

THE POLITICS OF FINANCIAL AUDITING

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Abstract: Accounting is an important factor in recent transformations in the management of economic life in Romania. A marked convergence between private and public sector philosophies of administration has occurred and accounting has given operational substance to ideals of „efficiency”, „value for money”, „competitiveness” and „accountability”. Accounting increasingly shapes the language of policy and has become as much an indisputable benchmark of rational economic conduct as a substantive practice. However, to suggest that accountants have been integral to the new financial performance culture in which we now seem to live is also to reveal an irony. Two of the professional tasks which are closely associated with the image of these champions of performance are currently undergoing a crisis of „performativity” themselves. Financial accounting and audit, practices through which the wider dissemination of a „financial rationality” has occurred, are being questioned as never before. In this essay we focus upon the varied processes of negotiation, debate and accusation which constitute a „politics of financial auditing”.

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When innocent parties lose assets because of fraud or the economic collapse of apparently healthy companies, institutional processes of „blame allocation” are set in motion. These processes are competitive. Litigation may be one particular and specialized method of allocating blame but press comment, internal inquiries and a host of other deliberative mechanisms are equally significant. Within these various settings the allocation of blame is not merely a question of finding scapegoats but also has much to do with establishing descriptions or „problematisations” of the event which favor certain allocations of responsibility, and hence certain regulatory responses, over others.

The political nature of regulatory blame allocation is revealed particularly acutely where the public criteria of success and failure for regulatory practices are imprecise. In such cases single events, have provoked generalized forms of inquiry about the nature of trust entities, banking supervision structures and forms of corporate governance. In the case of financial audit there is currently widespread doubt about what audits are for and, by implication, about the criteria for determining the difference between good and bad auditing. Accordingly, the politics of audit, though it may originate in particular events, also stimulates general concerns; it is as much about *what* an audit is as *how* it has functioned in any particular instance.

In recent years it has become popular to problematise financial audit in terms of an „expectations gap”, namely, a discrepancy between the demands made by user publics

on the audit function and practitioners' views of its role and capabilities. However, the imagery of the „gap”—as if there were well-defined points which needed to be brought closer together in some way—is too simple and static. Audit is always subject to such gaps since the circumstances under which it may be judged to succeed or fail are periodically subject to negotiation. The coherence of any practice depends largely upon a consensus about these circumstances but this is not to say that professional tasks must be fully transparent to their consuming publics; far from it. Rather, public conceptions of those tasks in the abstract must be sufficiently stable to tolerate particular deviations. When this consensus is disturbed by events such as corporate collapse, the institutional path of the disturbance corresponds to a political process which aims at a new form of consensus for the meaning of the practice, particularly its general criteria of success and failure. Furthermore, *who* decides and determines the public meaning of these criteria is as important as *what* is decided, especially where such criteria continue to be expressed in imprecise terms which require specialist interpretation.

In the next section, we describe the official image of auditing as a practice which is generally successful. This is followed by a consideration of the nature of financial reporting. Problems of financial audit and financial reporting are often confused in the public imagination, and the politics of audit is at its most intense where companies fail in a substantive economic sense and auditors are blamed for approving financial statements which did not give warning of this outcome. We argue that, intensity notwithstanding, the forms of response and negotiation in these cases are cosmetic in an important sense; they favor regulatory responses to critical events which *particularize*, *proceduralise* and *institutionalize*. Such responses systematically ignore the „cost-assurance” relationship which lies at the very heart of the audit process.

1. Representing the mission of audit

External financial audits have been officially defined as an „independent examination of and expression of opinion on, the financial statements of an enterprise”. The audit adds credibility to these statements. All companies are at present required by law to produce such statements, commonly called accounts, for their owners (shareholders). In this way it is thought that management is made accountable to shareholders and that the periodic production of accounts enables shareholders to make rational investment decisions.

In law it is the directors who are responsible for the preparation of financial statements. External financial auditors act on behalf of, and report to, shareholders (even though they commonly regard management as the „client”) to ensure that the accounts given by management are not fundamentally misleading. In Romania, the auditor must give an *opinion* on whether the accounts give a *true and fair* view. The auditor collects evidence as a basis for this opinion, a process which, over the years, has been regulated by professional statements of best practice. When financial statements are „technically defective”, in the sense of failing to „represent” the economic condition of a company, auditors are required to act in one of a number of institutionally prescribed ways: requiring accounts to be amended; expressing a „qualified” public opinion on the accounts; in certain circumstances reporting directly to a third party such as a regulator.

