Self-regulation in the Public Accounting Profession:

The Structural Response of the Large Public Accounting Firms to a Changing Environment

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The focus of this article is on large, international public accounting firms[1] and the manner in which these firms attempt to manage a changing environment and defend against threats to the self-regulation of public accounting. It investigates the strategies and responses of these large firms to the challenges of a changing environment, and questions whether such strategies and responses will be effective in the future in maintaining the self-regulation of public accounting. In addition, the article discusses why traditional accounting and auditing research methods have been unable to reveal and investigate the complexities of the environment in which the large firms operate. The article suggests the use of alternative research methods (i.e. qualitative methods) in order to address more effectively relevant research questions.

The remainder of the article is organized into four sections. The first section discusses the significance of the large accounting firms as an area of critical inquiry and summarizes recent literature which has investigated self-regulation in public accounting. The second section discusses the concept of structure and the investigation of structure through qualitative research methods such as participant observation. The second section also discusses the strategies which the large firms have developed to achieve success. The third section discusses why the strategies may not be successful in the future. The fourth section provides a summary and discusses implications for research in accounting and auditing.

Introduction and Review of Literature

Various researchers have established that accounting is centrally implicated in the control mechanisms of society and involved in an important way in the conflicts surrounding the exercise of economic and political power (Ansari and Bell, 1991; Arrington and Puxty, 1991; Burchell *et al.*, 1980; Cooper and Sherer, 1984; Dillard, 1991; Hopwood, 1987; Lehman and Tinker, 1987; Miller and O'Leary,

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1987; Tinker, 1980, 1985, 1988; Tinker *et al.*, 1991). The large accounting firms are arguably the most important organizations in public accounting. The large firms audit more than 90 per cent of the companies listed on the New York and American Stock Exchanges in the United States (Arens and Loebbecke, 1991). Such a level of industry concentration makes it difficult for smaller firms to compete and acts as a barrier to entry into the market for auditing services for public companies. The dominant position of the large firms is worthy of critical inquiry. However, the power and influence of these firms has only recently begun to be investigated (e.g. Allen, 1991; Byington and Sutton, 1991; Fogarty *et al.*, 1991; Humphrey, 1990; Humphrey and Moizer, 1991; Mills and Bettner, 1992; Neu, 1991; Willmott, 1991). The large firms are facing a changing environment which threatens their dominant position. The following sections summarize some of the recent literature which has investigated threats to the large firms in the form of increased external regulation.

Role Conflict

Mills and Bettner (1992) have discussed the role of ritual in public accounting and the manner in which ritual is used to mask conflicts arising from perceptual gaps concerning the independent auditor's role in society. Mills and Bettner state that "(perceptual) gaps provide a harbour for ongoing conflict due to miscommunication and misinterpretation" (1992, p. 7). Mills and Bettner go on to identify four perceptual gaps: The Expectations Gap; The Scope of Services Gap; The Intraprofessional Competition Gap; and The Role Ambiguity Gap. The Expectations Gap refers to differences between the perceptions of the large firms and society generally in regard to the duties and responsibilities of independent auditors. The Scope of Services Gap refers to conflict between the independent auditor's attestation responsibilities and the services which the large firms offer to their clients. The Intraprofessional Competition Gap refers to the conflicts associated with competitive behaviour among the firms. The Role Ambiguity Gap refers to the conflict between the values and norms that the firms project to their professional staffs and the professional staffs' perceptions of those values and norms. Mills and Bettner argue that rituals are used by the large firms to mask conflicts arising from these perceptual gaps (1992, p. 8).

