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Audit Planning Activities and Reporting Decisions**

*Comparative Questionnaire Surveys 1995 and 2005 in a Danish Context*

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*Publication date:*  
2007

*Document Version*  
Publisher's PDF, also known as Version of record

[Link to publication from Aalborg University](#)

*Citation for published version (APA):*

Kiertzner, L. (2007). *Effects of New Audit Regulation on Auditor's Perceptions by Independence Issues, Audit Planning Activities and Reporting Decisions: Comparative Questionnaire Surveys 1995 and 2005 in a Danish Context*. Paper presented at Annual Congress of the European Accounting Association, Lisbon, Portugal.

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# ***Effects of New Audit Regulation on Auditors' Perceptions by Independence Issues, Audit Planning Activities and Reporting Decisions – Comparative Questionnaire Surveys 1995 and 2005 in a Danish context***

## ***Abstract***

*This paper examines the effects of new audit regulation on the behaviour of Danish State Authorized Public Accountants when they confront independence threats, audit planning activities and reporting problematic findings in the audit report.*

*The detail approach and the stressing of the importance of scepticism in new audit regulation are expected to make the auditors' decisions by interpreting principles more restrictive, or direct in conformity with prescriptive regulation, whereas the importance of professional judgement is diminishing by independence threats and reporting decisions. Furthermore, the complexity of the new audit process is likely to increase the weight of planning and reporting activities, the use of qualified resources (senior staff and State Authorized Public Accountants) and interim auditing.*

*The approach used is questionnaire surveys in 1995 and 2005 respectively, in 1995 with 94 and in 2005 with 121 State Authorized Public Accountants as respondents.*

*The hypotheses are supported, except for the absence of an expected complexity effect of the new audit process in the context of a small audit engagement. Auditors are more restrictive in 2005 when confronted with threats of self evaluations by second engagements for an audit client, by a big audit client they take the complexity of the new audit process into account, and they do more often report problematic findings in compliance with regulation in 2005. Finally their reporting decisions are less influenced by external factors in regard to consequences for the client and the personal relation to client management in 2005.*

*Furthermore it seems likely that many of the effects are more conspicuous in Big Four audit firms. This could portend more strict reactions in the future in general given that new tendencies are first discernible in big leading audit firms.*

**Keywords:** Effects of new audit regulation, Independence, Audit planning activities, problematic findings in the audit report

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# *1 Purpose*

The overall purpose of this paper is to analyse the influence of the intensified regulation on auditors' attitudes relating to different aspects of an "audit of historical financial information" in a Danish context.<sup>1</sup> Independence, planning/performing/reporting audits, and reporting problematic findings are the three main themes of the paper. The intensified regulation is manifest in laws, the new 8.th Directive of the EU, and, most significant, in the new international standards on planning the audit, which have been implemented as Danish Audit Risk standards 12.15. 2004.

Auditors' attitudes in 2005 are compared to attitudes expressed in a survey from 1995. For this reason, all questions are from Kiertzner (1996) with some minor necessary adjustments.

In general, new regulation is detailed as opposed to being based more exclusively on principles with a reference to the auditors' professional judgement. This by nature leads the auditor always to consult the rules for answers while on the other hand auditors' professional judgement more rarely is considered a valid base for making decisions. Besides, an ever increasing number of references to the need of a sceptical attitude are fundamental characteristics in the wake of Enron, Worldcom, Parmalat etc. Obviously, these references create an impetus to be restrictive by interpretations of principles.

In general the questions in the survey cf. Appendix 1 on independence and reporting problematic findings are focused on issues where regulations in 1995 and in 2005 are quite similar in the Danish context. This makes it possible to analyse, in reporting cases whether auditors in 2005 to a higher degree are abiding by rules and in independence cases whether they are more restrictive interpreting principles.

The Danish setting is characterized by very widespread legal audits, being a member country of the EU.<sup>2</sup> This means that many traditional SME-problems are paramount. The auditor often provides accounting assistance to an audit client with immanent threats of self evaluation. On balance, auditors' assistance to SME` is most likely a benefit to society, and a too restrictive interpretation of the principle of independence would therefore probably be a detriment. By planning the audit, some of the main

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<sup>1</sup> This terminology is from the IAASB framework for assurance engagements – audits and reviews of historical financial information (100-1999 and 2000-2999 respectively) and other assurance engagements (3000-3999).

<sup>2</sup> Only very small limited companies are exempt from audit in the Danish context. Two out of three limits may not be exceeded: assets of app. 200 t. Euros, turnover of app. 400 t. Euros and 12 employees. The limits of possible exemption in the EU Directives are app. 3.900 t. Euros for assets, app. 7.800 t. Euros for turnover and 50 employees.

