit oversight system was the strong international embeddedness of German industry, as this increasingly affected national accounting and audit matters. The strong historical system of self-regulation, which for decades had ruled out public supervision and external quality controls, had become problematic for large German audit firms by the end of the 1990s, as the need for a formal oversight system that was independent of the profession arose. For this reason, the oversight system carried the signature of the IDW, which was put under pressure by large accounting firms to introduce an internationally recognized system of external quality controls under public oversight. Institutional studies have documented actors holding key strategic positions located within a “dominance hierarchy” within organizational fields have the ability to significantly impact the way in which existing institutions evolve (DiMaggio & Powell, 1983; Greenwood & Suddaby, 2006; Lawrence & Suddaby, 2006, p. 216). In other words, institutions reflect and reproduce power relations. The analysis provides a counterpoint to prior research by demonstrating how actors who were initially at the periphery of the organizational field increasingly impacted the development of German audit regulation. A key to understanding how the German case developed lies in the intra-professional conflict that, on the one hand, changed the power structures in the organizational field, but on the other, raised the awareness of both the public and the media concerning the self-regulatory ability of the profession.

Third, a rereading of how the German oversight system was established, and how it developed, illustrates that institutional change is a complex process involving different types of process and agents. The process of institutional change and disruption can occur abruptly - which was the case in the U.S., with its shift from self-regulation to government regulation within months - as a smooth transition or as a mixture of continuity and discontinuity (Thelen, 1999). It demonstrates how both intended and unintended effects have the ability to maintain, change and ultimately disrupt traditional legacies. Others have argued that institutional work can emerge from multiple, distributed actors that are engaged in parallel or uncoordinated activities (Lounsbury & Crumley, 2007, p. 1003). This case demonstrates that multifarious dimensions of institutional work do not

always occur in isolation, but are mutually dependent and interlinked, which can result in outcomes that were not intended by the actors involved. While prior work on power and agency in an institutional setting suggests that the link between actors, strategies and outcomes is traceable and deterministic, the picture is more complex when account is taken of the fragility displayed by organizational fields and of the duality of institutional stability and disruption. Institutional work is a fragile and vulnerable process. Whether as result of the struggle for domination, the audit profession will lose sight of its historical reference points and of the key privileges associated with the notion of professionalism remains a subject for future research.

### 3.8 Appendices

#### Appendix 9: List of abbreviations

<b>AICPA</b>	American Institute of Certified Public Accountants (USA). □
□	
<b>APAG</b>	Auditor Supervision Act (Abschlussprüferaufsichtsgesetz, Germany).
<b>APAK</b>	Audit Oversight Commission (Abschlussprüferaufsichtskommission, Germany).
<b>BARefG</b>	Law on Professional Oversight Reform (Berufsaufsichtsreformgesetz, Germany).
<b>BMWA</b>	Federal Ministry of Economic Affairs and Labour (Bundesministerium für Wirtschaft und Arbeit, Germany).
<b>BMWi</b>	Federal Ministry for Economic Affairs and Energy (Bundesministerium für Wirtschaft und Energie, Germany).
<b>CPA</b>	Certified Public Accountant (USA).
<b>DSW</b>	Association for private investors in Germany (Deutsche Schutzvereinigung für Wertpapierbesitz, Germany)
<b>EGAOB</b>	European Group of Auditors' Oversight Bodies.
<b>EU</b>	European Union.
<b>EY</b>	Ernst & Young.
<b>FREP</b>	Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung, Germany)
<b>IDW</b>	Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer, Germany).
<b>IFAC</b>	International Federation of Accountants.
<b>KonTrag</b>	Corporation Control and Transparency Act (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, Germany).
<b>PCAOB</b>	Public Company Accounting Oversight Board □ (USA).
<b>POB</b>	POB (Qualitätskontrollbeirat, Germany).
<b>PwC</b>	PricewaterhouseCoopers. □
<b>SEC</b>	Securities and Exchange Commission (USA).
<b>SOX</b>	Sarbanes-Oxley Act (USA).
<b>WPK</b>	Federal Chamber of Public Accountants (Wirtschaftsprüferkammer, Germany).
<b>wp.net</b>	Association for Small and Medium-sized Auditing (Verband für die mittelständische Wirtschaftsprüfung, Germany).
<b>WPO</b>	Law Regulating the Profession of German Public Auditors (Wirtschaftsprüferordnung, Germany).
<b>WPOÄG</b>	Act to Amend Auditing Regulations (Wirtschaftsprüferänderungsgesetz, Germany).

## Appendix 10: Analysed archival sources

<b>Sources</b>	<b>Time period</b>
Minutes of parliamentary debates.	1998 - 2015
Ministerial legislative proposals and laws.	1998 - 2015
Annual reports of the POB.	2002 - 2005
Annual reports of the APAK.	2005 - 2104
Annual reports of the IDW.	1998 - 2014
Statements of the IDW and Wp.net.	1998 - 2015
Statements of Wp.net.	2005 - 2015
Letters to the Ministry by the professional associations.	1998 - 2015
Member Newsletters (emails) from Wp.net.	2000 - 2015
Annual reports of the Chamber of Auditors.	1999 - 2015
Statements of the Chamber of Auditors.	1999 - 2015
Minutes of board meetings of the Chamber of Auditors.	2011 - 2013
Newsletters from PRIMUS blog.	2005 - 2015

## Appendix 11: The time line of events in the establishment of the POB and APAK

Date	Content
February 1998	IDW and WPK establish a technical committee on “Quality Assurance” to discuss a system of external quality controls in Germany.
November 1998	IDW and WPK agree on establishing a U.S. AICPA-like system.
April 2000	The Government issues the first draft of the Act (4 <sup>th</sup> WPO-Novelle) introducing a quality control system under formal supervision of a Public Oversight Board (POB).
October 2000	The Federal Parliament passes the Act.
January 2001	The WPK changes its professional statutes and introduces a mandatory system of external quality controls and public oversight board (POB).
January 2004	The 5 <sup>th</sup> WPO-Novelle is passed by the parliament, which enables POB members to attend the meetings of the management board of the WPK.
July 2004	The first draft of the 6 <sup>th</sup> WPO-Novelle is issued. The main element is the transformation of the POB into the Auditor Oversight Commission (APAK).
November 2004	The Federal Parliament passes the 6 <sup>th</sup> WPO-Novelle.
January 2005	The APAK comes into force and replaces the POB.
January 2005	Foundation of wp.net.
March 2005	The first draft of the 7 <sup>th</sup> WPO-Novelle is issued, which introduces inspections for audit firms with public interest clients.
November 2005	The Federal Parliament passes the 7 <sup>th</sup> WPO-Novelle.
December 2009	WPK, IDW and APAK agree on the further reforms of the audit oversight system.
January 2010	WPK, APAK, and IDW approach the Ministry to present the regulatory reforms, which would strengthen the APAK’s formal independence.
January 2010	The BMWi stops the discussion on further regulatory changes because of the EU Green Book.
Fall 2010	Change of the WPK electoral system.
June 2011	Wp.net wins in the WPK general elections.
March 2012	The WPK agrees to transfer the organizational responsibilities of the inspection to the APAK.
March 2012	Gschrei resigns as president of the WPK.
February 2015	The Ministry issues proposals for regulatory reforms of the APAK.

## Appendix 12: Coding for Institutional Work in Stage 1 – Institutional Maintenance

Source	1st-Order Quotes	2nd-Order	Modes
OF	“A professional independent oversight body must not question the long-established structures of self-regulation [...] therefore it is the responsibility of the legislator to meet the international requirements and at the same time to maintain the role of the WPK as a self-regulatory entity.” (Hammers-Strizek, 1999, p. 913)		
I	“This is linked to the philosophy of a “free profession”. Basically, we [the Ministry] take the view that they have to do this [to guarantee audit quality] by themselves. A profession, which, as it is perceived, has so much autonomy, so much quality and experience, has to be able to establish a quality control system [...]. In the [political] philosophy of this liberal age, there was a desire to avoid the establishment of a powerful regulatory authority.” (Interviewee, political actor)		
OF	“In our opinion, the U.S. should consider recognizing European professional oversight systems as being equivalent to, and as effective as, that exercised by the PCAOB in the U.S. Equivalence of these systems does not require that the systems be identical. Due to historical and cultural differences and the different legal environment in the U.S. and the EU member states, an appropriate and effective professional oversight system can be organized in various ways.” (WPK & IDW, 2003)	National belief in efficiency of Chamber system	
I	“The Americans do not have these concept of a “liberal profession”, they [the profession] do not have, how should I put it, this esprit de corps.” (Interviewee, political sphere)		
I	“We made sure that the external quality controls in Germany would not be established as a monitoring-procedure, but as a peer-review procedure [...]. That is important for us, because our colleagues actually know what they are monitoring. He is not a civil servant.” (Interviewee, audit profession)		Mythologizing
L	“The special design of this system makes it possible to limit the bureaucratic costs to the minimum amount necessary.” (Federal Government 2000)		
L	“With that [the organization and implementation of quality control system], the self-administration of the free auditing profession [...] is strengthened.” (Federal Government 2000)		
I	“The professional training route taken by a German auditor cannot be compared to the Anglo-Saxon, American CPA training, because the training itself takes place after the CPA exam. [...] and of course I have to look something up when the auditing company is not training me well, but it is different when I have done five years training, become an auditor at the age of 33 and have 10 years of auditing experiences.” (Interviewee, audit profession).	National belief in high quality of educational system	
I	“I think no training in Germany is more complex and complicated than the training for auditors. And a person who has two state examinations in law or a business diploma and a tax advisor examination, followed by an accountancy exam afterwards, numbers among the best qualified people. No question about it.” (Interviewee, audit profession).		

I	“The fundamental professional career and the conception of the professional access to becoming an auditor is very different compared to other European countries [...]. When I look at the professional career who is going to inspect on top? That has been a debate among colleagues who could not understand that in line with their self-image.” (Interviewee, audit profession).	
L	“The peer review approach is chosen, because the profession, which conducts the quality controls, possesses the relevant and recent [...] knowledge of auditing methods.”	
OF	“If we [the profession] want to stop external quality controls being initiated and organized by the legislator, we have to be prepared to tackle this question ourselves.” (WPK-President in WPK, 1998b)	
S	“We agree with the profession that the external quality controls represent the final brick in the house of quality assurance in the accounting profession.” (Hammers-Strizek, 1999, p. 913)	Implementation of a POB including external quality controls
S	“The organization and the supervision of the system are undertaken by the WPK [...]. Thus, safeguarding quality remains a core task of the profession.” (Hammers-Strizek, 1999, p. 913)	
OF	“[With the new regulatory changes], the installation of an additional entity on top of the WPK will be explicitly avoided [...] in order to avoid a supervision of supervision.” (Hammers-Strizek, 1999, p. 913)	

**Enabling Work**

OF: Official statement, S: Speech, I: Interview, LT: Legal text



## Appendix 13: Coding for Institutional Work in Stage 2 – Institutional Maintenance

Source	1st-Order	2nd-Order	Modes
SP	“A profession independent oversight body must not question the grown, long-established structures of the self-regulation [...]. The newly established APAK will not increase the regulation of the accounting profession. In truth, the APAK serves to fulfil European expectations – and thus of course also the expectations of the U.S. and its PCAOB – regarding an objective, profession-independent oversight system with final decision-making authority.” (Report Schmidt, former head of section in the Ministry, in Schmidt, 2005)		
PH	“Based on the proposed model, the APAK should cooperate closely with the Chamber and use its existing technical expertise. We support this [model] and we hope, that the self-administration of the Chamber will not be impaired.” (IDW President in IDW, 2004)		
I	“The attempt was to secure continuity through the maintenance of the POB members into the APAK Commission.” (Interviewee)	Trans-formation of the POB into the APAK	<b>Enabling work</b>
I	“The idea was to intervene as less as possible into the self-administration of the profession. For that reason, the APAK was a special creation [...] somehow related with the profession, but independent, but at the same time, close to the WPK.” (Interviewee, political actor)		
I	“The aim was the recognition of the German oversight system by the Americans.” (Interviewee, audit profession)		
OF	“It was not about breaking down existing and proven structures and to reinvent the wheel, but to find a useful addition and advancement for the existing structures.” (APAK Vice Chairman)		
LT	“[The APAK] is not a governmental regulatory solution, and a new agency or administrative office is neither necessary nor conducive [...]. With that model, we keep on relying on the proven Chamber principle.” (Federal Government, 2004)		
I	“What we are talking about is a free profession with self-administration of the Chamber. The implementation of a regulatory agency would have not met with enthusiasm by the profession, nor did we [the Government] saw the need for it.” (Interviewee)		
MPD	“With the new oversight committee, we [the legislator] do not want to come up with a government solution [...]. This would be against the current strategy of bureaucracy reduction.” (Deutscher Bundestag, 2004c, similar 2004d)	National belief in efficiency of Chamber system	<b>Mythologizing</b>
MPD	“The profession’s representatives warn to touch the profession’s system of self-administration in the course of the new legislation. This concern is absolutely supported through the CDU. The system of self-administration of the free occupation of the public accountants is, as well as the self-administration of the other free occupations, a historically developed successful form of professional regulation.” (Deutscher Bundestag, 2004e)		
MPD	“It is common conviction of the government and the profession, that the new oversight system should not result in the abolition of the established structures of self-administration, based on the Chamber.” (Deutscher Bundestag, 2004a)		

I	“That [the APAK] was somehow a weird constellation. That was neither one thing nor the other.” (Interviewee, Political actor)		
I	“Oversight in concrete cases was not possible, but – and they did that very well – they evaluated the system in an abstract, general way.” (Interviewee)		
I	“I expected a powerful PCAOB-like agency, and then we saw one tiny little office within the Chamber of Auditors.” (Interviewee, political actor)	Specific design of the APAK	<b>Dirty Work</b>
I	“If you want that the APAK is doing things right, than this a full-time job.” (Interviewee, audit profession).		
I	“In order to save the self-administration of the profession as much as possible, a lot of artifices were made when the APAK was established.” (Interviewee)		

I: Interview, LT: Legal text, MPD: Minutes from parliamentary debate, OF: Official statement published in Professional Journal, PH: Public Hearing (Technical Committee of the Parliament), SP: Speech

Appendix 14: Examples of Interview Coding for Institutional Work in Stage 3 – Institutional Disruption

Source	1st-Order	2nd-Order	Modes
I	“As I said, it all escalated with the protest vote by WP-Net. All the APAK representatives are in the advisory board and when they are constantly exposed to attacks, instead of discussing other topics, cooperation is impossible. I think that is how it must be seen.” (Interviewee)	Change of voting system of the WPK	
I	“The extent to which it (intra-professional conflicts) exists in Germany right now for the auditors, [...] does not exist in other professions.” (Interviewee, Political actor)		<b>Dis-associating moral foundations</b>
I	“The WPK [under the leadership of small auditors] held positions which were not consistent with the interests of the Big Four. That means they have faded out one part of the professional group and taken different positions.” (Interviewee)	Establishment of second association and	

I: Interview

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“The small auditor does not meet the reality of today’s business anymore [...] Small auditors have become outdated and should vanish from the market.”  
 (German Executive Board member of a Big Four company)

## Chapter 4

### From small auditor dissatisfaction to active resistance: a practice theoretical perspective on the “palace revolt” in the German auditing profession.