In the United States, CPAs have a monopoly of practice before the Securities Exchange Commission (SEC) in that the financial statements of public companies must be audited by CPAs. Because of their dominant position in the market for auditing services for public companies, practice before the SEC is done primarily by the large accounting firms. Byington and Sutton (1991) argue that monopoly power in the hands of the self-regulated public accounting profession has produced welfare losses on the part of third-party consumers of audited financial statements (i.e. investors, creditors and the public generally). The dominant position of the large firms has also provided them with an opportunity to influence the creation of GAAP and GAAS. Byington and Sutton (1991) have shown that the issuance of new GAAP and GAAS standards has occurred at strategic points when there has been a threat of increased external regulation of public accounting. A number of other researchers have also investigated the conflict between the large firms' role as providers of independent audits and as providers of services to clients (e.g. Fogarty *et al.*, 1991; Humphrey and Moizer, 1991; Neu, 1991; Willmott, 1991). The general conclusion of this research is that the conflict in the auditor's role is increasing rather than decreasing. As a result of this increasing conflict there have been threats of increased external regulation of public accounting including: increased Government regulation, increased legal liability and changing technologies.

Threat of Increased Government Regulation

Among others, Gaa (1991) and Willmott (1991) have discussed the threat of increased Government regulation of public accounting. Gaa argues that the threat of increased Government regulation results in an increased level of self-regulation which in turn reduces the economic welfare of the large firms (Gaa, 1991, p. 103). Gaa suggests that societal welfare is not necessarily enhanced through increased Government regulation of public accounting. Willmott on the other hand responds that:

> (Gaa's) model is of limited value for understanding the positioning of the players engaged in the regulation game and the historical constitution of the "interests" which are said to account for their strategic conduct. A more adequate form of analysis must take account of both the power/knowledge relations through which the discourses and practices of regulation are enacted as well as the involvement of the analyst in constituting the phenomena... (Willmott, 1991, p. 119).

Government regulation is an exercise of political power. Various researchers have examined the manner in which accounting is shaped by political processes (e.g. Armstrong, 1987; Hopwood, 1987; Humphrey and Moizer, 1991; Merino and Neimark, 1982; Miller and O'Leary, 1987). In particular Humphrey and Moizer (1991) have "cast doubt on the ability of the auditing profession to deliver the audit service traditionally demanded by society" and suggest the need for increased Government regulation.

Historically, the US Government has accepted the view that public accounting should be self-regulated. However, there have been persistent efforts on the part of members of Congress to increase the level of Government regulation of public accounting. Legislation has been periodically introduced in Congress which would, if enacted, create direct regulation of public accounting by the federal government. For example, H.R. 3159, "The Financial Fraud Detection and Disclosure Act", would have required audits to be conducted "in accordance with methods prescribed by the SEC" (AICPA, 1991). In addition, H.R. 4900 would have created a Federal Insurance Solvency Commission and would have granted the Commission the authority to set accounting standards. This bill would have required independent auditors to report directly to the Government when the auditor has substantial reason to believe that a company's records reveal material misrepresentations or illegal acts. The large firms have been opposed to this type of legislation and see it as a threat of external regulation (AICPA, 1992).

Increased Legal Liability

The large accounting firms have been impacted by the general increase in civil litigation in the United States during the last 20 years. An increasing number of lawsuits has resulted in the closing or bankruptcy of several large firms and threatened the financial position of others (Berton, 1992; Berton and Lublin, 1992; Rundle, 1992). As a result of a change in the laws surrounding the independent auditor's duty to third parties the large firms may be liable for ordinary negligence and may be sued by anyone who uses the financial statements (Fogarty *et al.*, 1991; Goldwasser, 1992; Huss, 1991). The potential liability of the large firms is also greater under the various securities acts and the Racketeer Influenced and Corrupt Organizations (RICO) Act. The viewpoint of the courts may be summarized by a quote from an opinion in a Supreme Court Decision written by Chief Justice Burger:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust[2].

The large firms are operating in a risk laden legal environment which acts as a threat to their dominant position.

Changing Technologies

Humphrey and Moizer (1991) view "auditing as a socially-constituted activity as well as a techno-rational function". The social and the technical aspects of accounting and auditing are linked. Technological advances have expanded communication and data-processing capabilities in both the reporting and the control functions of accounting. Increased capabilities in data collection and data-processing technology increase the ability of corporate managements to control and enhance their own power positions. Robson and Cooper (1989) point out that budgets and performance reports induce a continuous regulation and supervision of persons while effecting internal visibility to the organization. Robson and Cooper go on to state that:

> the growth of communicative technologies has greatly assisted this process (i.e. of control) by their reduction of "time-space distanciation" allowing the absence of face-to-face contact without absence of control.