SME issues would be to downsize the risk assessment procedures to fit the planning of the audit in a simple context, to carve out the necessary level of documentation, including documentation of what might be seen as an evident and a priori fact that audit plans overall need to be based on substantive procedures, and to interpret the statement that substantive procedures in some cases are inadequate as sole vehicle to obtain sufficient appropriate audit evidence. By planning the audit, over-implementation and thereby audit inefficiency seems to be the greater risk. In relation to reporting problematic findings, the SME risk on the other hand is under-implementation. How to combine the assisting role with the critical function is a central issue. In many cases of the past the auditors' professional judgement might in practice have led to overriding legislation, or to consider legislation as "theory" that should be bypassed and overruled by real life necessities in specific circumstances. With the intensified regulation and impetus on the sceptical attitude such a SME override is harder to justify.

The next section 2 deals with the characteristics of newer regulation, before section 3 presents the research questions and the surveys in context. The analysis follows in section 4 and section 5 sums up.

## ***2 The basic elements in new regulation – scepticism and detail rule approach***

### ***2.1 Scepticism***

Following in the footsteps of accounting regulation the need for a sceptical attitude is gaining ground in new standards on auditing, ISA. Scepticism has two aspects:

- The dominant aspect in relation to management representations and other types of audit evidence, and
- A minor aspect in relation to the auditor, securing that the auditor does what is deemed necessary considering circumstances.

The required sceptical attitude when the auditor is confronting management representations and other audit evidence is manifest in a rising number of explicit statements.

The importance of the auditor being sceptical is stressed in the generic planning standards RS 315 and RS 330 (2005) when obtaining audit evidence throughout from risk assessment procedures and risk assessments to general and specific reactions addressing identified risks of material misstatements. This basic requirement is stressed further in RS 240 (revised 2006) in relation to fraud.

On a more specific level scepticism is stressed in current updating projects with regard to standards on audit evidence. ED ISA 540 (2006) requires the auditor to do more specific evaluations of whether managements' accounting estimates are materially misstated and further whether such misstatements are resulting from management bias. Most significant, ED ISA 550 (2006) on related parties is per se with explicit reference to Enron and Maxwell. Undisclosed related party transactions and affiliations were major instruments in cheating the market successfully for a long time.<sup>3</sup>

A further manifestation of scepticism is the increasing number of references to management responsibilities in auditing standards. In essence, this is merely redundant references to facts from corporate law. When law and regulation oblige the auditor to remind management of its responsibilities in a rising number of cases it can only be interpreted as manifestations of scepticism. Examples of paraphrases of management responsibilities are RS 240 (revised 2006) in relation to fraud, and the far more detailed elaboration in the new RS 700 (revised 2007) when compared to RS 700 in the context of the audit report.<sup>4</sup>

Scepticism on such a high note is as of yet not a dominant main feature in relation to the auditor. Standards are still mainly based on the assumption that auditors will comply with the rules, and that they do not actively seek for loopholes in the structure of standards but rather try to fill gaps by professionally considering the necessary steps when obtaining sufficient appropriate audit evidence. An explanatory factor behind this may be that audit standardization internationally still to a high degree is professional regulation.<sup>5</sup>

Small signs of standardsetter scepticism as to whether an auditor will always make the right choice are nonetheless observable in some black letter paragraphs in RS 240 (revised 2006) on management override of internal controls, broad investigative inquiries into fraud on different organizational levels, and the a priori assumption that income recognition is a significant risk of material misstatement due to fraud with the generic consequences known from RS 330 (2005).<sup>6</sup> From a strictly professional point

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<sup>3</sup> Jf. IAASB (September 2004), agenda 2 A, Revision of ISA 550 "Related Parties. Issues Paper". The heading of paragraphs 2-5, arguing the case of the project, is plain and simple "Lessons From the Enron and Maxwell Cases".

<sup>4</sup> Cf. on management representations in the former RS 240 (2004), paragraph 51, and the existing fraud standard RS 240 (revised 2006), paragraph 91. On paraphrasing management responsibilities in the audit report, cf. RS 700 (revised 2007), paragraph 60.

<sup>5</sup> The pressure on this status is outspoken, cf. Public Company Accounting Oversight Board in the US, and the EU Commissions' pressure on IFAC and IAASB to involve non-professional interests (e.g. political interests) in the process as a prerequisite of sanctioning standards after the new 8. directive, cf. EU Commission 2004, p. 6. EU-implementation will be dependant on "satisfactory governance arrangements relating to the operation of the IAASB being established".

<sup>6</sup> Cf. RS 240 (revised 2006), paragraphs 74-76 (management override), paragraphs 34-47 (broad in-

of view all these procedures can be conceived of as merely underlining the fact that the subject matters will always (or nearly always, for the method of income recognition) be significant risks of material misstatements due to fraud.<sup>7</sup> Explaining this in such detail nonetheless implicitly rests on scepticism as to whether any auditor would reach these conclusions when left on his own.