#### Abstract

For decades the German auditing profession was governed under the relatively sedate supervision of two professional bodies the German Institute of Public Auditors (IDW) and the German Chamber of Public Auditors (WPK), both of whom worked in cooperation with the Federal Ministry responsible for these matters. This state of affairs was transformed, however, after wp.net, a third professional body, was set up in 2005 for small auditors and after it subsequently staged a takeover of the WPK, an event since termed a palace revolt by the media that reported on it. Based on a practice theoretical perspective, we trace the process that led up to these events. We show how the events are related to the differing practices pursued in the working environments of small auditors and large audit firms, and in the profession as a whole, and we demonstrate, moreover, the role played by a range of knowledge claims that were posited in the profession at that time. The most important of these was the successful implementation of the peer review in the German audit profession, which represented the decisive knowledge claim that got the ball rolling. We also discuss some important implications that might follow from the events for small auditors, large auditors, and the auditing profession worldwide.<sup>85</sup>

**Keywords:** small auditors, audit profession, resistance, practice theory, knowledge claim

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<sup>85</sup> This chapter benefited from David Alexander, Jörg-Markus Hitz, Martin Schmidt, and from participants at the EUFIN in Paris 2015.

#### 4.1 Small auditors: dissatisfaction, resilience or resistance?

For decades, the German auditing profession was discreetly and sedately represented and organized by the German Institute of Public Auditors (IDW) and monitored on a self-regulatory basis by the German Chamber of Public Auditors (WPK), working in cooperation with the Federal Ministry responsible for these matters. All this changed, when in 2005 small and mid-sized auditors successfully established a second, separate ‘professional association’, the Association for Small and Medium-sized<sup>86</sup> Auditing (wp.net) which subsequently led to the takeover of the German Chamber of Public Auditors (WPK) in 2011; an event that has since been termed a “palace revolt” by the media that reported on it (Jahn, 2011; Wadewitz, 2011).

Representing as they do a completely unexpected turn of events in the history of the German auditing profession, these two interconnected developments, when analysed, seem likely to provide us with remarkable academic insights: the two events, taken in combination, are indeed so unique and, at the same time, so far-reaching that they merit closer academic scrutiny (Collier, 2011; Hayek, 1979).

The events are unique because a glance at the literature on the rivalries existing between small, local auditors, on the one hand, and large transnational audit companies, on the other, shows us that – quite apart from the fact that these rivalries are still largely under-researched (Ramirez, Stringfellow, & Maclean, 2015, p. 201) – local dissatisfaction with, and resistance to, the trend towards globalisation, standardisation and adaptation was widespread among small auditors (Daugherty, Dickins, & Tervo, 2011 for peer and PCAOB inspections in the US, respectively; Durocher, Gendron, & Picard, 2014 for Canada; Fogarty, 1996; Ramirez, 2013 for the UK). Given the economic and political power wielded by the Big Four, it is not, moreover, at all surprising that the few additional case studies have tended to highlight how transnational audit firms have been privileged over local firms in intra-professional conflicts (Caramanis, 1999, 2005; Gallhofer, Haslam, & Kamla, 2011; Ramirez, 2010). Our study, by contrast, provides an example of more active resistance and an alternative outcome to this intra-professional ‘battle’: despite the economic and political dominance enjoyed by the large accounting firms – both at a national and an international level – this study describes how an at least temporarily successful mobilization of the previously “silent majority” of German small- to mid-sized auditors, culminated in the profession's self-regulatory supervisory body, the WPK, being taken over in 2011. Hence, this paper provides a counterweight to the vast volume of literature highlighting the national and international dominance enjoyed by the Big Four (Suddaby, Cooper, & Greenwood, 2007). Almost as an aside it also provides some insights into whether and to what extent, trends in the auditing profession such as commercialisation (Brivot, Cho, & Kuhn, 2015; e.g. Citron, 2003;

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<sup>86</sup> It is important to distinguish medium sized from second-tier audit companies. In this case, medium-sized refers to audit companies that are smaller in size than second-tier audit companies.

Gendron & Spira, 2010) or the increasing links between economies of scales or size, on the one hand, and audit quality, on the other, are inevitable or whether they might not, instead, be attributable to the economic and political power exercised by the Big Four and to the latter's increasing evolution away from constituting a profession and towards becoming a (regulated) industry.

At the same time, the two events described are more far-reaching than they might seem at first, as they permit us to shed a bright light on what the developments are that are taking place in the profession and on how sustainable a unified and self-regulatory audit profession worldwide is. The capacity of the Big Four to influence and determine governmental policies at a national level and their far-reaching market dominance have been identified by many scholars (Arnold, 2005; Boyd, 2004; Caramanis, 2002; Francis, Michas, & Seavey, 2013; Greenwood & Suddaby, 2006; Roberts, Dwyer, & Sweeney, 2003; Suddaby et al., 2007). Increasingly, recent research has begun to emphasise the significance of large accounting firms as self-contained actors and their site as playing an important role as a generator from which accounting practices first emerge and then become standardized (Carnegie & Napier, 2010; Cooper & Robson, 2006). Suddaby et al. (2007) predict the onset of an era of post-professional regulation, in which the historical regulatory bargain on accounting issues struck between professional associations and nation states "is being superseded by a new compact between conglomerate professional firms and transnational trade organizations" (Suddaby et al., 2007, p. 334). That said, other voices have pointed to the persisting segmentation of Western accounting professions (Richardson, 1987, 1989; Yee, 2012). Such debates show that there is still a considerable degree of uncertainty over how the accounting professions worldwide will evolve in the future, and this highlights how important it is for further research results to be gleaned which, as in our case, permit us to gain insights into what the key factors will be that determine which of the potential alternative routes is taken by professional bodies.

Finally, the events are also far-reaching insofar as they have taken place at a particular place in the world. Scholars have for a long time argued that the interactions between the accounting profession and the state, and between the profession and its various different members, may take different forms not only at different times, but especially in different countries (Caramanis, 1999; García-Benau & Humphrey, 1992; Puxty, Willmott, & Lowe, 1987; Yee, 2012). Yet, the debate over the evolution and revolution witnessed by the accounting profession has been almost exclusively dominated by analyses of the professions in Anglo-Saxon countries (De Beelde, 2002, p. 448; Ramirez, 2013). As a result, not much is known, either at a theoretical or an empirical level, about continental Europe (Caramanis, 2005; Hopwood, 1994). Yet, the forces of global standardisation may have entirely unexpected and very different side-effects in different parts of the world (for the importance of bearing in mind the side effects arising from the range of

professional practices that have not been taken into account by regulators see also Humphrey, 2008; Humphrey, Kausar, Loft, & Woods, 2011). Moreover, such insights could mitigate fears that ...”the global promotion of Anglo-American audit methodologies is ...undermining the capacity to learn from valuable, but less visible, governance traditions” (Humphrey, Loft and Wodds, 2009, p. 822).

Several features make the German case, in particular, interesting in this respect. First, unlike in the Anglo-Saxon setting, an accounting profession does not exist in Germany: instead, a strong and specialised auditing profession exists that insists on its members undergoing a lengthy period of education and on their acquiring vocational experience before they are permitted to begin working as an auditor. Moreover, the fact that similar events have taken place in Canada, the US and UK allows us to draw particularly insightful comparisons which deepen our understanding of the underlying processes and help us take theorising efforts one step further.

Second, the German economy is still characterised by a fairly strong backbone of small to medium-sized businesses which still prefer to use national German accounting standards rather than international accounting standards, but some of which, equally, are nonetheless audited. This German “Mittelstand” has proved in the past not only to be extraordinarily successful in commercial terms (Grottke, 2011; Langenscheidt & Venohr, 2010; Schildbach & Grottke, 2011; Simon, 2009, 2012), but also to be form backbone of the German economy at times of crisis. On top of this, it provides, in contrast to the situation in many countries, a large and profitable market for small auditors in Germany.

Theoretically, our study is primarily based on a practice theoretical perspective (Nicolini, 2012; Schatzki, 1996, 2001). In particular, we demonstrate how the differences in the auditing practices displayed by small auditors with a regional or national orientation and those displayed by transnational audit firms have, on the one hand, led to their drifting apart from one another, even though the desire to maintain the vision of a uniform audit profession – a notion strongly imprinted in the German auditing profession’s collective memory – has, on the other hand, persisted. We analyse how the knowledge claim that a peer review needed to be introduced was pushed through in the German auditing profession and how it was this that got the ball rolling. This knowledge claim seemed entirely legitimate when viewed against the background of the practices pursued by the Big Four firms, but it turned out to conflict with the practices pursued by small auditors and to pose an existential threat to their survival, or at least to put them at an enormous competitive disadvantage, and it consequently provoked their resistance. Based on a process perspective, we follow the key players who make up a mixed bag of parties, both within and outside the profession, and who are in conflict with each other in complex ways: initiatives from one actor produce immediate responses from other actors. As a result, a mutual interaction

constantly opens up new decision fields for the actors involved, while shutting down old ones (Caramanis, 2005; De Beelde, 2002; Miller, 1990; Puxty et al., 1987; Willmott, 1986).

The remainder of this paper unfolds as follows. First, we outline the theoretical background to our study, our research methodology and the data material. Then we describe the practices that characterise the site of by the Big Four, the site of small auditors and the site of the profession. Based on these practices, we show why over the last few decades the pendulum has increasingly swung towards the Big Four's stance and, as a consequence, marginalised the small auditors in the market and in the profession. In a fourth chapter, starting with the knowledge claim that started the ball rolling, we present a detailed record of the process that led to the establishment of wp.net and the palace revolt in the WPK. Subsequent to this, there follows a discussion that focuses on the larger theoretical implications of our study before we conclude and point to limitations.

#### **4.2 Theoretical background, research methodology and data**

The basic idea of practice theory is to understand phenomena such as activity, power, language, social institutions and transformation as being the result of interacting fields of social practices and material arrangements (Schatzki, 1996). Material arrangements are common set-ups composed of material entities, such as humans, artefacts and objects (Schatzki, 2005, p. 472), with which practices are interwoven. This involves people acting in a way that seems most natural and sensible to them and choosing those actions that they perceive to be those that should be performed (Schatzki, 1996). Such a conceptualization makes it necessary for us to start with the practices that surround the people acting in the field so that we can understand why they have done what they have done. According to practice theory, any form of human activity has to be set against a certain background or prior understanding, which is basically the practice in which it is embedded (Nicolini, 2012). In other words, there first has to be a basis of common existence which is more or less unquestioned and against which everything else can take place.

Our objective is, first, to reveal the key sites of small and large auditors, which are composed of practices and material arrangements that seem, at least to the individuals involved, to be beyond question and which at the same time structure the current setting (Schatzki, 2005, p. 473). In describing practices, we exclude what the literature - taken as a whole - reveals to be individual contingencies. Practice theory does not concentrate on contingent specific actions (Ahrens & Chapman, 2007) taken by individual auditors, but on the systemic features of a field of practice. Given the numerous practices prevailing among auditors, our focus will be on those practices on which small auditors and large audit firms take a contradictory stance to each other. Thus, even though we have analysed the practices used by mid-size and second tier audit companies, we

make no reference to them, as they turned out regularly to consist of a mixture of the practices prevailing among small auditors and large audit firms.

Second, because different practices overlap and evolve over time, we analyse how the practices of large and small auditors overlap and in what relationship they stand to the practices used by the auditing profession and the practices recommended by their professional bodies (IDW, WPK), as well as to the practices seen in the wider regulatory arena.

Schatzki distinguishes four different characteristics of practices. Practical understandings describe whether, in relation to a particular practice, the participants can agree on what the meaning of actions is. Importantly, practical understandings show that certain practices on "how to do things" emerge and that they are automatically carried by human actors, who thus become active bearers of practices (Nicolini, 2012, p. 166). They form, indeed, a central part of our analysis, as practical understandings between small, nationally oriented auditors and large, transnationally oriented audit firms increasingly started to diverge, while in the auditing profession itself there continued to be a practical understanding that focussed on preserving the uniformity which, for so long, had been shared by nearly all of the profession's members without any dispute ("an audit is an audit") and which was explicitly formulated by the WPK and the IDW on several occasions (Lenz, 2014). "Rules are programs of actions that specify what to do" (Nicolini, 2012, p. 166). They make people take them into account in their actions. Rules traditionally form a central plank of the auditing profession, whose role it is to develop, translate and interpret auditing and audit quality control standards that have to be observed and followed by the profession's members. The interesting question, then, is how rules, and thus practices, differed immediately before the foundation of the second professional body and how they interacted with the practices formerly pursued by small auditors, on the one hand, and large auditors, on the other. Teleo-affective structures, as a third form of practices, refer to the purposes which humans pursue in carrying out their practices, the set of ends pursued (Schatzki, 2002, p. 80) and the affective/emotional colouring that is attributed to these practices. However, this is, again, not understood to happen at an individual level; instead, it is seen as being learned with the help of instructions, corrections, socialization and a desire to make sense of things and as then being reinforced by repetition, sanctions and peer pressure (Nicolini, 2012, pp. 166, 167). Finally, a general understanding refers to the reflexive understandings of any given practice and then translates, again, into the way in which humans make sense of individual actions (Nicolini, 2013, p. 167). This refers particularly to the statements made in public by smaller and larger auditors, or by representatives of the profession with a background in fairly small or large audit companies.

On top of the practices, though, it is also important to conceptualize at a theoretical level the events that got the ball rolling within the professional bodies and to see how the different

practices respond to major changes. For this purpose, we draw on the notion of the knowledge claim. A knowledge claim can be understood as a type of specialized and exclusively owned knowledge possessed by members of a profession (or segments of a profession) with a view to constituting and controlling a market for their expertise by establishing their cognitive exclusiveness (Larson, 1977; Shafer & Gendron, 2005, p. 455).<sup>87</sup>

Prior literature has shown that knowledge claims have been strategically developed and deployed in the profession's ongoing attempts to secure and expand its area of work (Shafer & Gendron, 2005). To our knowledge, the idea that there is a relationship between knowledge claims and dominant groups within the profession was broached as long ago as Johnson (1972), who emphasized that knowledge claims will be accepted by the profession only when they have been accepted by its dominant groups.