Financial accounting and the representation of economic reality

The official representation of the mission of financial audit given in the previous section can be disturbed in a number of ways. Given that the perceived success of the audit process is heavily dependent upon the capacity of the financial statements to reflect the economic condition of the company, then the politics of financial audit cannot easily

be disentangled from processes of negotiating and criticizing the role of accounts. An abiding image of financial reporting is that it is the neutral representation of the financial affairs of an entity which provides information to a potentially diverse body of interested parties, principally investing publics. In Romania the official rules of accounting assist and fine tune this representational function. Sometimes the rules are shown to be inadequate and must be reformed. However, the principal idea of accounting as a technology which assists in the operation of capital markets is an enduring one. To the extent that audit enhances the credibility of financial accounting, then it also contributes to the efficiency of the markets for financial capital. On this view, financial accounting is an „apolitical” practice with merely an instrumental role in assisting the rational decision-making of investors.

However, this official image is difficult to sustain for a number of reasons. Firstly, it has long been recognized that the standard-setting process for financial reporting is political in the sense of being subject to interested pressures for particular outcomes. In this sense the precise form of financial accounting is perceived as having „economic consequences” for certain parties who will then be disposed to attempt to influence the standard-setting process.

Secondly, the representational aspirations of accounting are undermined by „creative” accounting practices which exploit the indeterminacies of official rules to reflect the performance of the enterprise in a desired manner. Some critics have argued that accounts can be whatever one wishes. Indeed, it is in the nature of rules that they cannot be written to control entirely the conditions under which they are applied and certain accounting areas, such as the setting of provisions, are difficult to prescribe and lend themselves to forms of „creative compliance”. However, creative accounting in this sense is not simply a by-product of the rule-making process. It is also a function of what auditors will permit.

Auditors, far from being the guardians of economic reality, are perceived to have conspired with management to assist in creative accounting practice.

Thirdly, the representational ideal of financial accounting can be undermined in a much more radical way. It is not just that creative accounting distorts our view of an independent economic reality; accounting practices effectively *constitute* that reality. In the context of management accounting, accounting systems provide a medium through which organizations become „visible” to themselves. That which is newly „visible” can be interpreted not as a representation of an independent reality but as the creation of a new domain of economic facts. Accounting therefore constitutes the economic facts that it purports to represent. The communication of economic „facts” in financial statements is simultaneously their construction *as* facts.

This is not such a strange and philosophical idea as it sounds. Consider recent debates in the UK about whether coal pits are or are not „profitable”. In adversarial contexts such as this, concepts of „cost”, and therefore of profit, are subject to many assumptions and are highly negotiable. In these instances one can say with some plausibility that different „accountings” determine different economic „realities” of the pit. From this point of view there is no single „true” representation of the economic condition of the pit, merely competing ones mediated by particular forms of accounting.

Another example concerns the recent debates about whether valuable but „intangible” brand names should be „assets” on the balance sheet. There can be little doubt that accounting for brands in this way does not merely „represent” them as if they were entirely independent of financial reporting and valuation methods. Brands are

constituted as real in a particular sense by accounting. More generally it can be argued that accounting constitutes a model of social reality. In this sense accounting is contestable not simply in terms of better or worse accounting for a particular class of transactions; preoccupations with creative accounting effectively accept the representative role that accounting has set itself. Rather, accounting provides the dominant medium through which companies make themselves visible both internally and externally. As a highly selective form of receptivity to outside disturbances, traditional financial accounting treats certain effects of corporate activity, such as upon the natural environment, as non-facts. Relative to the accounting knowledge system, these effects are „unreal” and the present trend for environmental disclosures in annual reports does nothing to disturb the dominant logic of financial accounting representation of corporate activity. This logic is reinforced and made legitimate by financial audit.

Overall, the sense in which the „auditee” company succeeds or fails (in the role of auditee) depends upon the definition of its performance which is relevant to the audit process. To the extent that financial reporting is far from being a simple representative practice then such definitions are far from being stable. This legalistic definition sits uneasily with emerging preoccupations with corporate governance which emphasize a broader set of stakeholders in corporate activity. In other words, financial reporting is now under pressure to develop in new ways at a time when its traditional role is uncertain. All of which makes the financial auditors” role problematic.

2. Negotiating audit failure

Audit can be represented as successful where the auditor has reported particular financial statement failure by „qualifying” his audit report publicly or, less publicly, by reporting to a relevant third party such as a regulator. However, success in both these cases can be contested. For example, one company had previously received a qualified audit report on the grounds that the auditors had doubts about whether it could continue as a going concern. While this information would have been communicated to shareholders in the accounts, and was „publicly” known in the sense that the qualified audit report was available for public inspection, it was not made evident to the customers who subsequently lost money.