The growth in communicative technologies affects the practices of the large firms in ways that are not yet understood. For example, independent audits may depart entirely from financial statements as we know them today.

> Computer-based audits may well become "real-time" audits, rather than periodic monitoring of financial statements, as corporations extend their databases to become reporting vehicles. Periodic financial statements may well become obsolete, if auditors and securities analysts and other interested parties can tap directly into corporate databases for instantaneous information (Weinstein, 1987, p. 203).

It is difficult to predict what the result of these changing technologies may be, but rapidly changing technologies appear to threaten the traditional scope of services provided by the large firms.

Firm Strategies and Structural Responses

Over a period of years the large firms have developed strategies to maintain their dominant position in the public accounting profession. These strategies are discussed below. First, the concept of structure will be discussed as well as the manner in which structure and structural responses may be investigated through qualitative research methods such as participant observation.

Structure and Qualitative Research Methods

Participant observation is one type of qualitative research method. Although it is an accepted form of research, participant observation has not been widely used in accounting and auditing research. The epistemological grounding of accounting and auditing research within the neo-classical economic model and its adherence to positivism and empiricism have been well documented elsewhere (e.g. Burchell *et al.*, 1980; Tinker, 1980, 1985, 1988). Nevertheless, various accounting and auditing researchers are now using qualitative methods, including participant observation, more extensively (e.g. Ansari and Bell, 1991; Covaleski and Dirsmith, 1990; McKinnon, 1987; Mills and Bettner, 1992).

In order to understand the usefulness of participant observation as a research method it is necessary to recognize that human beings have an ability to assimilate the "structural" characteristics of the environment in which they operate on a daily basis. There are modes of behaviour (e.g. norms, rules, values, ethics, ideologies, etc.) which make up the structural characteristics of the entity (e.g. group, organization, class, society, culture, etc.) in which the person lives and works. Novices are initiated into the structural characteristics through assimilation routines (e.g. the punishing work load of a junior auditor in a large accounting firm). Deviants are weeded out over time. Those who rise in the entity become fully assimilated and view its structure as received wisdom virtually inseparable from their own consciousness.

It is recognized that the word "structure" is being used here in a manner that is not typical within social science research. Unfortunately the definition of structure varies in significant ways as one moves from sociology and organization theory through anthropology to the fields of cognitive psychology and behavioural science. Structure has been defined in one instance by organization theorists as "the arrangement of people, tasks, and authority to achieve more calculable and predictable control over organization performance" (Ranson *et al.*, 1980). This definition constitutes a reification of structure which treats it as being in some sense apart from the human mind and as a variable that can be manipulated. It is this reification of structure that has prevented traditional accounting and auditing research from revealing the complexities of the environment in which the large firms operate.

There is another approach to structure which views structure as being essentially a creation of the human mind and inseparable from it. In this view, structure can be defined as a "template on experience" (Baker, 1977) which assists the organizational participant to structure his or her experience in a manner that allows the participant to deal with the complexities of the environmental setting. A structural response is a modification in the template on experience (i.e. structure) in order to re-organize and deal with changes and complexity in the environment.

There is a dual aspect to structure which causes frustration. Structure is both functional, in that the organizational participant must utilize some form of structure merely to survive in a complex world, and yet it is dysfunctional, in that it inhibits communication and mutual understanding and frequently causes conflict. A person with a different template on experience (i.e. structure) may be characterized as having deviant "values" or a foreign "ideology". Furthermore, structure in the form of knowledge is inextricably bound up with power. The powerful in organizations, societies, cultures and classes utilize structure and knowledge to facilitate and enhance their power (Foucault, 1980). The challenge to social science research and research in accounting and auditing is to penetrate through the surface aspects of structure which are often intended towards mystification. This is why participant observation is helpful in that it allows a researcher to penetrate through surface structures and helps the researcher to organize (i.e. structure) his or her view of the research setting in a manner that is more likely to provide both interesting results and results with long-term validity and relevance.