However, he did not reflect on the vital role played by the provenience of the knowledge claim. We argue that, when it comes to the question of whether or not a knowledge claim wins acceptance, a vital role is played by the origin of the structures contained in it, and in the procedures that guide its implementation, that is to say, the question of what field of social practices and material arrangements it is rooted in and to what degree it is compatible with the practices that prevail among other members of the profession. In fact, it might even define the shape of the profession, in that knowledge claims translate into power claims, which are then actively resisted within the profession, and this may end up with the boundaries of the profession itself being redefined. Our analysis provides evidence in this respect, because it shows that the success of a knowledge claim was fully rooted in only one part of the profession. This got a ball rolling that ultimately redefined the boundaries of the profession, generating an *ex post* wave of resistance that ended up with the profession being split and with the still joint professional body being (at least temporarily) taken over by a group which turned out increasingly to have been harmed by the knowledge claim - a knowledge claim that had previously been successfully pushed through.

Greenwood et al. (2002) argue that to push a knowledge claim through, it is necessary to show that there has previously been a failure and that the knowledge claim provides a solution to this failure. We argue that practices not only play an important role in pushing through knowledge claims, but that it is also vital to observe whether the content of a certain knowledge claim is rooted in common practices or merely in practices that are pursued by some members of the profession. In those cases where a knowledge claim is successful even though it is only rooted in the practices pursued by just some parts of the profession, while being in conflict with other

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<sup>87</sup> To increase acceptability and legitimacy for the profession it is often argued that the application of the specialized knowledge is in the public interest, based on scientific evidence, and that it is "codified enough to educate and standardize members" (Shafer & Gendron 2005, p. 455).



parts of the profession, this will invariably result in the emergence of a common “enemy” that can be addressed by that part of the profession which has been in conflict with the knowledge claim. From the viewpoint of this specific part of the profession this then reveals the “true” strategic character of the knowledge claim in unifying the forces for countermeasures to be taken not only against the knowledge claim but, increasingly, against any activity put forward by the professional group that initiated this knowledge claim in the first place.

With respect to the research methodology, we have chosen a case study format for our analysis (Flyvbjerg, 2001; Flyvbjerg, Landman, & Schram, 2012; Silverman, 2013). This is because our aim is to provide a study that is at the same time empirically “thick” and richly detailed (Flyvbjerg, 1998). Mintzberg (1971) suggests that such an approach is a useful tool to depict the life and behaviour of actors. Berry and Otley (2004) argue that such studies are particularly well suited to our “understanding and theorising the content, processes and context of practice.” As a result, they make it possible to be very informative for public policy on practices that prevail in a certain area and are useful to practitioners and policymakers (Stake, 2005).

With respect to the data material, and in line with the literature (Denzin, 2009; Jick, 1979, p. 19; Lincoln & Guba, 1985), our evidence is based on three different sources. First, we have relied on publications, newsletters, and e-mails from members of professional bodies. Second, we have taken recourse to publications by researchers and practitioners in professional journals, the press and public blogs that try to make sense of the events that have taken place. Third, we have carried out a series of interviews both with small, second-tier and large auditors and with members of professional bodies, in particular, the key players in the events that took place (overall 28 interviews). The interviews were conducted between January 2010 and September 2015 and lasted between 35 and 200 minutes, with an average length of 80 minutes.<sup>88</sup>

In organising the empirical data that emerged, we divided our methodology into two steps that basically correspond to the identification of practices and the knowledge claim and its impact as such, on the one hand, and to the identification of the relevant factors in, and, development of, the process that took place, on the other. With respect to the organization of the data material illustrating practices and the knowledge claim, we relied on the Gioia methodology (e.g. Gioia, Corley, & Hamilton, 2013). We make use of this methodology to organize empirical data material first into categories in the sources’ own terms and then into dimensions that can be derived by researchers as commonalities observable over a range of documentary sources. This ensures that

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<sup>88</sup> In addition to the interviewees listed in Chapter 3, the following individuals were interviewed: partner and founder of an audit company in Landshut (small auditor), an auditor in an audit company in Passau (small auditor), two partners from mid-size audit companies (Röfß & Partner, Pöllath & Partner), the CEO of a second tier audit company (Senger von Warth und Klein), an IT partner from a second tier audit company (BDO), and a Big Four auditor for the banking industry (Deloitte).

the dimensions derived can claim to have reached a certain generalisability. In our case, we feel this approach is particularly suitable, as we should be able to observe both the characteristics of practices and the effects of the central knowledge claim across a range of different sources if they have played the role in the course of the events that the paper attributes to them.

The process itself, however, was addressed by making use of process tracing methodology. Process tracing serves the goal of understanding the factual evolution of decision processes and their outcomes over time (Langley, 1999). To this end, the data associated with a process is systematically collected in order to identify the elements of causal chains, i.e., the causes, relationships and effects (Zürn, 1998). It is important to note that we understand causes in this respect as being necessary, but not necessarily already sufficient, to trigger certain effects (Mackie, 1965). On the contrary, it may be true, and in our case is true on several occasions, that a whole bundle of mutually self-reinforcing causes is necessary, and that this then leads to a certain event. In our case, which is more focused on theory generation (Falleti, 2006), we carried out an exploratory and therefore data-driven process tracing (Langley, 1999). This means that we went back in time and identified all the links between the two events of interest, that is the foundation of wp.net and the palace revolt, with their potential causes presented in the data material. This analysis step made it possible to identify causal formations which, while creating a certain impression, did not change the fact that interpretation was deliberately avoided (Grottke & Kittl, 2013). The next step consisted in weeding out apparently implausible causes. The remaining observable effects can then be traced back by their causal relationships to the factors that triggered them (Hall, 2006) – if necessary, taking into account mediating and moderating effects, too. With a view to increasing the insights beyond the individual case study, we have also made use of prior studies of a similar nature into small auditors' reactions, such as Durocher, Gendron, and Picard (2014) and Ramirez (Ramirez, 2013). In doing this, we included reflective moments at those junctures that ultimately accounted for the differences in the way the German case developed, as opposed to the other cases. Our case has the advantage that it is an extremely unusual and highly developed case (Flyvbjerg, 2001, p. 79) which at the same time includes major stages of the other cases. This allowed us to take the first steps towards making generalizations on effects across several case studies (Humphrey & Scapens, 1996).

In both steps, our data analysis was enormously enriched by the opportunity to take recourse to a mixture of action research formats and independent research (similarly, Gioia & Thomas, 1996). More precisely, we profited greatly from the fact that we constituted three authors, two of whom were not involved, while the third was involved in the case. While the first and the third author provided, independently of the second author, large parts of the empirical data base and drew first conclusions, the second author, having been involved in the events from the very beginning

and having maintained long-term personal relationships with all of the key players involved, was able to refine interpretations and often to shed a far more nuanced light on the events.

At the same time, the fact that two of the authors were unrelated to the case allowed us to allay concerns with respect to our impartiality and neutrality, as the entire research team discussed all deviating interpretations with respect to their plausibility. Our further efforts to address such concerns involved us, besides accumulating vast quantities of source material, relying on an ethnographic approach that covered the different perspectives represented in the case and making extensive use of feedback from actors and colleagues before we finalized the text. By paying careful attention to the views and perspectives that existed across a wide range both of the actors themselves and among distanced outsiders, we were then able to further strengthen and deepen our understanding of the events that took place and to repeatedly test preliminary hypotheses that evolved during the research process (Hall, 2006).

It is worth noting that caveats still have to be made over how this data should be interpreted. For example, decision relevant aspects like private or secret agreements cannot be captured via documents, even when the most intensive investigation process is applied (Langley, 1999). To mitigate such concerns, we undertook extensive interviews of the people involved. However, even interviews can only mitigate this issue. Interview participants must do more than just remember the events that have occurred. They must also understand *ex post* what exactly the significance of certain events was for the course of the resulting process. This may involve the causal relationships identified by the interview participants turning out to in fact be the result of rationalisations, so that the true mechanisms remain unknown (Bennett & George, 2005). However, action research has provided us, in many cases, with the opportunity at least to know that still secret areas do in fact exist and it thus helps us to avoid undertaking erroneous interpretations.

### **4.3 Mapping practices in the professional terrain**

In the following, we first outline the differing sites at which the practices used by small and large auditors, and by the profession, take place: these are outcome of the data collecting process just described. Moreover, we provide evidence on how regulatory changes in auditing standards, and their associated enforcement, have increasingly led to small auditors in Germany becoming marginalised. Against this background, we then describe the structural features of the central knowledge claim that get the ball rolling and relate its features to the practices observed in all three sites.

*The site of the German small auditors*

The site of small audit firms was characterised, according to our sources, as exhibiting several features. First, there was a shared understanding that these firms were regionally anchored in what they did. This was visible in a number of characteristics, which related mainly to their regional clients or topical foci (e.g. Lenz, 1996), to their regionally anchored audit partners and to the regionally anchored work done by their staff. A teleo-affective structure that characterised auditor-client relationships was often the value attributed to trust and a long-term relationship. As one small auditor put it, this auditor's practice displays features typical of small auditors' clients:

“When our client is out there in the landscape with his business, then he occupies a position that is based on trust. This is why employees come and work for him, this is why he does not suffer high staff turnover. Such people are not interested in short term effects.” (Interviewee, small auditor)

Furthermore, small audit partners follow a holistic approach. They continuously visit the client firms' themselves and thus often have personal contacts, over and beyond the top management, with the client's workforce, too. This is, for example, visible in this characterisation provided by one small auditor:

“We have a SME's approach to serving clients that is a holistic approach. In other words, we attend to our clients' every need, in all the circumstances of life, and with respect to every and any issue that they may have – I am always the key contact person for my clients.” (Interviewee, small auditor)

As these auditors' staff are likewise regularly employed long-term, continuity is ensured at the level of audit assistance. Other important teleo-affective structures relate to explicit marketing strategies being avoided and to the status enjoyed by the auditor on the basis of his being – a trustworthy expert who has gone through a lengthy period of education before becoming an auditor. To a significant extent, there is also the shared practical understanding that one's own judgments and expertise need to be applied in the course of an audit (e.g. recommending certain earnings management strategies within legal boundaries). With respect to the rules that govern the everyday work done by small auditors, recourse is taken, as a rule, to German GAAP and to the Auditing Standards set by the IDW, which are read in German, i.e. in the national language.

*The site of the Big Four*

The practices characterising the Big Four audit industry differ markedly from small auditors' practices.

First, the Big Four are globally linked within their networks and therefore have an interest in achieving, as far as possible, globally uniform and standardized audit standards. They rely to a large extent on a division of labour, which often simply follows the principle of where labour can be found at the lowest possible cost. This is associated not only with their relocating part of their work to other places in the world and to centralising many functions, such as human resources, in departments, but also to their specialising audit practice itself in departments and redistributing certain audit tasks to specialists on complex audit issues. With respect to the latter, they have (according to Ramirez 2012) created “networks of knowledge-based experts [...] articulating the cause-and-effect relationships of complex problems, helping states identify their interests, framing the issues for collective debate, proposing specific policies, and identifying salient points for negotiation” (Haas, 1992, p. 3). Because these Big4 expert networks play such a dominant role (see in detail also Humphrey, Loft, & Woods, 2009), Ramirez (2012) argues that the Big4 can already be understood as a sort of “shadow standard setter or rather a standard interpreter”. The reliance placed on these experts internationally homogenises the audit across countries, something that is illustrated by these “experts for high-quality transnational audits including the use of ISAs” forming part of an international Forum of Firms, a forum which explicitly aims to promote “consistent [...] auditing practices worldwide” (IFAC, 2015; FoF Constitution 2011). Such standardisation procedures are accompanied with a positive teleo-affective structure, because they make it possible for cost savings to be achieved by making use of further economies of scale. Moreover, these firms are well placed to benefit from large capital investments, for example, in databases and IT-infrastructure, as they can amortise those investment across a large client base (scale effects) and different services (scope effect). Having “a considerable number of tools that support” them (Interviewee with Big Four Auditor) therefore results in Big Four practices becoming enmeshed into a range of different cost-reducing material arrangements.

As a result, however, in the audit process standardisation and individualisation become divided. On the one hand, there are audit partners who have undergone a lengthy period education and who occupy a position of trust. However, in the course of the audit process, the latter have to coordinate a much larger number of specialists and to delegate work to their audit assistants. As a result, they are at the same time often less close to their client firms. On the other hand, there are “cheap labour white-collar workers” who do not stay with the auditing firm for long and whose task it is to record all the necessary information so as to make sure that standardised and predefined criteria are met in a tick box approach. Ultimately, the Big Four audit firms follow

much more the logic of industrialised commercialisation by actively pursuing a branding strategy, by engaging in efforts to bolster their firms' public image and by selling, together with their audit services, a wide range of non-audit services.

*The site of the German auditing profession*

A third site of importance that deserves separate attention from that of the small and large auditors, respectively, is the profession itself.

In Germany, the two main entities in the auditing profession were the WPK and the IDW. Both institutions' roles are strongly imprinted into the profession's collective memory. The IDW, a private sector organization, was founded in 1931 when the various professional associations that existed at this time merged. It serves as the profession's mouthpiece, particularly in advising or lobbying the legislature (Vieten, 1995, p. 488). Although membership is voluntary, almost 83% (as of July 2015) of German Public Auditors are members of the IDW. The IDW is also responsible for providing technical guidance ('Facharbeiten') by publishing accounting and auditing standards, commenting on vocational training issues and translating IFRS. The standards are not compulsory in a legal sense, but they are considered to be good practice.<sup>89</sup> Departures from these standards by an auditor must be justified (Dyckhoorn & Sinning, 1992, p. 84; Vieten, 1995, p. 488). It is noteworthy that at least in the past a contractual agency agreement ("Geschäftsbesorgungsvertrag") between the IDW and the WPK existed, which ruled that the IDW would assist the WPK with respect to technical guidance problems (WPK President Hense in WPK, 1998b). The WPK was founded in 1961 as a public sector organization and was governed by elected auditors on a honorary basis. Legally, the Chamber's responsibilities included both monitoring and promoting the professional interests of its collective membership (Dyckhoorn & Sinning, 1992, p. 85). It is supervised by the Federal Ministry of Economic Affairs and Energy (BMWi), whose approval is required for changes to its constitution. However, as the Ministry usually maintained a fairly distanced position, commentators have described the WPK as a quasi-self-regulatory agency (Vieten, 1995, p. 507), which played the role of an advocate for the auditing profession rather than being an institution whose purpose was to enforce rules (Dyckhoorn & Sinning, 1992, p. 85). Until the 1980s, the affiliation between the IDW and the WPK was described as one of close cooperation (e.g. auditors served on the committees of both organizations) (Dyckhoorn & Sinning, 1992; Markus, 1996; Vieten, 1995). Thus, Harston stated that the "monitoring function of the two organizations became practically inseparable and indiscernible" (Harston, 1993, p. 156).

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<sup>89</sup> However, in joining the IDW, members commit themselves to complying with IDW releases which thus acquire a quasi-legally binding status (Sahner, Clauß, & Sahner, 2002, p. 16).