Another sign of a minor key of mistrust is manifest in the reason given for dividing "modifications" in the existing RS 701 into "modifications" meaning qualifications in the coming ED 705 (2006) and "emphasis of matter and other matter paragraphs" in the coming ED ISA 706 (2006). This division is explicitly intended to make it obvious to the auditor that the two concepts are complementary. It is not possible to hide away a qualification (e.g. because of a disagreement with management) as an, in the eyes of the client perhaps, less critical emphasis of matter paragraph.<sup>8</sup>

Such signs of scepticism in the professions' regulation may historically be attempts to avoid that standardization is taken out of the hands of the profession. This goal is no longer achievable, it seems. In the US the SOX legislation and the PCAOB has put an end to the professions prerogatives, and a similar development is well underway in the EU, cf. the revised 8.directive, whose standard approving mechanism is without influence from the profession.

## *2.2 Detail Rule Approach by Standardsetting*

Another basic characteristic of new international auditing standards is the dominance of the US-inspired detail approach, and the corresponding defeat of the principle based approach as it was traditionally ingrained in the work of the IAASB. Somehow this seems a paradox considering that the crisis of auditing as a trustworthy profession primarily has an US background. "More of the same" seems a bad choice since it did not work in the past, and furthermore since the diagnosis: "poor and defect detail rules", often is a genuinely wrong diagnosis for US corporate debacles.<sup>9</sup>

The detail approach is dominant in the overall audit risk model as such in RS 300 (2006), RS 315 (2005), RS 330 (2005) and RS 500 (2005) on planning activities and generic audit evidence. RS 315 especially seems very complex, full of redundancies and unnecessary details and therefore less comprehensible. As a next step RS 240

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quiries as risk assessment procedures), and paragraphs 60 and 110 (on income recognition).

<sup>7</sup> Classification as a significant risk of material misstatement has the usual consequences: internal control has to be considered (understanding design and implementation) and if possible tested, further substantive procedures have to be performed, and if all audit evidence is obtained from substantive procedures some of these have to be tests of detail. Finally, no rotation of tests of controls is possible.

<sup>8</sup> Cf. IAASB (March 2005), Explanatory Memorandum p. 2.

<sup>9</sup> A more balanced analysis indicates that most corporate scandals was combined with trespassing detail rules and not in the first place taking advantage of loopholes in a defect structure of rules. On Enron, cf. Enron Report (2002) and based upon this report George Benston, Michael Bromwich, Robert E. Litan & Alfred Wagenhofer (2003).

(revised 2006) in its structure includes a total audit process relating to the subject matter “fraud”, and details a multitude of audit procedures as fundamental reactions to general and specific risks of material misstatements. This tendency is further broadened in coming new revised standards such as ED ISA 540 on accounting estimates, ED ISA 320 on materiality and ED 550 on related parties, with audit process conformity, auditors’ scepticism and more exact detail rules for identifying misinformation as a few keywords behind the fact that the new revised versions are triple+ the size of the outdated versions. To mention is furthermore the new reporting standards RS 700 (revised 2007), ED ISA 705 and ED ISA 706 with broad descriptions of the new audit process and of management and auditor responsibilities.<sup>10</sup>

A further manifestation of detail based ruling is IFAC’ Code of Ethics which is an integrated part of the IAASB’ standards. The rules on independence are presumed to be based on principles regarding threats and possible safeguards, considering deduced perceptions of a well informed third party. Nonetheless, the many examples given are likely to be handled by auditors as if they were detail rules, especially in the post-Enron context of good behaviour. The principle based approach is likely to disappear into vagueness.

### *2.3 Expected Consequences of Scepticism and the Detail Rule Approach*

The focus on scepticism as the domineering attitude of auditors’ and the growing importance and weight of detail rules are expected to have a number of consequences.

By independence issues it is expected that auditors will be restrictive by decisions of whether other assignments are compatible with the audit assignment. The many detailed examples of threats caused by risks of self evaluation are likely to be practiced as if they were rules, especially in the actual circumstances where eager and sceptical implementation is the dominant tone.

By planning an audit engagement it is expected that the new RS will lead to the use of, on average, more qualified resources. An audit is expected to be more complex, since risk assessment procedures, risk evaluations and tests of controls are heavier building blocks in the new audit risk model. These procedures are not likely to be delegated to un-experienced assistants in the audit team. Besides it is to be expected that planning and reporting activities will be upgraded compared to performing activities, and finally that a larger proportion of the audit activities will take place interim, since this is typical by performance of risk assessment procedures and tests of controls. The new audit approach would on balance be some combination of more qualified personnel, more planning/reporting activities and more interim audit procedures.