In one example of the use of participant observation in accounting research, Baker (1977) analysed the strategies which a large public accounting firm adopts towards a changing environment. Baker's analysis revealed three separate strategies which are interactive and complementary.

Maintaining Client Relationships (Doing)

The first strategy involves those activities a firm utilizes to maintain and enhance its relationships with its clients (i.e. Doing). This strategy is characterized by an economic contract between the firm and its client. The contract specifies that there will be a delivery of services in exchange for fees paid. On the client side, the contract is optimal when the services take the form of recommendations for cost savings or revenue increases (Baker, 1977, p. 579).

Entry level and less experienced personnel in the large firms may not fully comprehend that there is a range of services contemplated in the firm/client relationship, and that there may be conflicts in providing this range of services. They may consider only auditing as the principal objective of their task within the firm, and therefore perceive no significant level of conflict in their role. As staff accountants continue with the firms, those who learn, or become indoctrinated into the firms' perspective, become privileged and advance more rapidly, often irrespective of their technical abilities in auditing *per se* (Baker, 1977, p. 580). Further evidence along these lines was developed recently by Ponemon, who states that "management of a firm will screen and promote subordinates that share a common sense of morality and ethics" (Ponemon, 1990, p. 208). The more experienced members of the large public accounting firms learn quickly that clients will move to amend or dissolve their relationship with a firm if they are receiving unsatisfactory service, and it is the responsibility of the audit manager and the audit partner within the firms to see to it that satisfactory service is provided (Baker, 1977, p. 580; see also Humphrey and Moizer, 1991; Senatra, 1980).

Maintaining Relationships with Others (Representing)

The second strategy discussed by Baker involves those activities a firm undertakes to maintain and improve its relationships with outside parties other than clients (i.e. Representing). Included in this category are members of the business community, such as bankers and lawyers; potential clients; professional bodies such as the AICPA and FASB; governmental agencies; and educational institutions and members of the academic community. These activities are referred to within the firms as "practice development". A variety of observed behaviours fall under practice development (Baker, 1977, p. 580).

First, there is overt marketing. Members of the firm are assigned to investigate and make contacts in specific industries. Collateral to this effort is the creation of firm wide industry specialists who act as a clearing house for information about the industry. Second, there is a publishing effort. The large firms publish a variety of documents which are distributed to clients and potential clients. Included are magazines, newsletters, industry accounting guides, tax guides, and guides for doing business abroad. All publications are clearly marked with the name of the firm. Additionally, members of the firm are encouraged to publish articles in professional journals. The publishing effort adds to the image of the expertise of the firms and creates a societal and institutional presence. Third, there is a community service effort. Members of the firms are encouraged to join professional, charitable, and civic organizations. While most firms regard participation in these organizations as a civic duty, the fact remains that the firms recommend such participation and generally classify it under practice development. The image of the firm is enhanced by increasing its presence in the civic organizations of the communities in which it operates (Baker, 1977, p. 580).

Representing is further facilitated through a network of ties to lawyers, bankers and securities underwriters. There is reciprocity inherent in these relationships. Each entity is able to recommend clients to the other. The objective underlying such relationships is to position the large firms as an indispensable part of the societal infrastructure (Baker, 1977, p. 580).