However, the auditing profession as a whole swiftly changed soon under the impact of European legislation. By significantly lowering the thresholds determining whether businesses had to be audited, the implementation of European legislation in the German Accounting & Reporting Law (Bilanzrichtliniengesetz) of 1985 increased the market for audit services overnight. The legislation had triggered major controversies over whether statutory audits should be restricted to the auditors' profession or whether other professional groups such as tax consultants should also be entitled to carry out basic audits (Markus, 1996, p. 172). In the end, the auditors were not able to defend their turf, and the Act (re)created a second professional group; the group of sworn auditors (vBP), though the latter were restricted to performing only statutory audits of the annual financial statements published by mid-sized German companies with limited liability. As a result, the auditing profession became divided.<sup>90</sup> This division also marked the end of the close ties between the IDW and WPK, since the WPK had now become the supervisory body for both professional groups, while the IDW continued to represent only the interests of the auditors. The ending of these ties was also spatially visible in a change of material arrangements: the IDW officially terminated the jointly used administrative headquarters in 1990 and moved from Berlin to Dusseldorf.

The German auditing profession was still united by a number of important practical understandings. The guideline “*An audit is an audit (later modified to: an audit opinion is an audit opinion)*” has been shared by many (macro-) actors in the German auditing profession for decades. It served as a kind of practical understanding for the auditing profession as a whole, was shared by representatives of both large and small firms and was designed to unify the different segments of the profession. The professional bodies, i.e. the WPK and the IDW, are prominent witnesses for the use of this key guideline in standard-setting disputes.

The WPK has argued for decades with the notion of a unified auditing profession, something that can be nicely illustrated with a citation dating back to 1997: “The necessary audit quality should be always the same, irrespective of the audit client’s size, the legal form taken by his business or the extent to which he uses the capital market. This means that we should strive to keep the auditing profession unified and should prevent its becoming split into two” (WPK, 1997, p. 101). The WPK has stuck to this normative guideline, with one slight modification, to this day. “In this context, the principle applies that the reliability of an audit opinion ... voiced in a mandatory audit should not depend on whether the audit client is a small or medium-sized business or a larger company that might even be of relevance for the capital markets” (WPK, 2012, p. 24). The principle should not, however, be interpreted to mean that audit practices and audit documentation are entirely independent of the type, size and complexity of the firm being

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<sup>90</sup> Although as of 2004 it is no longer possible to become a vBP, the group of vBP are still represented by the WPK.

audited. “To mark this difference more emphatically than hitherto, the Chamber of Auditors would like to reformulate more precisely its former statement that ‘an audit is an audit’ so that it now reads ‘an audit opinion is an audit opinion’”(WPK, 2012, p. 25). In other words: irrespective of what kind of legal entity the audit practice is being applied to, each audit opinion should stand for the same audit quality, i.e. the same reasonable audit assurance. This is a view that the IDW has always shared, too (IDW, 2012b; IDW President Naumann in Naumann, 2012).

“The application of the principle ‘an audit opinion is an audit opinion’ to audits emphasizes that they should be carried out in line with professional judgements and with the professional scepticism that should invariably be maintained in the profession. The unity of the profession follows from the issuance of audit opinions with the same judgement quality, irrespective of the kind, size and complexity of the firm being audited.” (IDW, 2012a)

A second shared practical understanding within the profession was that self-regulation should be maintained and that the threat posed by outside regulation should be minimized (Dörner, 1999, p. 126; IDW, 2002; Lindgens-Strache, 1997, p. 262; Marks & Schmidt, 1998a, p. 976; Marten & Köhler, 2000, p. 1322).

“In the nineties [...] the question was debated: introduction of a quality control procedure, and the profession’s answer in this debate was that we do that ourselves, and the lawmakers said: Okay, if they develop a self-regulatory solution, there is no need for statutory measures.” (IDW President Naumann)

Finally, it was a shared practical understanding that the profession was to decide how auditors should be educated so that they attained a sufficient level of quality for them to represent the German auditing profession. Traditionally, the educational path took a long time, starting with a university degree, continuing with several years spent acquiring auditing experience as an assistant and culminating with the individual concerned taking and passing the German auditing examinations.

#### *Marginalisation of small auditors in the German audit industry*

The different characteristics displayed by small and large audit firms that have been outlined above have consequences for the way in which audit standards, accounting standards and, finally, the enforcement of these things with the help of peer reviews and monitoring systems affect both groups in the auditing industry. In this respect, it is important to be aware that the background to all of this is that the pendulum has increasingly swung towards favouring the Big Four’s practices in the past.

This is associated, first, with the increasing internationalization of German industry, which had a major impact on the German audit profession. In the 1970s, German industry transformed itself



into an export industry. Audit firms had to reach a "critical mass" to meet the challenges of internationalization (Markus, 1996, p. 157). In order to remain competitive, German auditors had to set themselves up internationally - either by merging with international partners or by merging with national partners (Markus, 1996, p. 161).

Second, regulation changed. With respect to accounting and auditing standards, the size of large firms is characterised by international standards which require specialist expert information for the meaning of the standard to be defined, but which, once the meaning has been defined, tend to demand that more non-expert work be done, since this not only allows economies of scale to be achieved, but also permits work to be delegated to someone who is merely required to tick boxes. In contrast, small auditors are more interested in standards which allow them to make use of concrete, tailor-made applications of their generalist expert knowledge that are based on their detailed knowledge of their client's circumstances.

With respect to audit norms, ISA norms were indirectly implemented in German audit practice as early as the 1990s, when the Big Five firms de facto implemented the international requirements in their firm-specific auditing guidelines so as to ensure that an identical standard of quality was being reached in their international networks (Coenenberg, Haller, & Marten, 1999). Translations of the ISA also formally entered the German audit market in 1998, making Germany one of the earliest countries in Europe to do this. These audit norms were also subject to formal changes and thus entered the scope of small auditors, as international audit standards were more and more replacing the formerly national standards set by the IDW. The effect of this transformation is, for example, described by the following interview:

“And I remember that time very well [at the end of the nineties]. In the professional news bulletins from the IDW, you received in each issue a new standard that had been transformed – this was a gigantic change for the profession. Previously, you had three expert opinions and then you had a transposition of the entire ISA into German audit standards: that is a direct intervention in real audit practices.” (Interviewee, Big4)

The structure of the audit market was not unaffected by the developments outlined above. Indeed, the consolidation of the audit market, characterised by an oligopoly of the "Big" audit firms (first Big Eight, then Big Five and then Big Four)<sup>91</sup> increased steadily. The studies of Lenz (1996), Lenz and Ostrowski (1999), Möller and Höllbacher (2009), Köhler et al. (2010), Wild (2013), Leidner and Lenz (2013) all show that the audit market became heavily and increasingly consolidated, especially for listed clients, banks and insurance companies. These markets are dominated by the large audit firms, especially the BigN-firms.

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<sup>91</sup> Markus (1996, pp. 156 – 167) provides a thorough review of the mergers between German audit firms and national or international audit firms.

Marginalisation and the teleo-affective emotion of feeling dominated describe exactly how small auditors felt about this, and that was mirrored in our interviews. In an interview carried out with a small auditor, the business environment for small auditors was felt to be dominated by the Big Four, while a certain sense of helplessness was widespread:

“The Big four dominate the world of audit, they dominate the IDW, they dominate the WPK and often they dominate even within the ministry in which the adoption of accounting standards is discussed.” (Interviewee, partner in a small audit firm)

It is interesting that the way these audit and accounting standards evolved, and the way small auditors felt about this development, largely run parallel to small auditors' experiences in Canada, as exhibited in the study done by Durocher et al. (2014). Durocher et al. (2014) focus on the impact of a globalizing standardization movement on the sites of small practitioners, who can be seen as a marginalized group, and look at how the latter react. Their analysis indicates that small practitioners in Canada adopted a logic of resistance when dealing with global standards in the context of their everyday realities. This logic “sustains a climate that marginalizes small practitioners' capacity to reflect on the ends of professional work” hampering emancipatory thinking and behaviour (Durocher et al., 2014, p. 5). The active resistance, i.e. the “refusal to accept new “standards of practice and [the] endeavours to fight against implementation” (Durocher et al., 2014, p. 8), undertaken by wp.net, which were triggered by the implementation of a disciplinary technology, can be interpreted – in stark contrast to the Canadian case – as an attempted *emancipatory and reflective act* by small auditors.

There are some notable differences between Canadian and German small auditors that might account for why the resistance witnessed in the case of Canada went further in our case, progressing from resistance to outright opposition.. Thus, it should be noted that even today small auditors have a significant share in the German mandatory audit market, since the degree of consolidation seen in the audit market for privately held companies is much lower than in other countries. Based on a sample of 284 large privately held family businesses for the financial year 2009, Dobler and Fichtl (2013, p. 169) calculated – that the market share accounted for by the Big4-firms stood at 43.66 % (number of clients), 57.85% (audit fees), respectively. More generally, it should be noted that with respect to the audit market for non-public interest entities (non-PIEs), which in Germany can be estimated to comprise between 33,000 and 50,000 companies that are obliged to have their financial statements audited, small and mid-sized auditing firms in 2013 accounted for a market share that stood at the not inconsiderable figure of roughly 57% (based on the number of clients; database BvD Dafne). For the period from 2002 to 2009, Loy (2013, p. 330) reports that mid-tier and smaller firms accounted for a similar market share of 59 % (based on the number of clients; database: BvD Dafne). These numbers should be interpreted cautiously, since in contrast to the audit market for listed firms, we do not have more

detailed studies showing the degree of consolidation in the statutory audit market for private firms. However, the figures do at least show that small auditors had certainly not been marginalised in the non-PIE sector during the time period investigated. Still it should be noted that these differences are not sufficient to explain the differences between Canada and Germany. After all, in Canada, too, an association of small practitioners called Groupe Servicpas was founded with the goal of developing technical tools and support for small auditors (“support mobilization”, Durocher et al. 2014, p. 22 et seq.). However, in contrast to Germany’s wp.net association, no explicit political lobbying strategy has been developed and only a few minimal signs of active resistance are reported in the data collected by Durocher et al. (Durocher et al., 2014, p. 26 et seq.). In sum, the description of the site of the small auditors (the audit practice) in Canada is similar to Germany, but interestingly the reaction or “coping strategies” (Durocher et al. 2014, p. 22 et seq.) displayed by the small practitioners is different. Despite some similarities with respect to mobilization, the Canadian small auditors did not engage in forms of active resistance. In this respect, it is interesting to note that a predecessor of wp.net was established as early as 2002. However, shortly after its establishment it foundered as a result of internal conflicts over the organization’s strategy, as the two co-founders (one of whom was the later wp.net founder Michael Gschrei) disagreed (wp.net, 2008c, p. 11) over whether to choose a version of wp.net that would focus more on offering various forms of ongoing aid in the form of seminars and workshops, along broadly similar lines to Canada, or whether it should engage in active political lobbying on behalf of small auditors. Thus, a further step was needed, which then led to the establishment of wp.net.

*The emergence of the knowledge claim that got the ball rolling*

By the end of the last century, Germany was among the few countries in the European Union that had not yet established any form of external audit quality assurance mechanism (FEE, 1998). External quality assurance only existed in the form of checklists for the internal control system provided by the IDW (Hammers-Strizek, 1999; Marks & Schmidt, 1998a). However, at the end of the 1990s the German auditing profession came under pressure from both national and international developments.

At the national level, the revelations exposed by the collapse of various domestic companies triggered intense debates over the scope and function of traditional statutory audits (Heck, 2006; Lenz, 2011; Martens & Pauly, 2000). The debates resulted in the Corporation Control and Transparency Act (KonTraG) being passed in 1998, an act aimed at improving German financial reporting and corporate governance (Eierle, 2005; Lenz, 2011). Even during the legislative debates on the KonTraG, a mandatory peer review system was debated, but the accounting profession made it clear that any questions related to quality controls should be solved by and

within the profession itself (Marks and Schmidt, 1998, p. 976), thus reaffirming the focus on self-regulation that has already been outlined above as forming the self-perception of the profession that is shared generally by its members.

Parallel to the debates at the national level, in the U.S. the NASDAQ stockmarket further upped the pressure to introduce a peer review system by changing its listing requirements. The new provisions required that listed companies had to be audited by firms whose quality control systems were externally reviewed. This was particularly crucial for German businesses, since at the time German audit firms involved in statutory audits of firms listed on the U.S. stockmarket represented the second largest group, after the UK (WPK, 2004b, 2005, p. 8). With the deadline for implementation set for February 1998, the IDW came under considerable pressure from the large audit firms to campaign for the introduction of external quality controls as soon as possible. Following internal debates within the IDW, a technical committee on “Quality Assurance” was set up between the WPK and the IDW to explore how the IDW’s demand for quality controls could be realised (WPK-President Hense in WPK, 1998a, p. 47).

Initially, the WPK and IDW pursued different regulatory modes (WPK-President Hense in WPK, 1998b). Since its global perspective was a priority for the IDW, it favoured a system as close as possible to the AICPA system. This was viewed critically by the WPK, which favoured a system that would impact the traditional self-regulatory understanding of the profession as little as possible. In the initial committee on quality control responsible for this issue in the WPK, significant influence can be seen to have been exercised by the large audit firms (for example, at the meeting on November 5<sup>th</sup>, 1999 (WPK President Hense in WPK, 1999d)). The committee comprised 11 members (one member had permanent guest status), six of whom were representatives of the large audit firms. More important than mere numbers, however, is the fact that, basically, the Big Four were already acquainted with the peer review system, giving them an informational edge which allowed them to exert a strategic advantage in its design.<sup>92</sup> When a consensus was then reached between the IDW and WPK, it thus came as little surprise that the committee followed the position taken by the IDW and announced that it proposed to establish a peer review in November 1998 (Committee Chairman in WPK, 1999a). In March 1999, the WPK management board voted unanimously to introduce a peer review system under the formal supervision of a Public Oversight Board. The introduction of the peer review system required amendments to be made to the WPO (Law Regulating the Profession of German Public Auditors) (WPO-Novelle). As changes to the WPO have to be passed by the Federal Parliament (Deutscher Bundestag), the WPK and IDW demanded a legal initiative from the Ministry (WPK, 1999b).

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<sup>92</sup> It should be noted that this, of course, made later on also a difference for quality control auditors. Thus, it was recommended sometimes that quality control should be carried out by an auditor of similar size (e.g. Ludewig, 2001).

A peer review as a regulatory instrument was unknown to the Ministry, so the latter depended on the large audit firms' international networks, which "the doors" to the AICPA and SEC (interview, Hammer-Strizek). In November 1999, policy advisors at the BMWi and representatives of the WPK and the IDW paid a joint visit to the AICPA headquarters and were introduced to the U.S. AICPA peer review system. The experience garnered with the system was further illustrated by representatives of KPMG (WPK 1999c, p. 235).