Clearly, much hangs in this instance on what it is „reasonable” to expect of the audit function and the litigation against auditors Ernst & Young and Price Waterhouse may, if it ever arrives in court, have something to say on this. There is a long history of preoccupations with the financial auditor’s role in relation to the discovery of material fraud and currently there are some indications that they may accept an extension of their responsibilities. This shows that what is „reasonable” may change over time, as reflected in the development of official audit guidance. Furthermore, public events may dilute the ability of auditors to retain professional discretion in determining the content of „reasonable” practice. In this sense the politics of audit is as much about *who* is to control the definition of „reasonable” practice as it is about the content of that definition.

For many years auditors have been concerned that they have been unduly burdened with the risk of financial statement failure. In response they have emphasized directors” responsibilities for providing systems of internal control and have lobbied unsuccessfully for recognition of this fact in company law and in the tort of negligence. More recently this campaign for „risk sharing” has been conducted in terms of a new agenda for corporate governance in which the role of the financial auditor is articulated as but one part of the total control environment of the corporation. This reinforces the

traditional defense that it is unreasonable to blame auditors when errors and irregularities have their source in corrupt management practice.

There are certain dangers for auditors in pushing this idea of risk-sharing too far. It is not unreasonable to argue that the manifest economic success of firms of financial auditors has in fact been aided and not hindered by ill-defined conceptions of their role. High expectations generate high fees. In seeking to „spread risk” auditors may devalue their own product. In addition to pressures on audit fees, there is also evidence that the recent financial scandals have provided a platform for „professionalisation” initiatives by *internal* auditors, who are employees of organizations, in making claims upon the territory of corporate governance. Indeed, some audit fee reductions indicate a level of corporate substitution between the internal and external audit function. It seems that auditors cannot limit expectations about their role without also limiting their capacity to earn high fees.

Important as the negotiation of „reasonable” audit practice is, the politics of financial auditing is also characterized by a certain „cosmetics” of response. In the wake of financial scandals in which the audit function is implicated, audit must be seen to respond. The restoration of a consensus about the mission of audit often takes the form of new practice recommendations by the auditing authorities. Hence, an important product of the politics of audit is the body of codified procedure which is produced in the wake of perceived public failure. One might even suggest that the *production* of discussion documents and audit guidance in the wake of such scandals is as important as what they say; being seen to be serious about reform is an important political resource. But, in these cases, audit knowledge is codified and proceduralized in a manner which also leaves untouched the problematic relation between audit work done (inputs) and assurance given (output). In our view, the politics of audit is as much about leaving this core problem alone as it is in promoting better practice. It is this issue to which we now turn.

3. The politics of audit

So far we have considered three possible representations of the success or failure of audit practice. Firstly we presented the official story of audit success coupled with financial statement success. Secondly we considered the sense in which financial statements might be said to succeed or fail. Thirdly we considered the negotiation of audit failure in the context of financial statement failure. These discussions correspond to boxes 1, 2 and 3 respectively in Figure 1. The latter describes the „logical space” within which the politics of audit, the market for interpretations of its efficacy, occurs. Figure 1 also enables an analytical distinction to be made between two issues which are often confused; auditee and auditor failure. The difference between the two *rows* in Figure 1 concerns the performance criteria of companies in their capacity as auditees. we have considered in some detail the continuing debates about the adequacy of financial accounting as a reflection of corporate activity. The difference between two *columns* concerns the success or failure of the audit process itself and we have discussed the problems of negotiating „reasonable” audit practice in the contested territory between boxes 2 and 3.

Table no. 1 The logical space of the politics of financial audit

		AUDITOR FAILURE	
		No	Yes
AUDITEE FAILURE	No	1	4
	Yes	2	3

The idea of a „politics of financial audit” refers to the institutional settings in which the four possible representations of the audit process in Figure 1 can be negotiated. This negotiation involves the need to settle the criteria of success and failure *in general* for both auditee and auditor. However, it is also apparent from the figure that we have not addressed the possibility that audits may „fail” and yet not be seen to fail because the financial statements are not technically defective. This is an intriguing possibility because public knowledge of the efficacy of the audit process is usually mediated by the perceived integrity of the financial statements. By the same token, financial statement non-failure is often regarded as evidence of audit success. Figure 1 suggests that both these inferences are misleading; box 4 represents the logical possibility that audits can fail but are not publicly seen to do so. Are there any institutional processes which correspond to this possibility?