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<sup>10</sup> ED ISA 540 (revised), ED ISA 550 (revised), ISA 700 (revised 2004), ED ISA 705 and ED ISA 706.

By reporting, some effects are expected as consequences of auditors being focused on rules whereas the auditors' professional judgement as a rationale for making individual departures in specific circumstances is relegated to a minor position. In the past, many auditors in a Danish context have had a false conception of theory versus regulation versus practice, often outright mistaking regulation for theory. Educational background was a major reason behind this, since most State Authorized Public Accountants hardly ever were confronted with theory. By such a misinterpretation, "rules as mere theory" could always be overridden by practical circumstances, and this override was the broad playing field for the professional judgement of the auditor. Scepticism and the weight of rules will probably per se in the future lead the auditors to be more in conformity with written rules.

### ***3 Surveys and Research Questions***

The questionnaire is shown in Appendix 1. The questions were, with minor necessary adjustments, the same in 1995, cf. Kiertzner (1996), and in 2005.

#### ***3.1 The Surveys***

In the 1995 survey, questionnaires were mailed to 216 randomly selected State Authorized Public Accountants, and 94 valid answers were obtained, cf. Kiertzner (1996). The sampling was made systematically from a membership list provided by the Institute of State Authorized Public Accountants.

In the 2005 survey, questionnaires were mailed to 400 randomly selected State Authorized Public Accountants from the electronic membership list of the Institute. 121 valid answers were obtained.

The response rate declines from 43 to 30 %, probably resulting from a higher workload, cf. Appendix 2, and a rising number of survey participations. In both years tests were made for late response effects. Since none was found, it seems legitimate to consider the sample respondents as fair bases for evaluation of population statistics.

Appendix 2 shows some demographic characteristics of sample respondents. Table 1 below shows figures for the independent variables that are used later in multiple regression analyses. The survey question is in Appendix 1, Question 1.



*Table 1 Independent variables – Big Six/Big Four, Age and Audit-Speciality*

		1995	2005	Total
Big Six/Big Four	No	56	66	122
	Yes	35	55	90
Total		91	121	212
Age +45	Younger (Max. 45)	51	45	96
	Older (45+)	43	76	119
Total		94	121	215
Audit Specialist	No (-30 % of time)	59	72	131
	Ja (30+ % of time)	34	44	78
Total		93	116	209

## 3.2 Research Questions

### 3.2.1 Independence

Independence scenarios, cf. Appendix 1 Question 2, are all on subjects in the grey zone where no absolute solution existed in neither 1995 nor 2005. In this way, the auditors' personal attitudes and mental setup is tested relative to boundaries of principles. By establishing grey zone scenarios it was taken into account that Danish legal regulation in the period shifted from a strict regulation on general independence combined with some rules on specific independence to the international standard principle based rule on independence in appearance and independence in fact. All scenarios relate to principles only and not prescriptive rules.<sup>11</sup>

The nine scenarios in Question 2 are similar in structure: whether the respondent as the auditor of the financial statements would also consider himself to be able to accept, with or without safeguards, another assignment for the same entity. The second assignment is:

- Preparation of the memorandum of association/articles of incorporation
- Preparation of a shareholders agreement
- Preparation of registration forms
- The role as tax-advisor for the entity
- The role as tax-advisor for the founders personally
- Development and implementation of EDP-based accounting systems
- Bookkeeping on the basis of manual journals of the entity
- Compilation of the financial statements of the entity

<sup>11</sup> This shift was made effective in the law on auditors LSRR September 1. 2003. This law implemented the recommendation of the EU Commission (2002). Later the IFAC Code of Ethics was implemented, cf. FSR (Bestyrelse og Etikudvalg) (2004) and IFAC (2004).

To secure the grey zone status in 2005 the scenarios were explicated not to concern so called public interest entities, since these on a few of the scenarios are strictly ruled en detail.

- Compilation of the financial statements of the entity by another State Authorized Public Accountant in the audit firm.

All the scenarios should be answered by unconditional acceptance – “Yes” – or unconditional refusal – “No” – and finally acceptance based on necessary safeguards – “Yes, if ...”

The hypothesis is:

H<sub>1</sub> Auditors’ unconditional acceptance of another assignment simultaneous with the audit assignment in scenarios with no prescriptive rules is less likely in 2005 than it was in 1995.

### 3.2.2 *Audit planning activities*

Audit planning questions are deducted from a small client scenario and a big client scenario, cf. Appendix 1 question 3 and 4. The two questions represent planning activities by a small audit client and a bigger sized audit client respectively.<sup>12</sup> It is expected that the new risk based approach requires:

- More qualified audit resources (relatively more time allocated to senior staff members of the audit team and State Authorized Public Accountants)
- Use of relative more time on planning and reporting of the audit
- Use of relative more time interim because of the focus on risk assessment procedures and tests of controls.