The internal WPK/WPK board discussions were accompanied by attempts to convince the accounting profession of the need for such a system. This was rather difficult, because one practically shared understanding contradicted the other generally shared understanding. As one German auditor pointed out, from an educational viewpoint a peer review was seen to make simply no sense at all, given the selection and education process undergone by auditors in Germany:

"The peer review, that is, the idea that someone is going to come and monitor the auditor, was never accepted. In the US that might be different, there people can take their CPA within three weeks. In such circumstances, it makes sense to check what they are doing, because this depends entirely on the practical experience provided by the audit company at hand in such a case. However, in Germany, when I have to have undergone a thorough, five year education, when I can only become an auditor at the age of 33 and when I need to prove that I have ten years practical experience in auditing, the situation is completely different." (Interviewee, audit profession)

Thus, an additional shared understanding of the profession was mobilised: In various essays and statements by the WPK board members published in the WPK-members journal it was pointed out that the debate at the European level (e.g. Green Paper) suggested that the European Commission would soon be issuing its own legal requirements. Thus, the time window for establishing a specific national system that at least ensured self-regulation in broad terms – rather than the profession becoming subject to European regulatory initiatives – would, it was argued, close soon, as becomes visible in the statement by the former WPK-President Hense:

"If we [the profession] want to prevent the issue [external quality reviews] being initiated and organized by the lawmaker, we have to be prepared to tackle this question ourselves." (WPK President Hense in WPK, 1998b)

In addition, the establishment of a peer review system was seen particularly by the IDW and the large audit firms, but not infrequently by smaller auditors, too, as constituting a marketing tool to demonstrate high audit quality.

"When these questions were addressed in the late nineties, everyone assumed that this [the introduction of the peer review] represented a perfect marketing tool for the profession." (Interview, IDW President Naumann)

In April 2000, the government published the first draft of the bill (WPK, 2000, p. 113), which almost exactly mirrored the proposal made by the IDW and WPK. As both the initiative and the design of the legislation had been undertaken in line with the wishes voiced by the IDW, it was later described as a "law on demand" (Kluth, 2000). Eventually, in October 2000, the bill was passed by parliament without further amendments and without being the subject of controversial debates (WPK President Wahl in WPK, 2001, p. 38). The necessary amendments to the professional statutes of the WPK were passed unanimously at an extraordinary meeting of the profession (WPK, 2002).

Under the law, the peer review was made mandatory for all statutory auditors and audit firms in two phases and it involved every auditor undergoing a peer review every three years. It is interesting to observe that this law went beyond the Recommendation made by the European Commission, which demanded quality controls only for audit firms with public interest clients and which envisaged a six year cycle rather than three years (European Commission, 2000). The Act stipulated, furthermore, that an attendance certificate ("Teilnahmebescheinigung"), confirming the auditing firm's successful participation in a peer review, should be made a prerequisite for conducting statutory audits. Auditors and auditing firms of stock corporations that were listed on a regulated stockmarket (formerly "amtlicher Handel") required this certificate in order to be able to perform audits for the financial years beginning after December 31, 2001 (phase 1). For all other statutory audits, the certificate was required for audits beginning after December 31, 2005 (phase 2). Moreover, after 2007, in the event of the annual financial statements being audited by a firm without this attendance certificate, the auditor's approval of the accounts became invalid (§ 256 I Nr. 3 HGB). In other words, auditing firms that had not been peer reviewed were excluded from the audit market.

Clearly the knowledge claim resonated well with the practices that we have observed in the case of the Big Four: It addressed public quality concerns and was a suitable marketing tool, and it even permitted improvements to be made to the firms' own delegation-based auditing practices, which relied heavily on a systems-based delegation of tasks to less highly skilled workers. Moreover, a quality control system had already been introduced on the basis of the fairly standardised and uniform approach to undertaking audits worldwide that were offered by these companies, so in terms of the costs involved, it was a zero-sum game (Engelken, 2005).

However, at the same time the knowledge claim conflicted with the practices pursued by small audit practitioners: Thanks to their long-term relationships with their clients, they did not need to restore lost trust or to rely on marketing tools. Moreover, since they were often one-person practitioners, they as a rule had neither any practice of quality control nor any system for documentation. For them, the peer review therefore often involved their having to build up an

entirely new, additional quality control system to document controls that had already functioned more or less efficiently previously (Heininger & Bertram, 2003), and this represented an investment that their clients were not willing to pay for.

#### 4.4 The foundation of a second professional body for small auditors

The mobilization of small auditors was set in motion by several simultaneous developments. First of all, an institutional body was set up: In 2005 wp.net was founded. At first, the small auditors seemed to be sceptical: at the date of its foundation on January 22, the association's first meeting was attended by just ten auditors and one sworn auditor (Gschrei & Lahl, 2015, p. 22), and regional meetings of the association were attended by only a handful of auditors (wp.net, 2006a). The newly founded wp.net swiftly took up the issue of the peer review and positioned itself in opposition to the IDW (wp.net, 2005).

The speaker of the IDW board, Prof. Dr. Naumann in November 2005 didn't expect any "significant consequences" for the market structure, since "only a few firms will withdraw from the statutory audit market" (IDW President Naumann in Engelken, 2005, p. 16) and the lawmaker even expected in 2000 that "the peer review would enhance the competitive abilities of small and medium sized auditors in comparison to large auditors [...] in the medium-term the profession in its entirety will certainly participate in the system" (Deutscher Bundestag, 2000, p. 24). Michael Gschrei, president of the newly founded association of small practitioners wp.net, by contrast feared massive economic consequences for small auditors: "With the help of the argument that the small (auditors) have not passed the peer review, the way will be paved for large (audit firms) to take over audit clients who will be available because of over-bureaucratization" (Engelken, 2005, p. 13).

As a result of the time lag until audit firms without issuer clients were obliged to be peer reviewed, the impact of the peer review system on the audit market was not immediately visible. There were nevertheless a few signs of what was to come. In December 2003, a WPK survey (with a response rate of 45.4 % of the 8,900 polled) of 4,040 audit businesses (1,262 audit firms; 2,778 sole practitioners) indicated that 87.2 % of the audit firms (1,101) but only 49.1% of the sole practitioners (1,364), i.e. 61 % of all respondents intended to participate in the quality control system (WPK, 2004c, p. 11).

Then, in 2006 the last chance came, and many auditors who up to this moment had not participated in a review missed their opportunity. Motivated by the shared practical understanding of the profession, the procedures followed in a peer review were identical across all auditors. Within the IDW, this had been explicitly demanded by those in the group of small auditors who had feared that different procedures could lead to perception arising that there was

a first class composed of auditors with peer reviews and a second class made up of auditors without these. However, it now turned out that this had a boomerang effect: unlike large accounting firms, the vast majority of small auditors did not possess the technical skills and/or financial and human capital needed to carry out the procedures demanded by a peer review. A "shock wave" was triggered in the profession's small auditors segment (Gschrei, 2009a, p. 5): in the years following the introduction of the peer review, widely differing IDW and wp.net estimates assumed that between 20% and 70% (Waldthausen & Gschrei, 2011, p. 100) of the audit firms<sup>93</sup> and 90 % of the sworn auditors had left the audit market. 2006 then marked the final year of the first review round, an occasion which was used by wp.net to offer seminars on quality controls and on IFRS (Gschrei & Lahl, 2015, p. 22).

Even earlier, the debates on the various different quality controls for different audit firms had received fresh impetus, after U.S. lawmakers had passed the Sarbanes-Oxley Act in 2002. The act introduced additional governmental PCAOB inspections only for audit firms with public interest clients. This did not, however, replace the peer review, as AICPA's peer review system was retained.

The law stated that the specific provisions relating to the process and requirements governing peer reviews should be determined by secondary legislation ("untergesetzliche Regelungen"), and this took the form of a charter for quality assurance (§ 57c Public Accounting Act/WPO) issued by the WPK and adopted by the Advisory Board of the WPK (Beirat), which also required the approval of the Federal Ministry of Economic Affairs and Technology, in consultation with the Federal Ministry of Justice, to become effective. Both the law and the bylaw were the legal basis for the new quality assurance system. Two things which, while not legally binding were of considerable practical relevance insofar as it represented recommendations backed by the WPK and the IDW were the joint statement "Requirements on Quality Assurance in Audit Practices" (VO 1/2006) and the auditing standard IDW PS 140: conducting quality controls in audit firms, implemented in 2008) released solely by the IDW. Small auditors demanded that the relevant standard should include and consider more explicitly the principle of proportionality

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<sup>93</sup> It is difficult to quantify the precise number of audit firms, which left the audit market. While the WPK and IDW estimate that around 20 % left the audit market, WP.Net reckon that 70 % left the audit market. These widely differing estimates by the respective lobby groups cannot be validated, because the number of audit firms who were operating in the audit business before the peer review was introduced is not known. What can be said is that by the end of 2006 only 31.8 % (4,180) of 13,134 audit firms (sole practitioners, partnerships or incorporated businesses or other entities of professional accountants) successfully completed a peer review or obtained a temporally limited exceptional license. This percentage increased to 33.8 % in 2010 and dropped to 29.2 % in 2014 meaning that 70.8 % of audit firms currently have no licence to do statutory audits. 61.81 % of all German auditors (including 4,050 sworn in auditors) were working in these firms in 2006; this percentage remained more or less stable until 2014 (62.18 % of 14,407 auditors). If we conservatively assume that before the introduction of the quality control system only 50 % of all the roughly 13,000 audit firms (6,500) were actually in the audit business, an estimated decrease of 36 % to 4,180 can be calculated.



(Verhältnismäßigkeit). Indeed IDW PS 140 is conceptually based on a detailed audit (not review) of the quality control system with a strong emphasis on an evaluation of the appropriate performance of selected financial statement audits. Emphasizing the importance of the shared practical understanding in the profession ("an audit is an audit"), however, the IDW refused to make any changes (Müller, 2004).<sup>94</sup>

In addition, it was argued that the “Requirements on Quality Assurance in Audit Practices” (VO 1/2006) reflected the standards on quality control commonly used internationally (ISQC and ISA 220). The difficulties were increased not just by the fact that the Institute’s first manual on quality controls was only published a couple of years later, but also by the fact that it was not perceived to be very helpful (interview with Michael Gschrei, founder of wp.net).

The European Directive of 2006 heated up the debates on external quality controls even more. The fact that the Directive used the term “review” rather than “control” and that it did not require any form of “certificate attendance” was interpreted by wp.net as proof that the IDW and WPK had intentionally overstepped the mark when established the German peer review system in order to “purge” the audit market of small auditors. This accusation was then repeated constantly in members newsletters, annual reports, in discussions with political representatives and on the association’s website, which was launched at the end of 2006. It was fuelled still further when a further legislative change added to the conflicts: starting in 2007, additional inspections – undertaken either randomly or in the event of any signs of misconduct - for auditors and audit firms that performed statutory audits for public interest entities (§ 319a (1) 1 HGB) were introduced.

Moreover, wp.net started actively political lobbying: in 2006, the association was officially invited to the Ministry for a first consultative meeting, which was seen as a first political success (wp.net, 2006b). In the course of the 7<sup>th</sup> amendment of the Law Regulating the Profession of German Public Auditors (WPO Novelle), the association received an invitation from the relevant committee of the federal parliament, which was seen as “the crowning of our political efforts” (similar wp.net, 2007, 2008b). The discussion highlighted once more the differences that existed between the IDW and wp.net. With regard to the new introduced inspections for audit firms with public interest clients, the IDW demanded that inspections should be limited to audits for public interest clients (Deutscher Bundestag, 2007). Citing the increase in costs, the threat of even greater consolidation in the audit market and disproportionality, wp.net argued that all of these arguments should have been mentioned at the time when the debate had centred on

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<sup>94</sup> However, it should be noted that in the commission for quality control there was no unanimity on this issue. On the contrary, even quality control auditors from the Big Four emphasized that the size of the audit company played a central role in what could be expected with respect to the quality control system of an audit company (Müller 2004, p. 118). And even in the IDW, at the very beginning of the discussions about the peer review system it was proposed to introduce a mandatory peer review only in the event of their being listed clients (Marks & Schmidt, 1998b, p. 987).

criticisms of the audit, when they would have been far more justified and necessary (Deutscher Bundestag, 2007; wp.net, 2008a, p. 13). The political campaigns were accompanied by constant attacks on the IDW (e.g. wp.net, 2007).

However, at the beginning of 2007, the mobilization of small auditors by the new association had still not reached a critical mass and meetings and gatherings had to be cancelled because of the low number of participants (wp.net, 2007). However, the effects of the peer review, which seemed to have been followed by exactly the effects feared by wp.net, in combination with the absence of proportionality, on the negative side, and the positive lobbying activities, on the other hand, led to the IDW being increasingly perceived critically by small auditors and to its being accused of working on behalf of large audit firms rather than for the profession as a whole. It should be mentioned that the Big Four contribute approximately 57 % of the IDW membership fees (Lenz 2014, p. 317). It makes sense to compare this juncture of the events with the developments in other countries, namely, the US and the UK.

In the U.S., in 1976, the AICPA initiated a voluntary peer review programme (Giroux, Deis, & Bryan, 1995, p. 65) for member firms. The programme was opposed by smaller audit firms, which considered the costs of a review process to be excessive (Fogarty, 1996, p. 244). As a result, many firms left the program. Although the idea of a mandatory programme was frequently discussed (e.g. in the Anderson Committee of 1983), it was not implemented as it was argued that the costs would lead to a substantial erosion of membership (AICPA, 2005). This explains why the review programme never attracted a critical mass of practicing auditors, especially in the AICPA Private Company Practice Section (PCPS) (Niehus, 1993, p. 148 et seq.). In other words, small auditors in this region of the world, at that stage, did not need to organise themselves because there was no substantial threat that the peer review would become compulsory.

In April 1987, however, the AICPA asked its members to vote whether the participation of the peer review programme should become mandatory for CPA firms auditing one or more SEC clients (White, Wyer, & Janson, 1988, p. 27). Again this was rejected by the profession because the necessary two-thirds majority has been missed but “61 percent of the 130,000 respondents voted affirmatively” (White et al., 1988, p. 27). But now peer review became a divisive topic for the auditing community, pitting small audit firms that opposed it against larger firms that supported it (Fogarty, 1996, p. 244). The latter became (in)directly supported by SEC, which threatened to launch a government review program in case the profession would keep on rejecting peer reviews. This caused the AICPA to start broad-based lobbying actions, which resulted in a second vote in January 1988. Now AICPA members voted to adopt a mandatory peer review system for members engaged in the practice of public accounting (Huff & Kelley, 1989, p. 35). Nevertheless, a significant minority of almost a quarter of the members still

opposed the introduction of a mandatory peer review in the final ballot (Berton, 1988). However, the AICPA peer review for auditors of private companies considered the specific situation of small local practitioners. Within the responsible AICPA quality review committee 11 out of 12 members were local practitioners, three were sole practitioners who “understand how local firms operate in the real world” (Huff & Kelley, 1989, p. 36). That may have contributed to a greater peer review acceptance by small practitioners.