Creating a Firm Image (Being)

The third strategy discussed by Baker is focused on creating a perceived need for the services of the firm on the part of the client, and on the part of the business community and society generally (i.e. Being). This perceived need for the firm's services is developed through the creation of a strong, well-formed firm image. The principal activities observed under this strategy are directed towards controlling the image and the name of the firm in order to convey a message of integrity, expertise and service. Integrity includes qualities such as confidentiality, personal competence, objectivity and an institutional profile. The firm strives in all of its activities to achieve these qualities both in fact and in manner. Members of the firm intuitively know that what they appear to be is highly important in their relationships with clients and others. The audit manager and the audit partner are the principal members of the firm responsible for the maintenance of the name and the image of the firm. The manager is responsible for the disciplining and indoctrination of the professional staff, the maintenance of expertise, and the completion of the audit routines which signify competence, confidentiality and objectivity. The partner is responsible for controlling the timing and manner of the symbolic act of signing the name of the firm, for maintenance of the societal and institutional profile and for developing the image of service to society generally (Baker, 1977, p. 581).

Discussion

Other researchers have also investigated the strategies of the large firms towards a changing environment. As previously mentioned, Mills and Bettner (1992) investigated the manner in which ritual is used by the large public accounting firms to mask conflict arising from the perceptual gaps between the independent auditor's duty to society and the firms' need to satisfy clients. Mills and Bettner's discussion of ritual parallels in many respects Baker's discussion of strategies. Allen (1991), has also investigated the strategies of the large firms in her study of the Australian public accounting profession. She found strategies being employed by Australian firms which were similar to those found by Baker. In another study, Neu (1991) investigated the manner in which the appearance of trust is created and sustained in the Canadian public accounting profession. In particular, Neu's findings are comparable with those of Baker's third strategy described above (i.e. Being) which has as its goal the creation of a perceived need for the services of the firm (i.e. trust) through the creation of a firm image which reflects competence and integrity. Humphrey and Moizer (1991) also investigated auditing as a socially-constituted activity. Their findings are similar to Baker's in that they identified a techo-rational function (i.e. Doing), a marketing function (i.e. Representing) and an ideological function (i.e. Being) within the larger strategy of audit planning.

Strategies Confronting a Changing Environment

Despite recurrent criticism and threats of external regulation, the three strategies of the large firms (i.e. Doing, Representing and Being) have allowed the firms to achieve financial and professional success. However, increasing change in the environment places doubt on the continued ability of the firms to maintain their dominant position. As discussed previously, there is a perceived conflict between the delivery of services to the client and the independent auditor's role in society. The Being strategy which strives to create a firm image has usually been able to mask this conflict and defend against threats of external regulation by manipulating the symbols of integrity, expertise and service. This image creation function appears to be no longer adequate to its task in that a quite different concept of the societal role of public accountants is developing on the part of Congress, some governmental regulators and various juries and courts. It appears that the perceptual gaps regarding the independent auditor's role in society persists and are growing.

There have been several responses on the part of the large firms to the threats described above. One such response is an emphasis on audit committees as subsets of boards of directors. This response has been intended to create a buffer between the independent auditor and the management of the client. The concept of an independent audit committee is appealing on its face in that potentially it allows independent auditors to perform the role prescribed for them by society while reducing, via the intermediate structure of the audit committee, the negative consequences to the auditors that may arise while the auditors are functioning in the socially mandated role. The large firms have asserted that audit committees should be composed only of non-employees of the client. This has become standard for public companies. However, the propensity of corporate managements to select outside directors who are favourably inclined towards incumbent managements can defeat the oversight function of the outside audit committee and render the large firms relatively powerless to confront the conflict in their role.

Another response of the firms has been peer review. All public accounting firms which are members of the SEC Practice Section of the AICPA are required to undergo periodic peer reviews. The essence of this system is that professionals from one firm review the working papers of another firm in order to perceive areas of substandard audit work. Unfortunately, the peer review system has several drawbacks. For example, few firms receive a negative review, therefore raising the question of whether the peer review system is a structural response designed to defend against threats of external regulation. In addition, since the selection of client engagements for working paper review is not controlled by the peer reviewers, there may be opportunities to avoid reviews of substandard work. Furthermore, since the peer reviewer is not in a position to know all of the facts pertaining to a given client there is difficulty ascertaining whether the working papers adequately reflect the proper extent of audit work required in the circumstances. Finally, since the peer review process is *ex post* rather than *ex ante*, substandard work is not necessarily precluded by this response.