The variable

$$\log (\text{qualified time (\%)} + \text{planning/reporting (\%)} + \text{interim (\%)})$$

measures the cumulative effect of the new risk based audit approach. The hypothesis is:

H<sub>2</sub> Auditors use a more risk based audit approach in 2005 than they did in 1995.

### 3.2.3 *Reporting in the audit report*

Reporting on problematic issues is the subject of five different scenarios in Appendix 1, Question 5 and 6. For all five scenarios the regulation 2005 is basically unchanged

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<sup>12</sup> The numbers for assets etc. were inflated with the price index in 2005 (up by app. 23 %) to secure the same size of clients in the two years.

compared to 1995. In this way, the responses only measure the degree of the rule conformity of the auditors.

The scenarios are:

- Disagreement with management who does not disclose required information on important R & D activities in the Directors' report (Special Danish regulation requiring a qualified opinion<sup>13</sup>)
- Possible penalty because management does not entirely fulfill the legal requirements on safekeeping of accounting records (Special Danish regulation requiring an other matter paragraph<sup>14</sup>)
- Disagreement with management regarding useful life (and consequently depreciation) of machinery (qualified opinion)
- Possible penalty because of a violation of the limits for discharging of waste water (Special Danish regulation requiring an other matter paragraph<sup>15</sup>)
- Uncertainty regarding the presumption of going concern (qualified/adverse opinion or an emphasis of matter paragraph).

The hypothesis is:

H<sub>3</sub> Auditors more often report on problematic issues in the audit report in 2005 than they did in 1995.

In the questions, cf. Appendix 1 the respondents are asked to specify their exact reaction. In the context of this paper, the line is drawn between respondents who will report on the problematic issues in the audit report versus the respondents who will not. The exact form of modification is not taken into account and is deemed less important to the public.<sup>16</sup>

By going concern uncertainty, cf. Question 6 in Appendix 1, it is furthermore tested, whether the auditors' reporting decisions depend on external factors. When the going concern assumption is problematic, the auditor is under extreme pressure, since his

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<sup>13</sup> The reason for this is that not only the financial statements but also the Directors Report lies inside the scope of an audit in a Danish context. Normally, the scenario could result in an emphasis of matter paragraph, cf. RS 720 and RS 700.

<sup>14</sup> This terminology is from the future ED ISA 706. In existing Danish regulation it is still called an emphasis of matter paragraph.

<sup>15</sup> Cf. footnote 14.

<sup>16</sup> These limitations of analyses are necessitated by the fact that the prescriptive rules on how to report exactly are slightly different in 2005 than they were in 1995. This is especially the case by going concern uncertainty where the "subject to"- modification was handled as an all inclusive category in 1995.

decision on how to cope with the situation in the audit report may be decisive for the audit clients' survival. This auditors' reporting sensitivity is measured on a four level Likert scale for the variables:

- Third Party reactions
- Unfavourable consequences for the company
- Effect on the relationship between auditor and company board/management.

The hypothesis is:

H<sub>4</sub> Auditors are less influenced by external factors by reporting decisions 2005 than they were in 1995.

#### *3.2.4 Influence of independent variables besides the year of survey*

Besides the expected influence of whether the respondent is from 1995 or 2005 the multiple regression analyses of the next section will test for whether Big Six/Big Four affiliation, the respondents' age and degree of expertise in relation to audit assignments have any influence.

Expressed vaguely, there might be some tendencies to faster implementations of new practices in the multinational audit firms, by younger practitioners and by audit specialists.

## **4 Analysis**

In table 2 multiple regression analyses are shown for testing the hypotheses relating to the three dependent variables:

*Acceptance of other assignments:*

Average of the nine different scenarios (0-1)

*Risk based audit approach by the Big Client/Small Client:*

Log (qualified time (%) + planning/reporting (%) + interim (%)) (0-6)

*Reporting problematic findings:*

Average of five different scenarios (0-1)

The dependent variables in the analyses are:

*Year*

1995 = 0      2005 = 1

*Big Six/Four*

Non Big Six/Four = 0

Big Six/Four = 1

*Age*

1 -              Discrete, years of age

*Audit Specialist*

1 – 100 % of productive time on audit assignments

Table 2 Multiple Regression Analyses – Effects of New Audit Approach 2005 vs. 1995