The U.S. profession developed over the years and in different phases also a more differentiated review system: a peer review for members of the AICPA division for CPA firms prevailed with respect to their clients subject to SEC regulations, SECPS (later on SOX regulations replaced peer reviews by PCAOB inspections) on the one hand, while non-SEC clients were reviewed under the Center for Public Company Audit Firms (CPCAF) Peer Review Program (PRP) on the other hand; audit firms with only private audit clients were subject to the AICPA Peer Review Program, either as a System Review for audits and similar engagements or as an Engagement Review for firms which perform other accounting work including reviews and compilations (Dennis, 1997; Freundlich & Webb, 2000).

The U.S. case proved further that the real factor that drove out the small auditors from the U.S. public audit market was governmentally induced. In particular, research has revealed that PCAOB regulation drove many small audit firms out of the issuer audit market (Daugherty et al., 2011; DeFond & Lennox, 2011; Hermanson & Houston, 2008; Read, Rama, & Raghunandan, 2004). The PCAOB defines a small audit firm as an audit firm that regularly audits 100 or fewer issuers each year; these firms are inspected triennially. 95% of audit firms that are triennially expected have fewer than 10 clients (DeFond & Lennox, 2011, p. 25). Read et al. (2004) demonstrated that small audit firms were much more likely to cease performing SEC audits in the post-SOX period than in previous periods due to the perception of a more stringent oversight by PCAOB.

Hermanson and Houston (2008) found that particularly small audit firms were not able to solve their quality control defects within one year. The vast majority of quality control defects were related to audit performance issues, followed by independence, monitoring and addressing identified weaknesses, partner workload, and review of interim financial statements. The results indicate that firms that inadequately addressed their quality control defects were among the smallest audit firms in terms of partners and employees per client. Daugherty et al. (2011) showed that PCAOB inspections are associated with voluntary client losses. The figures show that small audit firms voluntarily resigned from their clients because the costs associated with regulatory compliance outweighed the benefits of auditing publicly traded companies. DeFond and Lennox (2011) revealed that the audit market is not negatively impacted by the exit of audit

firms from the issuer audit market. They found that from 2002 to 2004 almost every second small audit firm left the audit market. The exiting firms were of low quality, less independent, and more likely to be the target of PCAOB enforcement actions than the remaining auditors.

In comparison with the case of Germany it is interesting that some similarities exist: When the peer review was introduced for AICPA member firms this was done because the professional self-regulation and therefore a key shared value was at stake because it was threatened to be taken away by governmental action. What is different, however, is that (i) in the first stage the peer review was voluntary, (ii) in the second stage AICPA members voted in a democratic process with respect to compulsory peer reviews, and (iii) the AICPA seemed to consider more explicitly the implications of peer reviews for small practitioners (Huff & Kelley, 1989). Furthermore, whereas the AICPA is a private law body with voluntary membership (i.e. an exit option is available) which, by the way, may also explain the more democratic process, the WPK is a public law body with mandatory membership for every audit practice, i.e. German audit firms with the intention to perform mandatory audits can't escape the quality control procedures and all official seal engagements according to Art. 57a Para. 2 Sentence 2 WPO (e.g. voluntary audits, reviews, compilations) are subject of a peer review.<sup>95</sup> This increased pressure in Germany may have contributed to the mobilisation of small auditors. It should also be mentioned that since 2005 the German system should be described as "monitored peer review" because the law maker installed the independent German Auditing Oversight Commission which oversees and has the right to overrule the WPK according to Art. 66a Public Accounting Act (WPO). Moreover, it was rather the local U.S. SEC than outside pressures from a supranational body like the EU or the U.S. as in the German case in which the local government rather paved the way for the profession to decide on its own how to react to the international challenges. Later on, in the U.S. case a governmentally installed oversight system drove smaller auditors out of the public audit market and not a peer review system. The higher liability risk for auditors in the U.S. may have also contributed to a greater acceptance of the peer review (Fogarty, 1996, p. 248). The comparison between the U.S. and Germany shows that there are many different factors possibly influencing the reaction of small auditors on peer reviews and because no explicit study in the U.S. context is available we can only conjecture that the above mentioned factors may explain the different behaviour of auditors in the two countries.

The German case also differs from the case of the UK. In a detailed descriptive and interpretative study without explicit reference to a theoretical framework of the ICAEW policies from 1961 to 2000, Ramirez (2009) illustrates the growing tension over the decades between the

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<sup>95</sup> It should be mentioned that in the US some State Boards of Public Accountancy require also the enrollment in a Peer Review Program for licensed firms performing audits if such firms are not members of the AICPA. For example, such a requirement was recently introduced by the Florida State Board of Accountancy as of January 1, 2015 ([www.ficpa.org/content/Members/PeerReview.aspx](http://www.ficpa.org/content/Members/PeerReview.aspx)). National State Boards administer also separate Peer Review Programs, i.e. audit firms can choose between AICPA or national programs.

interests of small practitioners, who constitute the majority of the members, and the larger audit firms, who are said to dominate the Institute. However, unlike the German case at that stage, counter measures were taken by the professional bodies in the UK case. The ICAEW commissioned reports to explore ways to better realign the heterogeneous interests and also tried to maintain the privilege of self-regulation against the growing regulatory influences. The Institute did not pursue the possible option of dividing the membership into different divisions and setting up bodies to represent these divisions. Instead, in this phase (1983 – 1990) it tried to improve the communications with, and the education of, the small practitioners via the creation of a General Practitioners Board. “The small practitioners were no longer distant citizens of the ICAEW. They were now its lay citizens, who needed to be educated and taught to become good citizens” (Ramirez, 2009, p. 397). In other words, the small accounting firms were not, as they were in Germany or Canada, left stuck on the periphery, but instead they were re-integrated yet simultaneously stigmatized – something that never happened to the small auditors in Germany.

Inspired by the Eighth Auditors Directive, the ICAEW and two other professional organizations founded the Joint Monitoring Unit (JMU) for quality control purposes for registered auditors as early as 1987. This led to raucous complaints by small practitioners (“heavy-handed and unwarranted enquiry of audit regulation inspections”, inspectors behave like a “professional Gestapo”, Ramirez 2009, p. 398 and p. 400) over standards created by and for the larger firms; the latter issue is developed in a more general way in Ramirez (2012). According to Ramirez 2009, p. 858), the introduction of the Joint Monitoring Unit (JMU) in 1987 led “to attributions of worth that are deemed unjust” by small practitioners, who get more or less the “bad or inferior auditor” label in comparison to the elite members (the BigN-firms). Such criticisms and a report undertaken by the academic Peter Moizer in 1994, however, resulted in a fundamental change in the inspection process. In other words, unlike the German IDW, the main professional body reacted to the emerging criticisms. However, despite these efforts to calm down small practitioners, the introduction of a quality monitoring mechanism made the formerly implicit hierarchy explicit and “demonstrated how small practitioners could collectively be associated with an image of ‘bad practitioners’ (Ramirez, 2009, p. 405). Therefore, rather like in the German case teleo-affective structures such as the feeling that they were being treated unfairly, incited anger and resentment and triggered the foundation of the Small Practitioners Association (SPA) in 1996 with the goal of increasing small practitioners’ influence at the ICAEW (Ramirez 2013, p. 860). The association operates currently under the name of The Society of Professional Accountants (SPA) and represents about 1200 chartered accountants throughout the UK (<http://www.spa.org.uk/about-spa/>). As a result, we find that in the case of the UK, too, a new professional body emerges, albeit one which was much less aggressive than its German counterpart, probably because the ICAEW reacted much faster than the IDW and because it was more willing to compromise. In Germany, however, as a consequence the story was still not

over. At this point, the WPK, which was subsequently to be the scene of a palace revolt, moved to the centre of conflict.

#### 4.5 The Palace Revolt

Membership of the WPK is mandatory for all German auditors. Every three years, all members have the right to vote on the composition of the Advisory Committee (Beirat), from whose ranks the Board of Management (Vorstand) is elected. Until 2010, only members who attended the Chamber's general meeting had the right to vote. In addition, it was possible for a member attending the meeting to exercise the proxy votes of up to six absent members. This electoral design resulted in very low voter turnouts. The general meetings were, on average, attended by around 5 % of all members.<sup>96</sup> By virtue of the proxies granted, almost one fifth of all members elected the new WPK President.<sup>97</sup> This system came to favour the large accounting firms (Sack, 2011, p. 150), which were able to systematically collect absent colleagues' proxies and cast these votes at the meeting. Thus, backroom meetings among the large accounting firms determined who was to be the president of the chamber: "It was an open secret that the winner of the election had already been chosen before the election took place" (Interviewee, Big4). The specific election system therefore represented a serious obstacle for the group of small auditors who wished to turn their political dissatisfaction into political participation.

Even in the course of the general elections of 2002, a group of small auditors proposed (but at the last moment refrained from) going to court, and in 2005 the newly founded wp.net did indeed go to court (wp.net, 2009). However, on both occasions, the courts declined to intervene, as the design of the electoral system was seen as something, which ought rather to be discussed within the profession.

At the end of 2007, the relevant Administrative Court (Verwaltungsgericht) dismissed the association's challenge to the WPK election of 2005 (VG Berlin, decision as of October 31, 2007, 13 A 40.07 in WPK 2008a). Again, the new association seemed to be stalemated, as it seemed barely feasible to find intra-professional solutions. While the first political successes had been won, the profession still played a rather passive role, and because of the lack of political support, on the one hand, and the lack of support from the profession's association, on the other, the chances of initiating significant changes remained marginal. A new strategy had to be found (wp.net, 2007) that was capable of politicising the small auditors in the profession.

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<sup>96</sup> In the election of 2005, 400 members attending the meeting cast proxy votes for round about 2,000 auditor votes (wp.net, 2008b). In the election of 2008 622 members of the group of the auditors participated. This amounts to a participation rate of about 4.8 %. As each individual present could vote for up to six absent auditors, the 622 represented around 2,656 auditors and 170 audit firms (WPK, 2008b, p. 7).

In 2008, the association officially announced its collaboration with PRIMUS, which was one of the leading national providers of training and workshops for mid-sized auditors. In addition, PRIMUS was enjoyed a nationwide reputation for its daily blog, which was written by a member of the auditing profession who obtained a good deal of insider information from various different sources and in which it spread news about the German auditing profession. It was regularly launching strong attacks on the IDW, the WPK and the Big Four. At the general assembly of 2008, members of wp.net proposed introducing a postal vote, something which was opposed by the WPK President (Gschrei, 2009b, p. 30). Although the proposal was rejected, 40% did in fact vote in favour of the proposal even at this stage. The movement was slowly getting into gear. At the same time, the association intensified its own political lobbying activities.

At that time, the Federal Ministry of Economic Affairs and Technology (BMWi) responsible for this issue was headed by a member of the CSU (Christian Social Union), the Bavarian sister party of the Christian Democratic Union. As the new association was located in Munich, the natural material arrangements facilitated its communications with the Ministry. In April 2010, the Ministry invited the WPK and representatives of wp.net to discuss possible solutions with a view to calming down a conflict, which had already reached a fever pitch. The Ministry agreed to change the WPK's electoral system and, after the German parliament had passed the amendments to the WPO (Bundesgesetzblatt, 2010), the Chamber changed its statutes and electoral regulations in January 2011 (WPK, 2011a). This huge success for wp.net was commented on in various national newspaper stories. Reacting to the inspections that had been introduced for statutory auditors with public interest clients, the association successfully challenged plans to have the resulting costs borne by the entire profession, rather by only that segment with public interest clients.

In addition, the association received support from the European Commission. In October 2010, the Commission launched the EU Greenbook, a consultation on the role of the auditor in the financial crisis and potential remedies. In particular, critical attention was paid by the Commission to the fact that most EU Member States showed high levels of consolidation in their audit markets for listed companies (European Commission, 2010), and this marked the beginning of a regulatory process that ended with the Regulation and Directive of 2014. The European legislative proposals helped to mobilize wp.net because it had clearly positioned itself in opposition to the IDW. From the 700 comments which Commission received, the vast majority came from (identical) wp.net submissions (wp.net, 2011). While the IDW opposed these initiatives (IDW, 2011), wp.net welcomed major parts of the reform (Gschrei, 2015a). Unlike in previous years, the WPK and IDW were not able to reach a compromise supported by the entire profession (Lenz, 2014). At the end of 2010, wp.net had between 900 (Primus, Newsletter 18, January 2011) and 1,000 members (Gschrei & Lahl, 2015, p. 24).

The following months were shaped by intense election campaigns by wp.net, which were accompanied by attacks from PRIMUS. The main points pursued by wp.net were the introduction of a minimum fee scale to avoid price dumping (Honorarordnung), changes to the peer review system, and support for several proposals made by the Commission, such as those on joint audits and audit rotation. Moreover, it directly accused the WPK of intentionally understating the number of auditors who had left the market as a result of the peer review system (wp.net, 2009). The attacks from PRIMUS, on the other hand, not only added rhetoric to the election campaign, but also contributed a considerable degree of what one might call investigative journalism. They were essentially composed of five strategies, all of which were pursued at the same time:<sup>98</sup> The first pillar was to present as much evidence as possible that was liable to deflate the reputation enjoyed by the Big Four as honourable members of the profession (“cartel”, “driven by greed”, “PwC betrays...”).<sup>99</sup> The second pillar was to provide as much evidence as possible on network relationships between the Big Four and the IDW and WPK, with evidence being produced that both were flaunting professional values (e.g. “speaker of the IDW has provided the qualified opinion for KPMG”).<sup>100</sup> The third pillar was to provide evidence that served to damage the reputation of key figures in the professional bodies (e.g. on the IDW president: “Sun King Klaus Peter”) creating the impression that they were driven by money and

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<sup>98</sup> To provide at least a scant impression of the way in which the four strategies were pursued see the following footnotes. In addition one has to take into account how enormous the effect of this newsletter was in a profession that had previously been characterised mainly by absolute understatement.