A third response was the issuance in 1987 of nine new Statements on Auditing Standards which were intended in part to reduce the public's level of expectations regarding independent audits. These so-called "Expectations Gap" standards encompassed a variety of auditor activities including: Detection of Fraud (SAS 53), Illegal Acts (SAS 54), Internal Control Structure (SAS 55), Analytical Review Procedures (SAS 56), Auditing Accounting Estimates (SAS 57), Audit Reports (SAS 58), Going Concern Matters (SAS 59), Reportable Conditions (SAS 60), and Communications with Audit Committees (SAS 61). Apparently, it was expected that the issuance of these standards would forestall further activities by Congress or the SEC that threaten self-regulation of public accounting. The issuance of these standards has required considerable time and effort to be expended by the large firms, users of financial statements, accounting educators and others to absorb and understand the meaning and implication of the new standards. All auditing textbooks in the United States had to be rewritten as a result of the issuance of the standards. However, the more one analyses the Expectation Gap standards the more one senses that little has actually changed with respect to the conflict between the independent auditor's duty to society and the large firms' need to satisfy clients. Therefore, it is not clear that the Expectation Gap standards as a response will act to reduce the threats to the firms arising from this conflict.

The three responses discussed above (i.e. audit committees, peer review and expectations gap standards) have done little to stem the tide of lawsuits and the continued propensity of Congress to investigate the public accounting profession. It is necessary, then, to question whether the strategies of the large firms as discussed in the third section of this article are adequate any longer to deal with the challenges posed by a changing and conflict-laden environment. On the one hand, there is a need for a truly independent auditor/observer of the complex interactions between business, Government and other organizations in an increasingly technological society. On the other hand, the large firms are being forced to compete in a global economy where the rules are still highly in flux. It is time to question whether these disparate roles can be adequately served by one type of organization such as a large accounting firm.

Summary and Conclusions

The strategies of the large firms discussed previously in this article were investigated through the use of a participant observation research method. Participant observation is one method in a broader class of research methods classified as qualitative methods. Although acceptable in some academic journals, participant observation has not been widely used in accounting and auditing research. The epistemological grounding of accounting and auditing research within the neo-classical economic model and its adherence to positivism and empiricism have been well documented elsewhere. Nevertheless, various accounting and auditing researchers are now using qualitative methods, such as participant observation, more extensively. The challenge to social science research and research in accounting and auditing, is to penetrate through the surface aspects of structure which are often intended towards mystification. This is why qualitative research methods are helpful in that they allow a researcher to penetrate through surface structures and help the researcher to organize (i.e. structure) his or her view of the research setting in a manner that is more likely to provide both interesting results and results with long-term validity and relevance.

The focus of this article has been on the large accounting firms and the manner in which these firms attempt to manage a changing environment through structural responses designed to defend against threats to the firms' dominant position in public accounting. The large firms are facing a changing and conflict-laden environment. Over a period of years the large firms developed strategies to achieve success. This article has investigated these strategies and certain responses of the firms to a changing environment. The article has questioned whether the strategies and the responses will be effective in the future to maintain the firms' dominant position as well as self-regulation of the public accounting profession. In addition, the article has discussed why traditional accounting and auditing research methods have been unable to reveal and investigate the complexities of the environment in which the large firms operate. The article advocates the use of alternative research methods (i.e. qualitative methods) in order to more effectively address relevant research questions.

Notes

1. The large, international public accounting firms include six firms that are usually referred to as the "Big 6" (i.e. Arthur Anderson; Coopers & Lybrand; Deloitte & Touche; Ernst & Young; KPMG Peat Marwick; and Price Waterhouse) plus several other firms that are international in scope but somewhat smaller in size (e.g. BDO Seidman; Grant Thornton; McGladry Pullen; Pannell, Kerr, Foster).
2. *United States* v. *Arthur Young & Company* et al., 104 S. Ct. 1495, 465 US 805 (1984), p. 1503.

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