Regulating audit knowledge

A distinction between the „ethical” and „technical” failure of audit practice can be drawn. Ethical failure can be said to occur where auditors fail to report reportable matters which have come to their attention. This form of failure is closely associated with long-standing concerns about the independence of auditors. The audit profession has resolutely resisted attempts to change existing institutional arrangements for audit, such as by rotating audit firms and prohibiting the provision of non-audit services. However, over time, concessions have been made with the intention of improving the image of the independence of audit. The audit industry can no longer appeal to the ethical „attitude of mind” of its practitioners, a rhetoric which is increasingly hollow in the face of a more commercial way of talking. However, by comparison with the considerable level of commentary on the question of ethical failure, i.e. non-independence, there has been little „politicization” of „technical” failure until recently.

Public institutional mechanisms to question the fundamental basis of the audit product, i.e. the relationship which is presumed to exist between work done and levels of assurance available, do not exist. Other than in very limited circumstances where statistical technologies are available, this fundamental relationship is largely a matter for professional hunch.

From this point of view an important „non-politics” of financial audit becomes apparent and defines a set of issues which even critics of auditing are unable or unwilling to face. Visible preoccupations with procedure, the codification of incremental and very specialized audit routines, and proposals for new institutional structures create a certain specialized density around the audit function such that a more radical and systematic conception of audit failure cannot become a public issue. From such a radical point of view the weakness of the knowledge base of audit and the problematic nature of the audit product would be apparent.

The „non-politics” of audit failure must not be understood in conspiratorial terms. It is primarily a function of the regulatory system within which audit operates. A great deal of financial regulation *presupposes* the efficacy of audit. Without audit as the possibility of some form of *ex post* inspection, financial regulation would appear unenforceable. To preserve the mission of financial regulation, the politics of regulatory blame has an inherent tendency to *particularize* audit failure and to *proceduralise* in its wake. In addition, regulatory response is heavily weighted towards the creation of new *institutional* structures, such as the suggestions for creating an „audit panel” or a „general audit council”. The result of these three tendencies is what we call, uncharitably perhaps, a „cosmetics of response”. New licensing rules for auditors, ethical codes,

reporting functions and duties, official routines and new regulatory bodies for audit reconstitute the mission of financial audit in the wake of scandal. Yet these elaborations also prevent a more fundamental problematisation of the audit product and it is to this that we turn in conclusion.

4. The future of financial audit

Today we hear much of environmental audit, safety audit, medical audit, academic audit and many others beside. This institutionalized belief in the productive benefits of verificatory activity is such that one might describe today as an „audit society”. Audit has become the condition of the functioning of a distinctive style of regulation, and to be audited is to be made an accountable and thereby legitimate economic agent. It was suggested above that because audit is a *presupposition* of regulatory programmes, a radical problematisation of audit practice is not a regulatory option. Hence, the politics of audit functions as much to circumscribe debate as to allocate blame within the system of financial regulation. Audit failure paradoxically but inevitably leads to a reintensification of audit. At the point where systemic doubts about audit might be possible, the response is to have more if it.

We propose additions to the existing reporting responsibilities of auditors; respectively, to shareholders on the compliance of the company with the code of best corporate practice, and to wider interest groups on a range of issues. In both these cases the likely effect is to amplify expectations about the audit function. Furthermore, we endorse institutional innovations such as enhanced audit committees, audit panels and shareholder audit representative groups.

Whether or not these are implemented is less important than the style of regulatory response which they symbolize. We believe in the efficacy of audit and seek to extend it in new directions. Initial conceptions of the expectations gap were premised upon public ignorance of audit which could only be remedied by changing the wording of the audit report. Now it is the scope of audit which must be extended to meet public expectations. However, to reinterpret the „expectations gap” in these terms also conceals real doubts and confusion about the level of assurance which financial audit provides.

It may be that the desire is not for *more* audits of *new* corporate statements but for clarification of the audit product and the nature of the attest function which constitutes it.

It is conventional practitioner wisdom that higher levels of assurance are more costly and yet this assurance-cost function is, to say the least, difficult to specify empirically. It is also part of the conventional history of audit that it has evolved in the direction of greater efficiency in the sense of the development of techniques which give a greater level of assurance for any given level of cost as compared with their predecessors. These „stories of audit” are reinforced by a growing regulatory dependence on audit, a dependence which ensures that the idea of systematic audit failure cannot become a theme in the politics of audit. Indeed, the politics of audit is concerned to prevent a situation arising where we might be required to think of alternative institutional mechanisms to audit. In the „audit society” these alternatives are literally unthinkable. To conclude, it seems that the politics of financial audit does not merely give voice to the doubts of aggrieved parties. It also channels and translates these doubts into thinkable and therefore workable regulatory solutions; disciplinary action against *particular* individuals, the production of new official *procedures* and the creation of new *institutional* mechanisms.

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