	Acceptance of Other Assignments	Risk-based Audit Approach Big Client	Small Client	Reporting Pro- blematic Issues
Constant	0.759*	2.138*	2.070*	0.486*
Year	<b>-0.309*</b>	<b>0.144***</b>	0.058	<b>0.476*</b>
Big Six/Four	<b>-0.165**</b>	<b>0.137***</b>	<b>-0.157**</b>	0.015
Age	<b>0.136**</b>	-0.038	0.053	-0.026
Audit Specialist	-0.095	0.088	<b>0.140***</b>	<b>-0.118***</b>
R <sup>2</sup>	0.161	0.049	0.036	0.229
Durbin-Watson	2.015	1.923	2.103	1.993
Max. Correlation	0.257	0.257	0.257	0.257
* Significant < 0.01      ** Significant < 0.05      *** Significant < 0.10				

The multiple regression analyses of table 2 supports H<sub>1</sub> and H<sub>3</sub> whereas H<sub>2</sub> is only partially supported by the big client and not at all by the small client. The results indicate that auditors react more strict by visible and obvious issues of evaluating threats relative to their independence and their reporting obligations than they do on the more complex issue of audit planning activities.

Besides, more of the analyses show a significant Big Four effect since auditors here are more alert to new developments. They are more likely to reject second assignments for audit clients, and are more consequently implementing the new audit risk

model by the big client, whereas this model does not seem to have the same effects when implemented by small clients.

When dividing the reporting variable into reporting material problematic issues (R&D, Useful life of assets and Going concern uncertainty) and reporting formal problematic issues (Safekeeping of accounting records and Penalty for discharging of waste water), table 3 shows that the effect of “abiding by the rules” is by far more significant by the formal issues. This indicates that auditors’ professional judgement in their perception is no longer as it was the case in 1995 a base for an override of prescriptive rules in the legislation as “merely theory”.

Table 3 Multiple Regression Analyses – Reporting Material vs. Formal Matters in the Audit Report 2005 vs. 1995

	<u>Reporting formal problematic issues</u>	<u>Reporting material problematic issues</u>
Constant	0.295**	0.642*
Year	<b>0.538*</b>	<b>0.257*</b>
Big Six/Four	-0.066	0.076
Age	-0.009	-0.043
Audit Specialist	<b>-0.117***</b>	-0.080
R <sup>2</sup>	0.297	0.072
Durbin-Watson	1.947	2.157
Max Correlation	0.519	0.257
* Significant < 0.01    ** Significant < 0.05    *** Significant < 0.10		

Table 4 shows reporting decision dependency on external factors. The three independent variables are:

#### *Third Party Reactions*

Likert scale 1= no influence ..... 4 = great influence

#### *Unfavorable consequences for the company*

Likert scale 1= no influence ..... 4 = great influence

*Effect on the relationship between auditor and company board/management*

Likert scale 1= no influence ..... 4 = great influence

The independent variables are the same as by the tests shown in table 2 and 3.

Table 4 Influence of External Factors by Reporting Going Concern Uncertainty (Likert Scale 1-4)

	<u>Third party reactions</u>	<u>Unfavorable consequences for the company</u>	<u>Effect on perso- nal relations</u>
Constant	2.680*	2.521*	2.519*
Year	0.019	<b>-0.316*</b>	<b>-0.283*</b>
Big Six/Four	<b>-0.168**</b>	-0.083	-0.056
Age	-0.080	0.027	-0.057
Audit Specialist	0.063	-0.058	<b>-0.156**</b>
R <sup>2</sup>	0.031	0.115	0.126
Durbin-Watson	1.854	1.913	2.122
Max. Correlation	0.257	0.307	0.287
* Significant < 0.01      ** Significant < 0.05			

The analyses in table 4 support H<sub>4</sub> except for the reporting sensitivity by Third party reactions. The Big Four firm auditors, though, show the expected reduced sensitivity on this factor as well.

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IAASB Meeting March 2005	Agenda Item 13, Modified Auditors Report. Explanatory Memorandum
IFAC Code of Ethics (2004)	Code of Ethics for Professional Accountants
Lars Kiertzner (1996)	En komparativ undersøgelse af revisors tilgang til den lovpligtige revision af kapitalselskabers årsregnskaber i UK, Tyskland og Danmark, ph.d.-afhandling HHÅ 1996
RS 240 (ajourført 2006)	Revisors pligt til at overveje besvigelser ved revision af regnskaber (Danish implementation of ISA 240 (revised 2004), The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements)
RS 300 (2006)	Planlægning af revision af regnskaber (Danish implementation of ISA 300 (2004), Planning an Audit of Financial Statements)
RS 315 (2005)	Forståelse af virksomheden og dens omgivelser og vurdering af risiciene for væsentlig fejlinformation (Danish implementation of ISA 315 (2004), Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement)
RS 330 (2005)	Revisors handlinger som reaktion på vurderede risici (Danish implementation of ISA 330 (2004), The Auditor’s Procedures in Response to Assessed Risks)
RS 500 (2005)	Revisionsbevis (Danish implementation of ISA 500 (revised 2004), Audit Evidence)
RS 700 (ajourført 2007)	Den uafhængige revisors påtegning på et fuldstændigt regnskab med et generelt formål (Danish implementation of ISA 700 (revised 2004), The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements)

# *Appendix 1*

## *Questionnaire*

### *1 Personal information*

#### *Your fields of activity*

Please answer the following questions concerning your fields of activity.

