

THE POWER AND THE GLORY OF BIG 4: A RESEARCH NOTE ON INDEPENDENCE AND COMPETENCE IN THE CONTEXT OF IFRS IMPLEMENTATION

Cătălin Nicolae ALBU¹ and Nadia ALBU


The Bucharest Academy of Economic Studies, Romania

Szilveszter FEKETE PALI-PISTA and Dan CUZDRIOREAN VLADU

Babeş-Bolyai University, Cluj-Napoca, Romania

ABSTRACT

One of the major roles in promoting accounting convergence is played by big accounting firms (Big 4). The objective of this paper is in this context to analyze and question the role of big auditing firms in developing and implementing IFRSs worldwide, in order to better understand the convergence process. This is a research note intended to contribute to the debate on the role of auditors in general and in the context of IFRSs application in particular, to raise some questions and to identify future research directions, and to invite to reconsider the hidden aspects (both positive and negative) of apparently simple issues. We identify some questions to be addressed in the future regarding the competence of Big 4 in IFRSs, the relationship with their clients issued from this well-known competency and the associated issues of independence.

 *Big 4, IFRS, independence, competence*

INTRODUCTION

The process of accounting convergence and the issues related to the implementation of International Financial Reporting Standards (IFRSs) worldwide are topics of much interest recently for both researchers and practitioners. While there is some research in this area, a lot of research still needs to be done in order to understand all the mechanisms of accounting change and resistance to change

¹ *Correspondence address:* Cătălin Nicolae Albu, The Bucharest Academy of Economic Studies, Piata Romana No 6, Sector 1, Bucharest; tel: 021/3191900; email address: catalin.albu@cig.ase.ro.

around this process. Also, this subject is of interest borderless, since IFRSs tend to become the main set of standards (at least for capital markets) at the international level, and to have an influence on national standards and regulations.

This process of movement towards IFRSs is supposed to be driven by globalization. The impact of globalization is illustrated by the growing number of multinationals, by the economic integration measured by the evolution of commerce and of the relationships between countries, but also by the countries' and people's adherence to global organizations, which affect individual actions. Obviously, globalization leads to the need of "a single accounting language" and the International Accounting Standards Board (IASB) responds to this need by issuing IFRSs.

On the other hand, the national characteristics, represented by each country's accounting culture and traditions developed over time in close relationship with the political, social and economical environment of each of them, influence the manner in which IFRS are applied. Accounting in this context is more than debit and credit, because it supposes a set of accounting policies, reflected in recognition, measurement and disclosure practices. Factors such as the role of the State, the type of legal system, the providers of finance, the relationship between accounting and taxation, the culture, the role of the accounting profession significantly influence accounting practices (Alexander *et al.*, 2006; Nobes & Parker, 2008). These factors also lead to differences in IFRS application from country to country. For example, Delvaille *et al.* (2005) found out that France, Germany and Italy, previously viewed as sharing many similarities between their accounting models, have differences in their accounting practices and the way in which IFRSs are applied.

Consequently, accounting convergence proves to be a slow and difficult process. Different factors affect and interfere with this process. It is considered that a major role in promoting convergence is played by the big auditing firms (Big 4 in the present). Generally, auditing was treated as "a politically neutral technique of verifying the accounts" (Flint, 1988 cited in Klarskov Jeppesen, 1998: 518) and there is a paucity of research on the political implications of this process. The objective of this paper is in this context to analyze and question the role of big auditing firms in developing and implementing IFRSs worldwide, in order to better understand the convergence process.

This is an exploratory study, since the role of auditors in the IFRSs implementation was marginally researched before. We mainly build our theoretical argument on previous research papers on IFRSs application and auditing, while for the Romanian case we also make use of several interviewsⁱ we have conducted for another study (Albu *et al.*, 2009), as they revealed besides the original purpose of the paper, interesting aspects related to the role of auditors. Humphrey *et al.* (2009) and Sikka (2009) recently discussed the audit process in general and the case of

Big 4 in particular in the context of the global financial crisis, and called for research in this area. We intend to contribute to this need by raising some questions about the role of Big 4 in IFRSs implementation in emerging countries (where the accounting profession generally lacks developed competencies) in particular.