<sup>99</sup> E.g. Newsletter 15, 2010: p. 7-8: “the cartel of the Big Four“, “Lex Big Four“, (in the newsletter 19, p. 5: Lex Big Four & IDW) “E & Y prosecuted because of Lehman Brothers“ “PwC is lending out staff to the Ministry of Economic Affairs (Wirtschaftsministerium), and now an investigation is being undertaken to see whether it has breached the professional values of the forbidden self-audit.“ p. 9: “Deloitte [...] plays in the club of the Germany Corporation (Deutschland AG) – this has nothing to do with auditing, but it is good for business, market consolidation and the satisfaction of greed.“ Newsletter 14, p. 2: “Who has provided unqualified audit opinions to all the banks with their gambling business – our elite (PwC and KPMG) - the revenue billionaires” Newsletter 18, 2011, p. 4: “PwC intends to have audits done in low-wage countries to save costs.“, p. 5: “Big Four have initiated an unprecedented war on audit fees that is to the detriment of the entire profession.“ p. 6: “For years, extraordinarily risky derivatives have been booked erroneously (in this bank). An internal audit (not by E & Y, of course) has now detected 57 errors that accounted for 121 million less profit.“ p. 9: “Big Four were responsible two years ago for ensuring that no statutory regulations governing fees came and that advertising was allowed” and now: “discounts of 30% compared with the fees of the previous year. What makes this possible?-Unduly low staff levels, masses of inexperienced audit staff. [...] Driven by greed and a deluded drive for expansion, they have destroyed the reputation of the entire profession.“ Newsletter 20, 2011, p. 2: “Let us be very clear on one point: The false audit opinions during the financial market crisis all came from the Big Four and now the EU Commission will look at whether the representation of the interests of the Big Four (he means the IDW) wanted that or not.“ p. 9: “PwC betrays the owners of Yukos [...] How can this be reconciled with our professional values of conscientiousness and responsibility? What values are still supposed to apply at PwC?”

<sup>100</sup> E.g. Newsletter 16, 2010, p. 5: “From being an IDW president to being a crashed pilot [...] he was formerly IDW president, [...] career at KPMG [...] was said to be a bearer of great hopes [...] now the prosecutor is investigating“. P. 11: “KPMG changes its auditor...For years the speaker of the IDW has provided the qualified opinion for KPMG, even though he was with the board of KPMG in the same committee [...] I informed the professional supervisory body which did not, however, see a major problem in that.“ Newsletter 14, p. 3: “Do these people still reflect on the fact that they are jeopardizing even the little reputation that has been left to the profession? Big mouth, gigantic audit fees, 99% unqualified audit opinions – and no legal third party liability for anything.“ Newsletter 17, p. 9: “E & Y prosecuted“. Newsletter 19, p. 2 (reacting to the Big Four being criticised by a second-tier audit company’s CEO: “That morning reading the newspaper was fun, because the Big Four “ were hit where it really hurts.”



the quest for luxury and that they relied on propaganda rather than transparency.<sup>101</sup> The fourth pillar consisted in providing evidence on how small auditors, that is the “true profession”, had been marginalized, and the last pillar was, finally, a call for active resistance<sup>102</sup> establishing wp.net as the association that is fast-growing and “without alternative” to be elected<sup>103</sup> in order to pursue this resistance.<sup>104</sup> Essentially it was this mixture of seriously good quality and the ever-new insights unearthed by investigations, scathing political rhetoric and the repeated assertion that the alternative was to spring into action that accounted for the Primus newsletter in the end having more than 5,000 subscribers, and over 2,000 clicks per day on its homepage (Newsletter 19, February 2011) from readers who were eager to hear about, and get worked up over, every new wave of scandals or at least the amusing rhetoric offered in the newsletters.

The conflicts between the WPK and IDW, on the one hand, and wp.net, on the other, intensified when the IDW refused to compile a single electoral list. Hence, the accounting profession for the first time had to choose between two electoral lists. Directly before the elections, all 17,000 members were mailed by the WPK and informed about the election and the electoral programme

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<sup>101</sup> E.g. Newsletter 16 „Sun King Klaus Peter“, Newsletter 17, p. 3ss: “fat six-digit salary for Klaus-Peter including driver and international stage” Newsletter 19, 2011: “driven by filthy lucre. Someone is finally unmasked and revealed to be a hypocrite, destroying his own reputation” Newsletter 18: “WPK spends millions on advisory agreement with EX-IDW member of the board [...] which Ex-IDW will be the next one to get millions paid out of our membership fees?” p. 8: “survival in boasting and pomposity”, Newsletter 14, p. 3: “Propaganda department of the IDW (public relations)- Öffentlichkeitsarbeit”. Newsletter 17, p. 7: Difficult thing: On the one hand E & Y board member (the audit company that triggered the EU greenbook with its unqualified audits for Lehman brothers) and on the other hand president of the WPK, which represents the profession (mostly small and medium-sized auditors). Arguing against the greenbook would mean arguing in the interests of the market leaders. However, arguing for the greenbook would involve being clobbered by the Big Four at home.” Newsletter 19, p. 3: “Board members of the Big Four or our representatives of the professional bodies are quite clear: greed, holding onto market share, pension rights, power and influence. One of the best examples: The propaganda department of E & Y (our WPK president).” Newsletter 14, 2010, p. 6: “Quiz: Who will be the next WPK president? [...] Big Four and “approved” second-tier audit companies represent alternately the president [...] in 2011 we would expect then a second-tier that lets the Big Four “do as it pleases”. [...] The Big Four accept bets because they know the result of the election already.” Newsletter 14, 2010. p. 11: “ You are highly motivated, have your career still ahead of you and want to engage in the profession? Forget it. If you are not part of the old boys network and are not tested and do not fit in with the strategy of the Sun King [...] and the Big Four, then I’m afraid you are on a hiding to nothing.”

<sup>102</sup> E.g. Newsletter 16, 2010 p. 8: “I have said years ago: the Big Four will go their way! They don’t give a damned shit about the future of the profession. The IDW and WPK are used as an alibi if necessary. When will the time come when we understand that we cannot stay on the sidelines, but have to take our future into our own hands?” Newsletter 14, p. 10: “The Big Four will dominate the 11 billion audit market, purge the market, cross-subsidize etc. Other professionals must prostitute themselves at predatory prices, will be hectored on quality by the WPK and IDW, exposed to regulatory madness and then stalked by the professional oversight body.”

<sup>103</sup> Newsletter 20, p. 11: “In July there are elections – for the first time per mail. Thanks to the initiator of the mail election. Wp.net was not tired to fight against all obstacles of the WPK for the election [...] And we will elect! Promised!”

<sup>104</sup><sup>104</sup> E.g. Newsletter 18, 2011, p. 10: Incredible from only 120 members in 2006 to 900 members now. On the way to true opposition [...] wp.net is without alternative! Still one heres the arrogance of the network IDW –WPK – Big Four [...] but the times are changing”, Newsletter 16, 2010, p. 8: “My recommendation: Go to wp.net! There is no alternative!!!! It is time!” Newsletter 14, 2010, p. 3: “After many members of the profession increasingly understanding that the IDW does not represent the interests of the entire profession wp.net has terrific increases in membership [...] wp-net is without alternative for small and medium-sized audit companies.” Newsletter 19, p. 12: “wp-net without alternative. Therefore: You should also become a member to help to ensure our professional objectives. I am there: Membership number 131.”

(Gschrei, 2011). By contrast, IDW and Big Four remained fairly calm and trusted in their economies of scale.<sup>105</sup>

Wp.net won the WPK election in 2011; the voter turnout was 50.2%, a sharp increase that was attributable to the postal ballot system and that provided a significant majority (WPK, 2011b). Under the majority voting system, all 51 seats on the Advisory Committee went exclusively to wp.net representatives. The Big Four were “shocked” (Interviewee, Big4). For the first time in a very long time, the composition of the Chamber’s Management Board did not turn out as forecast. This radical change in the Chamber’s organization was so extraordinarily unexpected that it was dubbed a “Palace Revolt” (Jahn, 2011; Wadewitz, 2011) by the media. That the absolute number of votes for wp.net was higher than the number of its members shows that the new association was able to attract votes from all parts of the profession. However, the success at least of its key protagonist, Michael Gschrei, did not last for long. A mere six months later he was induced by internal conflicts<sup>106</sup> to resign as the new president of the WPK. In the most recent election in 2014, candidates of wp.net won the most votes. However, the newly established electoral system of proportional representation allowed its opponent to form a coalition and thus to provide the next president, and wp.net members did not get any seats on the WPK management board.

#### 4.6 Discussion

The following discussion will focus on five key topics. First of all, making use of case-based theorisation (Humphrey & Scapens, 1996), we will shed light on the theoretically interesting fact that in our case small auditors were able to organise themselves and to start actively resisting. Second, we will discuss the role played by the new media, in particular blogs, in this event. The last three points worthy of discussion focus on implications for both small and large auditors and for the profession(s).

Were we to rely on standard political theory, then we would not have expected small auditors to have been capable of organizing themselves, while the few big audit companies might indeed have been expected to be able to organize themselves. The rationale behind this logic of collective action in the seminal work of Mancur Olson (1965) is precisely that the effort needed by small auditors in comparison to the effect reached, together with free-riding opportunities,

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<sup>105</sup> Probably the perceived superiority in terms of members - while more than 13.000 public auditors were member of the IDW, Wp.net still did not have more than 1000 members - made them feel safe.

<sup>106</sup> Two reasons lay behind the resignation. First, Gschrei rejected the proposal by the IDW and APAK to transfer the authority for the inspections of audit firms with public interests clients to the APAK. However, the majority of board members supported the proposal, which was why he resigned in March 2012 (wp.net, 2012). A second reason for the President’s resignation was that the employment contracts for the WPK’s managing directors were extended for another five years by the outgoing President (a Big Four partner) without his giving notice to the incoming President, an act that was (probably correctly) deemed by Gschrei to be a breach of trust.

create incentives that deter them from taking action, whereas a few large players both influence and simultaneously benefit events to an extent that they can organise themselves quite easily. When we analyse the developments from this angle, then we can identify several key factors that enabled the two events described above to happen. However, and this is an interesting point in comparisons drawn from a range of countries, they were all sufficient rather than necessary. First of all, it seems that there was already a climate for small auditors in which they exhibited signs of resistance. However, as we have seen, such a climate also existed in other parts of the world (e.g. Canada), but did not lead to similar events. Then it seemed as if it was, in particular, the success of the knowledge claim, that is, the introduction of a far-reaching mandatory peer review system for all auditors with statutory audits in 2000, that was the last straw that broke the camel's back. While only a few small auditors suspected at first that the introduction of the peer review would lead to facing a further competitive disadvantage, it became increasingly obvious that the quality argument was far outweighed by the costs in the context of small auditors' practices. However, as we learned from the comparison with the case of the U.S. the peer review while being again – together with other causally relevant conditions – a sufficient condition could not have played this role alone; rather it was important that it was enforced under public law and that within a short time period this made its effect visible. Only then did it lead to the foundation of a separate professional body. Finally, the comparison with the UK showed us that more than the establishment of a second professional body was necessary to produce the palace revolt that took place in Germany, but not in the UK. Three more elements were necessary to make that happen: First, the institutional requirements that allowed small auditors to vote in absentia needed to be installed. However, while this was certainly necessary, it was still not sufficient, because the ICAEW, too, allowed voting to be done online or by post, fax, SMS (text) or telephone (Paragraph 26, ICAEW Council: Election Regulation).<sup>107</sup> Second, they needed to be mobilised by arguments. This happened because the IDW allowed wp.net to take counter-positions that were revealed to be valid. As was becoming all too clear, the German peer review confronted small German auditors with disadvantages and it imposed more and not – as previously argued by the IDW – fewer burdens on them. This gave wp.net additional credibility, as its prediction that the peer review would enormously worsen the situation of small auditors, and that large numbers of them would be swept out of the market increasingly materialized (at least partly). Each further step taken by the IDW and wp.net was then interpreted in the light of the previous events, so when inspections for audit firms with public interest clients were introduced in 2007, it was again argued that the disproportionate system tended to push small audit firms with public interest clients out of the auditing market (Gschrei, 2015b). Third, wp.net allied itself with PRIMUS and thus gained an invaluable partner that vociferously propagated it as being the one and only alternative left for small auditors – a message that reached even the smallest audit firm in the

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<sup>107</sup> Even the electoral system of the AICPA is based on a “mail ballot system”.

country. This finally mobilised the small auditors to an extent that allowed them to win the election at the WPK in 2011.

At the same time, it is interesting from a theoretical perspective to see what role was played by the media in this case. As we demonstrated, the PRIMUS Blog played a big role in the course of events: Before this alliance, wp.net was well-nigh invisible, after this alliance it became widely known and rapidly gained new members among the small auditors. This was, moreover, done in a fairly polemical way that reinforced the already existing teleo-affective structures of resistance at the site of small auditors. Three roles are fulfilled by this aggressive means of communication: the role of surveillance (and this time not for the small auditors, but rather for the professional bodies and the large audit companies) and the role of dispersion and therefore politicisation and the role of interest representation. These roles were implemented along with the above mentioned five communication strategies.<sup>108</sup> With respect to the first role, surveillance, we noted in the interviews with key players how cautious they had become and how they tried – in anticipation – to take potentially detrimental reactions to their own actions into account. Within the WPK, the WPK managing director noted:

“There was a clear cultural change in terms of transparent structures and processes, for example, as reporting guidelines for the advisory and executive board were introduced.”  
(Interviewee, WPK managing director)

Within the IDW this had, for example, the effect of mobilising small auditors on other occasions, too, in this institution, as in the case of joint audits:

“The Big Four were against [joint audits]. And initially the IDW was also against joint audits, however, when the small and mid-sized auditors made it clear that they wanted them, we had to acknowledge that we had no mandate with respect to joint audits from our members.” (Interviewee, WPK managing director)

Another example that demonstrates how wp.net has left its mark on the IDW is that in the latest IDW comment letter on the new EU Directive, the IDW itself argues (finally, after fifteen years of fighting against any relief for small auditors) that it is of the opinion that the attendance certificate represents a market entry barrier that should be eliminated (IDW 2014). This is particularly noteworthy when compared to the British case, in which the inspection process was “interpreted as a means for large firms to surreptitiously impose their conception of professionalism on other members of the profession” (Ramirez, 2013, p. 860). Here it was argued that the Big N-firms had an interest in legitimizing their dominant position because they were not the *de jure* standard setters (Ramirez, 2012). One way for them to do this is to suggest that they are members of a profession dedicated to the public interest, so the attempt to

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<sup>108</sup> The first three communication strategies can be assigned to the surveillance and politicisation role and the last two strategies address the role of interest representation.

attenuate the small practitioners' criticisms and restore a new natural order was in the interests of the large firms, too. A decisive measure was to redesign the inspection approach along the lines of the proposal made in the Moizer report, e.g. decoupling the audit situation from the inspection situation (Ramirez, 2013, p. 864). "Peace was restored to a professional body where small auditors could be 'great' firms again" (Ramirez 2013, p. 862), but the price they paid was that they had to accept to a large extent the working patterns of the larger firms. In the German case, large firms and the profession likewise try to sustain the impression that they are part of a profession that is dedicated to the public interest. However, they were forced to learn that there was a small bull terrier whose only activity appeared to consist in sniffing around to see whether their honeyed words corresponded to their actions and to start aggressively broadcasting even the slightest potential violations far and wide across the entire profession.