Approximate number of working hours a year  
\_\_\_\_\_ hours

Working hours divided between direct and indirect time (approximate)

Direct client-related time	%
Indirect time	_____%
	100 %

Division of your direct, client-related time (approximate)

Audits of financial statements	%
Accounting services	%
Tax advisory services	%
Legal advisory services	%
Other client-related work	_____%
	100 %

#### *Your age*

Please give the following information regarding your age

Your present age	_____years
Your age when qualifying as a State Authorized Public Accountant	_____years

#### *Your sex*

1 Female	2 Male
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#### *Information about your firm*

Part of/affiliated with the Big Four?	1 yes	2 no
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Approximate number of professionals (including staff)  
in Denmark \_\_\_\_\_

Approximate number of offices in Denmark \_\_\_\_\_

## ***2 Independence***

Please consider the following cases concerning problems related to combining the role as an auditor with some other function. Assume that the cases do not involve special important companies (listed companies e.g.)

- a. In connection with the incorporation of a company you have accepted to take on the audit. The founders ask you if you can take on the following services as well:

Preparation of the memorandum of association/articles of incorporation

1 yes

2 no

3 yes, if \_\_\_\_\_

Preparation of a shareholders agreement

1 yes

2 no

3 yes, if \_\_\_\_\_

Preparation of registration forms

1 yes

2 no

3 yes, if \_\_\_\_\_

The role as tax-advisor for the company

1 yes

2 no

3 yes, if \_\_\_\_\_

The role as tax-advisor for the founders personally

1 yes

2 no

3 yes, if \_\_\_\_\_

## ***2 Independence (continued)***

- b. You are the management consultant for a company. Your fees from this job come up to 9 % of your gross revenue. The consulting concerns EDP, e.g. development and implementation of EDP-based accounting systems. The client suggests that you might take over the audit because you know the accounting systems so well. The audit fee will probably be of the same size as the consulting fee you have been receiving up until now.

1 you will take on the audit

2 you will not take on the audit

3 you will take on the audit, if \_\_\_\_\_

- c. One of your audit clients asks you

whether you could take over the bookkeeping on the basis of manual journals of the client.  
You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

whether you could take over the compilation of the financial statements. You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

whether another State Authorized Public Accountant could take over the compilation of the financial statements while you remain as auditor. You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

## ***2 Independence (continued)***

d. One of your audit clients asks you

whether you could code transactions using a general chart of accounts accepted and issued by management. You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

whether you could make a due diligence report prior to the clients acquisition of a subsidiary. You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

whether you could use your experience to estimate the useful life of tangible assets, so that management can use your estimations afterwards. You answer

1 yes

2 no

3 yes, if \_\_\_\_\_

## ***3 A typical small audit engagement***

Suppose that a small audit engagement is defined as an audit of a client with:

A balance sheet total of	31 Mio.DKK.
An equity of	9 Mio.DKK.
Net turnover of	49 Mio.DKK
Pretax accounting income of	3 Mio.DKK
Number of employees	50

Please assume that the client is engaged in industry, and that internal controls are insufficient.

Please answer the following questions on materiality, time-consumption and time-allocation on a typical client in this category in an audit of financial statements 2005.

What would your preliminary judgment of materiality be \_\_\_\_\_ DKK.

Estimated time-consumption in total \_\_\_\_\_ hours

*Typical allocation of time on different categories of professionals*

Staff with less than two years of experience	_____ %
Staff with more than two years of experience	_____ %
State Authorized Public Accountants	_____ %

*Typical allocation of time in phases in the audit process*

Planning	_____ %
Performing	_____ % *
Reporting (audit report, management letter)	_____ %

*\* Estimated allocation of time in the performing phase*

Interim	_____ %
Year end	_____ %

#### ***4 A typical big sized audit engagement***

Suppose that a big sized audit engagement is defined as an audit of a client with:

A balance sheet total of	184 Mio.DKK.
An equity of	37 Mio.DKK.
Net turnover of	367 Mio.DKK
Pretax accounting income of	6 Mio.DKK
Number of employees	300

Please assume that the client is engaged in industry, and that internal controls are good.

Please answer the following questions on materiality, time-consumption and time-allocation on a typical client in this category in an audit of financial statements 2005.

*What would your preliminary judgment of materiality be* \_\_\_\_\_ DKK.