This is a research note intended to contribute to the debate on the role of auditors in general and in the context of IFRSs application in particular, to raise some questions and to identify future research directions, and to invite to reconsider the hidden aspects (both positive and negative) of apparently simple issues. We will present a short history of the big accounting/auditing firms, some considerations on the role they undertake in IFRSs development and implementation, and the implications on the independence/competence debate resulting from the relations they develop with their clients in the process of IFRS implementation. Finally, we raise some questions for future research and the debate on the role of Big 4 in IFRS implementation.

1. BIG AUDITING FIRMS – A SHORT HISTORY

From its development in the 19th century and until the present day, auditing was not a static activity and underwent several evolutions. Auditing is considered to be a mechanism of control, a means to increase the credibility of the financial image of an entity. The audit process is an activity that reduces agency costs from the economic point of view, and a social mechanism of control from the social point of view (Richard, 2006: 155). The audit developed as a referee, and the auditors are considered “guardians of trust” (idem: 155) or watchdogsⁱⁱ (Reckers *et al.*, 2007).

The phenomenon of auditing internationalization is associated with the emergence of big auditing firms. While auditing developed in Anglo-Saxon countries, these countries are also the origin of the big firms. A paper published in 1960 in *Fortune* uses for the first time the term ‘Big Eight’ (Big 8) to refer to the then existing biggest audit firms. As a result of several mergers in the 1990s, they turned into the Big 5, and after Enron and the fall of Arthur Andersen, they finally turned to Big 4 (Deloitte Touche Tohmatsu, Ernst&Young, KPMG, and PricewaterhouseCoopers). These auditing firms are considered as engines of growth, profitability, and internationalization (Zeff, 2003a: 190); they audit the biggest companies; and they engendered and still do the major changes in audit, but also in accounting.

One of the major issues discussed in the context of the Big 4 evolution is the ratio between auditing and advisory (consulting) services. A detailed historical analysis of the evolution of big auditing firms is made by Zeff (2003a, 2003b) and Klarskov Jeppensen (1998); the authors describe how these organizations changed over time their ethical objectives with commercial ones, and the implications of these changes. Zeff (2003a) considers that the profession was at its peak between the 1940s and the mid-1960s, “reaching the height of their standing and reputation”

(idem: 193). At the beginning, auditing and consulting services were considered as being different; for example, Mautz and Sharaf (1961 cited in Klarskov Jeppensen, 1998: 525) explain that in consulting activities, there is a mutuality of interests between the auditor and auditee because the auditee's success proves the success of the consultant. But the big firms gradually began to expand their activities, and started to employ a strategy of "adding value to audit" by a proximity to their clients and a commodification of the auditing process (Klarskov Jeppensen, 1998), with an ultimate impact on the auditors' ethics and independence. For example, Zeff (2003b: 276) uses the opinion of Mark Stevens, the author of the book "The Big Six", published in 1991:

"Beyond the issue of size, the firms must face a more serious question: What, exactly, do they want to be? For generations, the Big Eight were proud of their role as audit professionals [...] as the firms become more intimately involved with their clients through their consulting practices, as they think of themselves more and more as consultants who happen to do audits [...]"

Klarskov Jeppensen (1998) considers that audit is a commodity because starting with the 1970s the strategy of the big firms changed. This change was driven by the increasing competition and clients' expectations. The big firms responded by changing their approach to auditing, by developing new audit approaches (as for example the risk model developed in the 1980s), by setting financial objectives and becoming businessmen. The author supports his argument by public documents of the big firms, published during the years. For example, KPMG published on its website in 1997 (idem: 521) the following explanation for the change in strategy:

"... clients are asking for an audit that does more than look at numbers. They want to know how they compare against industry best practices. They want to know about potential risk facing their business. Most important, they want and expect their auditors to deliver this information".

These changes in the approach of big firms had an impact on their independence and competence, elements affecting the relationship between the auditor and the auditee, and the quality of the audit report. We will analyze these issues in the next section.