One recent example is the outcome of the election of 2014, which was used to point out once again the democratic shortcomings displayed by the Chamber: "If one Big Four member is elected onto the Management Board based on 892 votes, while the representative of wp.net with 11,214 is not, then this illustrates a rather strange understanding of democracy" (wp.net, 2014). The second visible effect consists in politicisation. Before the palace revolt, the majority of public accountants employed in the Big Four or medium-sized audit firms showed no interest at all in the all too distant activities of the Chamber nor in the politics of accounting regulation in general (Interview with IDW President Naumann). Today the PRIMUS Blog (nowadays called WP Watch) and the wp.net newsletters have become a kind of a daily tabloid for auditors who are indeed able to raise topics that are subsequently discussed among auditors. What remains open so far is the quality of the newsletters and the Blog and the question of whether the subsequent discussions are still shaped by arguments or rather by surrounding teleo-affective structures on which, as Schumpeter (1992) famously put it, "less intellectual capacity is wasted than on a bridge game" (Schumpeter, 1992, p. 415). This might make such activities and their effects something that should be feared rather than desired. So far, the evidence is mixed: Points that are well worth discussing and transparency frequently alternate with wild, baseless accusations.

Finally, the events described above do not just a bright light on the profession, but also raise many points worth discussing with respect to the sustainability of the business models used by both small and large auditors. We will address them in the following remarks, which will be structured to address the questions raised with respect to small auditors' business model, with respect to large auditors' business model and with respect to the implications of the future roles played by professions in the German audit industry.

With respect to the small auditors' business model the question has to be raised as to the significance of the events. Did the founding of their own, separate "professional body" imply

that small auditors can stop the increasing marginalization? For this to hold, they would need to be able to make a sustainable case for their remaining competitive. Over and beyond mere lobbying, they would have to demonstrate why it is still better to rely on small auditors, even though their services can probably not compete on price with services offered by the Big Four companies. Indeed, the site of small auditors indicates that there might be convincing arguments for the survival of small auditors. They include such arguments that small auditors may be able to provide long-term relationships not only at the partner level but also with respect to the workforce and that, as less delegation is involved, they possess a more holistic view of their clients' business. Similarly, they have the advantage of being able to build up over the long term relationships of trust that are so characteristic for members of professions. In this respect Jonnegard (2012, p. 70) notes:

“For smaller firms, the profession and support from the professional association are probably more important for the legitimacy of the auditor than they are for the larger firms. This might explain why auditors from smaller firms argued for balance in intra-professional relationships.”

At the same time, small auditors have to face up to the fact that economic and regulatory developments have promoted a situation in which the central knowledge claims of the auditing professions, i.e. the interpretation and application of IFRS and ISA, QC-systems characteristics, are defined by larger audit firms, and particularly by the Big4 networks, or national (IDW, WPK, AOC) and international (IFAC, IAASB) professional associations that are strongly influenced by the larger firms. Moreover, increasingly IT is employed in the course of audits to reduce audit costs. With respect to the regulatory environment, small auditors are therefore crucially dependent on the existence of a professional body that lobbies on their behalf and prevents any undue regulatory burden being imposed on them – a function which is now actively being taken on with more or less success in Germany by wp.net. Even then, however, it is open to question whether such a profession for small auditors has the capacity to ensure that a proper education is undertaken that can serve as a quality signal and that is able to lobby on behalf of its members on a credible basis. It is, after all, this that brings to the fore experts who are in a position to mobilise enough expert knowledge. Wp.net is in this respect at a critical stage now. On the one hand, it frequently manages to launch successful and well-thought out lobbying efforts and to reveal the disadvantages suffered by small auditors. On the other hand, it has also acquired the reputation of being a collection of grubby urchins within the audit profession, as it has on several occasions sought to engage the public by airing less well thought-out proposals and criticisms, which has consequently created the impression that a small group of people are engaging in a personal vendetta, rather than that professional politics can be pursued in this body.

With respect to economic developments, it is worth discussing whether small auditors can organise themselves so as to realise the benefits of specialisation and thus counter the price and margin pressures that they face at the market place. In this respect, it is interesting that the peer review triggered precisely such deliberations over specialisation and market-based cooperation between different small auditors with a view to reducing costs per unit (Engelken, 2005).

With respect to the business model used by the Big Four companies, common practices raise questions which amount to exactly the reverse, that is to say, which focus on the degree to which further specialisation can take place without the audit firm losing the holistic view that is so decisive for its professional character and that allows it to portray itself as an expert beyond the pure industrialised market forces that compete on price. In this respect it has often been stressed that in the US the former audit profession has already turned into a common or garden, regulated audit industry (Catasus, Nellman, & Humphrey, 2013, p. 46). Moreover, it is fair to ask how far a business model that is based more on capturing an ever large market share from small auditors and on increasingly generating additional work by successfully lobbying to increase the complexity of financial statements, and thus the amount of work that has to be done by auditors, can really be said to be successful. After all, it is not inconceivable that there may be a backlash once those who prepare the accounts realize more and more that the benefits do not justify the costs. Indeed, it should be noted that some years after the introduction of IFRS, preparers of accounts at index listed companies engaged in a widespread change in their audit opinion commissioning practices that resulted in an enormous decrease in audit fees (Manager Magazin, 2010). What is also worrying is the fact that compared with other industries, there is an absence among large audit firms of more than just incremental innovations that secure the long-term survival of the industry (Catasus et al., 2013). In this respect, it might be one important aspect that “innovation means learning to be different” – and that it is important to ensure that global convergence does not end up creating pressures to conform that eliminate any scope for auditing practice to learn from differences (Humphrey, Kausar, Loft and Woods, 2011).

Taken together, all of this raises questions about “one size fits all” measures. We believe that one reason for the at least temporary success enjoyed by wp.net might have to do with small auditors’ unwillingness to accept the notion that “one-size fits all” measures are in fact appropriate. Different types of audit firms might be valuable for different companies, and this should be communicated lucidly without reaching judgements on the question of whether an audit is first or second class. As our interviews revealed, for example, small auditors are regularly better at offering tailored solutions, as they approach their clients more from a generalist perspective than from a specialist’s perspective. The opposite is true of large audit firms, which certainly provide better and more uniform quality when it is a matter of complying with separable and complex laws and providing cost-efficient tick-box audits. Such differences provide, in our view,

promising avenues for research on whether the trend towards market consolidation are, in fact, desirable or not, and whether they are market driven or more politically driven (Humphrey, Kausar, Loft and Woods, 2011).

Last, the events are important when it comes to the future of the auditing profession and its self-regulatory bodies. In this respect, it should be noted that the attractiveness of the audit profession as an employer has suffered enormously in the recent past.<sup>109</sup> Given that practices increasingly differ between small auditors and large audit companies, it must indeed be asked whether a division of the profession into different specialised professions is not a necessary consequence of the different interests (Lenz, 2014) that arise as a result of the practices that prevail at the different sites. We might face here what Nicolini (2012, p. 167) characterised as a trigger to changing practices: “It is through such disputes that practices continually evolve in response to changes of circumstance. Conflict can continue until there is at least a basic agreement about what is acceptable or not in practice. When such an agreement falters, practices cease to exist, or the camps split, and the practice is divided in two or more distinct practices.” These disputes – with the introduction of a peer review system into the German audit profession being the trigger that got the ball rolling – could explain how a palace revolt could take place in the end and how a division between different segments of the audit profession could happen. Before the introduction of the QC-system, starting in 2002, every certified public accountant (*Wirtschaftsprüfer*) could do an audit of the financial statements; every member of the German audit profession could benefit from the knowledge claim of the whole profession. Since the introduction of the QC-system, the profession has been split up into two parts: one segment which has passed the QC-test and obtained the certificate it needs to do audits of financial statements, and another segment which does not participate. The introduction of an additional inspections system by the Auditor Oversight Commission (AOC) for auditors of PIE-clients has further segmented the audit profession into specialized auditors for PIE-clients and non-PIE-clients. In practice, the knowledge claim for the PIE-segment, which since 2005 has had to set up its financial group statements in line with IFRS, is more or less dominated by the Big4-firms (Ramirez 2012). As a result, a once unified audit profession – in the eyes of the public and the profession – which argued that an “audit is an audit” and that in principle every member could do an audit is now clearly separated into different segments with different and conflicting knowledge claims. Such developments nurture the suspicions of Humphrey, Kausar, Loft and Woods (2011) that “an audit is an audit” will only remain true at the most basic level of specification, while the audit itself can be expected to differ very much depending on the context

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<sup>109</sup> Three different indications can be put forward in this respect. First, whereas 1,141 examinees have participated in the German CPA exam in 2004, ten years later this number decreased by 48 % to only 596 examinees (WPK, 2004a). Second, also the number of newly appointed auditors has decreased. This has even led to the IDW initiating an image campaign among pupils and students ((Klein & Naumann, 2015). Finally, also the attractiveness of the discipline auditing at universities has decreased (Klein & Naumann, 2015, p. 568).



in which it is undertaken, the professionals who deliver the service and the regulation of the profession. However, even then a comparison between Canada and Germany – which both provide evidence of the observable and well-documented fragmentation within the audit professions – reveals that small auditors might end up very differently. Small practitioners in Canada “were reportedly marginalized and virtually expelled from the audit market” (Durocher et al. 2014, p. 29) and if they tried to stay in the audit business they were increasingly seen as “second-class auditors” who should be closely monitored, “especially through bureaucratized, panoptic-like controls” (Durocher et al. 2014, p. 32). This conclusion can be applied to the German audit profession, too, but in stark contrast to Canada, where small auditors “willingly accepted to be monitored and to monitor themselves in the conduct of their professional activities” (Durocher et al. 2014, p. 33), we document in our paper a very strong form of opposition and resistance to the above mentioned bureaucratic controls. Durocher et al. (2014, p. 37) found small practitioners’ “propensity to accept their peripheral and marginalized status”, while we found that small auditors emancipated and – unlike the case of Canada – distinguished themselves clearly as “the true profession” from the audit practices seen in Big Four companies and the traditional professional bodies. Indeed, they started themselves to monitor and if necessary to discredit audit practices in large companies as being unworthy of the members of an audit profession. Generally, these audit professions can, then, be best understood as “segments in movement” (Bucher & Strauss, 1961) which can collide and for which outcomes might be different.

The still frequent use of the mantra “an audit (opinion) is an audit (opinion)” in regulatory debates in the auditing profession has, then, changed its meaning. Previously, it was a necessary and widely accepted general understanding that was used to hold together the different audit practices of small local firms and large transnational audit practices within one profession. This benefited both practices, because smaller firms are part of the same profession as the more reputable and better known larger elite firms. On the other hand, larger firms benefit because as a profession it is easier for them to use the public interest argument in regulatory debates, i.e. economic interest can be masked behind the public interest (Ramirez 2013, p. 860). With practices drifting apart, however, it becomes increasingly a form of *symbolic power* that “can be exercised only through the complicity of those who are dominated by it. This complicity is all the more certain because it is unconscious on the part of those who undergo its effects – or perhaps we should say its more subtle extorted from them. [...] the element of arbitrariness at the heart of its functioning [...] remains unrecognized” (Bourdieu, 1987, p. 844). The big firms which dominate the leading professional bodies WPK and IDW, and which via these bodies define to a large extent the ‘rules of the audit (quality) game’, can use the common assumption to force their definition of audit quality on the audit practices of small auditors. Stringfellow et al. (2015, p. 97) argue for the UK that the Big4 used symbolic power and violence “subjecting smaller firms to

systematic monitoring and scrutiny of their practices. They are increasingly judged according to the standards set by the Big Four who are ‘quasi-exclusive’ producers of accounting and auditing standards and the *de facto* voice of the profession” (see also Ramirez, 2009). Whereas Bourdieu assumes that symbolic power is not recognized by the dominated agents, Stringfellow et al. (2015, p. 97) argue that in the audit field the increasing and well-documented divide between the Big4 and the remaining firms “makes it unlikely that dominated agents will not be conscious, to some degree, of their subjugation” and that is exactly what we can observe, in a more pronounced guise than in UK, in the German context.

#### 4.7 Summary & Limitations

In the previous sections, we analysed the emergence of a second professional body for small and mid-sized auditors, which subsequently led to the palace revolt in the German auditing profession. As such, these events present a case in which resistance by small auditors against the overwhelming dominance of Big Four auditors is demonstrated to have been successful. We showed that, very much like in other countries, the situation facing the small auditors had already deteriorated over decades and we demonstrated how the introduction of the peer review, which effectively swept many of them out of the market for audits, in the end led to their mobilisation. However, we also show that several other factors were needed to allow the association to make a difference. Unlike the U.S. case, for example, quality control did not tighten over decades, but instead within a short period of time, and it was extended to the private audit client segment. Thus, small auditors proved to be able to organise themselves. Unlike the UK case, small German auditors proved also to be able to take over, at least temporarily, the professional regulation in Germany. Three factors might have accounted for this: the first factor was that the counterpart of the large auditors, the IDW, showed little inclination to take care of the interests of the small auditors. The second factor was that wp.net was soon successful in political lobbying and thus provided small auditors with the feeling that it was looking after their interests. Finally, the collaboration between wp.net and PRIMUS furnished wp.net with a loud speaker which somewhat resembled a ship’s klaxon and which soon seems to have awakened with its roar even the last rural audit practitioners’ office.

Our discussion has revealed that the case raises a whole number of further questions: questions about the future of a unified profession, about the existence of an audit profession or its possible relegation to the status of a regulated industry, and about the sustainability of the business model used by small auditors and by large audit practitioners. Moreover, while it has revealed that even among such highly educated people as German auditors, it is the rhetorically gifted loud-speaker rather than the refined argument that makes a big difference in complex business activities: whether this is a desirable development has been left open to debate.

An important limitation to our study is that we did not ourselves engage in observations or even carry out ourselves practices at the sites of small and large firms. This contradicts Schatzki's recommended empirical work to some extent:

“Incidentally, identifying practice-arrangement bundles requires considerable ‘participant observation’: watching participants’ activities, interacting with them (e.g. asking questions), and – at least ideally – attempting to learn their practices” (Schatzki 2005, p. 476).

As a consequence, we can only rely on statements made by the parties involved. This is a limitation that many studies in auditing have, as “there is very little of what is called “field work” in auditing” (Power, 2003, p. 308). However, as outlined above, we have tried to mitigate this problem by taking recourse to a vast number of different sources that describe practices from different angles. The usual limitations of studies that are to a large extent based on the interviewer, on the one hand, and the distortions created by interviewees using their opportunity to paint favourable self-portraits, on the other, (cf. the latter also Kornberger, Justesen, & Mouritsen, 2011) apply here, too. Another problem can arise insofar as interviews were not conducted to the point of theoretical saturation. In our case, we cannot guarantee that there may not exist some further insights beyond our interviews. To counter these problems, we have searched for additional information in order to triangulate the interviews’ findings as far as possible.

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