*Estimated time-consumption in total* \_\_\_\_\_ hours

*Typical allocation of time on different categories of professionals*

Staff with less than two years of experience	_____ %
Staff with more than two years of experience	_____ %
State Authorized Public Accountant	_____ %

*Typical allocation of time in phases in the audit process*

Planning	_____ %
Performing	_____ % *
Reporting (audit report, management letter)	_____ %

*\* Estimated allocation of time in the performing phase*

Interim	_____ %
Year end	_____ %

## ***5 Reporting in the audit report/management letter***

Please state your likely reaction as an auditor to the following situations.

- a. A company has reported its financial statements and Directors Report without the required information on important research and development activities. This will not be changed. Your reaction would probably be (more simultaneous answers are a possibility)
- 1 to qualify your opinion
  - 2 to issue an unqualified opinion with an explanatory paragraph
  - 3 to comment on the issue in the management report
  - 4 another reaction\_\_\_\_\_
  - 5 no reaction
- b. One of your audit clients does not entirely fulfill the legal requirements on safekeeping of accounting records. Vendors invoices are only stored for the last two years due to lack of space. Otherwise, the records are proper. Your likely reaction would be (more simultaneous answers are a possibility)
- 1 to qualify your opinion
  - 2 to issue an unqualified opinion with an explanatory paragraph
  - 3 to comment on the issue in the management report
  - 4 another reaction\_\_\_\_\_
  - 5 no reaction
- c. One of your audit clients has acquired a very large piece of machinery for the production, which is depreciated in the financial statements with 10 % p.y. on a straight line basis. You cannot decide that this is inappropriate or illegal, but in your opinion the machinery should rather be depreciated at a 20 % rate. In Your opinion, the effect could be material on the financial statements. You would consider (more simultaneous answers are a possibility)
- 1 to qualify your opinion
  - 2 to issue an unqualified opinion with an explanatory paragraph
  - 3 to comment on the issue in the management report
  - 4 another reaction\_\_\_\_\_
  - 5 no reaction
- d. By chance, you become aware of the fact that an audit client violates the limits for discharging of waste water. The management is aware of this, but does not see it as a big deal, “while we do not risk anything but a minor fine”. The fact is not disclosed in the financial statements and Directors Report. As the auditor you would consider (would you consider??) (more simultaneous answers are a possibility)
- 1 to qualify your opinion
  - 2 to issue an unqualified opinion with an explanatory paragraph
  - 3 to comment on the issue in the management report
  - 4 another reaction\_\_\_\_\_
  - 5 no reaction

## 6 Going Concern

Please state your likely reaction as an auditor to the following situation.

As an auditor you seriously investigated a qualification of your opinion on the presumption of going concern. In the final round you were convinced that a qualification was not needed, although material uncertainty still remained. Would your likely reaction then be (more simultaneous answers are a possibility)

1 to supplement your audit report with an explanatory paragraph to document enquiries and final conclusion

2 to comment on the issue in the management letter

3 other reaction\_\_\_\_\_

4 no reaction

Please state the degree to which your decision on where and how to report your considerations in the situation above could be influenced by the following factors

- a. A third party would have the opportunity to learn about your considerations be a possible future insolvency

1 no influence

2 small influence

3 some influence

4 great influence

- b. You wish to prevent a third party from obtaining knowledge of your considerations because since? this could lead to notfavorable consequences for the company (withdrawing of credit, withdrawing of suppliers and the like)

1 no influence

2 small influence

3 some influence

4 great influence

- c. You wish to keep your good relationship with the company board and management

1 no influence

2 small influence

3 some influence

4 great influence



## Appendix 2

### *Some demographic characteristics of the respondents in the 1995 and 2005 surveys*

*Big Six/Big Four, number of employees, number of offices, age, age by qualification 1995-2005 (t-tests of averages)*

		Big Six/Four affiliation	Number of employees in the Danish firm	Number of offices in Denmark	Age	Age by qualification
1995	Share/average	,38	647,85	17,64	44,47	31,27
	Respondents	91	55	55	94	94
2005	Share/average	,45	707,21	9,73	48,24	31,52
	Respondents	121	120	120	121	121
P		0.310	0.589	0.001	0.001	0.547

*Working hours, client related time and indirect time 1995-2005 (t-tests of averages)*

		Working hours p.a.	Client related time in %	Indirect time in %
1995	Average	2015,55	66,98	33,02
	Respondents	93	94	94
2005	Average	2066,94	63,29	36,71
	Respondents	117	119	119
P		0.236	0.042	0.042

*Client related time on different assignments 1995-2005*

		Audits	Accounting Services	Tax Advisory Services	Legal Advisory Services	Other Client Related Work
1995	Average in %	30,62	24,35	22,08	2,69	20,26
	Respondents	93	93	93	93	93
2005	Average in %	31,43	23,25	22,75	3,70	18,87
	Respondents	116	116	116	116	116