2. BIG 4 AND THE ROLE THEY UNDERTAKE IN IFRS IMPLEMENTATION

Big accounting firms have always been involved in standard setting, especially in Anglo-Saxon countries. In respect with the IASB, a large number of its members have been involved with these large accounting firms, while these firms largely contribute to the financing of the IASB (Brown, 2004). These issues raised doubts regarding the independence of the IASB and how Big 4 are involved in standard

setting. This led to the distinction between the standard-setting process (the IASB) and the financing one (the IFRS Foundation) in 1999/2001.

On the other hand, Big 4 have always considered that “the traditional roles of a major accounting firm – [is] participating in standard setting and developing guidance on the application of accounting standards” (Tokar, 2005: 64). Two papers authored by Big 4 partners (Tokar, 2005; Hoogendoorn, 2006) show that all big accounting firms have established working groups acting internationally, in order to develop the same interpretation of the issues raised by IFRS implementation. In this line Tokar (2005) shows that her accounting firm is concerned with training its staff to ‘speak IFRS’, with avoiding divergence through different interpretation, and with developing publications and electronic resources on IFRS.

Hence, members of large accounting firms demonstrate they are aware that IFRS can be interpreted in many ways, based on national systems and cultural factors. However, as the market and securities regulatory bodies expect a uniform application of IFRSs, large accounting firms feel this pressure: “One brand –name, one interpretation – that is the expectation securities regulators seem to have of the Big 4 auditors” (Hoogendoorn, 2006: 24). Accordingly, these firms found it appropriate to stimulate large consultations in order to find one solution to different interpretations. Such situations occur because of the principle- not rule-based nature of IFRSs, and principles tend to lead to interpretations. Also, large accounting firms assume an important role in training on IFRSs, as national training usually focuses on national regulations and legislation, not IFRSs.

Since Big 4 firms regard themselves at least “in part as arbiters” on the application of IFRS worldwide (Tokar, 2005: 51), sometimes there is a risk that they interfere in IFRS application by their customers:

“There is a deep involvement of the auditors in achieving full compliance with IFRS. The involvement of auditors is so significant that they run the risk of becoming heavily involved in preparing financial statements they are required to audit.” (Hoogendoorn, 2006: 24).

We will deal in the following section with the perception of other actors on the role of Big 4 in IFRS implementation, and the related issues of competence and independence.

3. THE ROLE OF BIG 4 IN IFRS IMPLEMENTATION

In previous sections we have analyzed the strategic objectives of Big 4 in terms of development and profitability, as well as their intent to get significantly involved in standard setting and application. We will turn now our attention to their role in IFRS implementation, and to the expectations of the other interested parties.

We consider relevant the description of Big 4 made by Cooper and Robson (2006: 416):

‘... important sites where accounting practices emerge, become standardized and are regulated, where accounting rules and standards are translated into practice, and where professional identities are mediated, formed and transformed.’

But auditors are also considered an enforcement mechanism in IFRS implementation (Brown & Tarca, 2005). A correct application of IFRS requires an enforcement mechanism comprising (Idem: 183): control and management systems for good reporting, independent auditors and IFRS experts, and oversight bodies. One can note that auditors are viewed as part of the enforcement mechanism, but only to the extent they prove to be independent and competent. These two are of crucial importance in order to have good quality audit; yet, the number of studies analyzing both of them is low, as such studies regard them as associated (for example, they assume independence as a prerequisite for competence, and vice versa, that auditors cannot be independent unless they are competent).

A relevant study related to this issue (Richard, 2006) argue however that a balance needs to be maintained between independence and competence in the sense that auditors, especially from Big 4, are highly competent but clients expect to have a close relationship with them. The above-mentioned study contains significant evidence on the matter, obtained via interviews; part of which follows:

- in respect with the justification of the need to act both as consultant and auditor: “an auditor is both insider and outsider. The insider side should be only there to be sure that the role of outsider is held perfectly” (Auditor);
- in respect with firms’ expectations: “Often, we ask them for ideas. We need their technical skills, their creativity, their intimate knowledge of our business but also their experience outside the company in the same kind of situations, to know which solution can be applied”;
- on independence: “I think that you heard about the word independence, often... I think we try to respect it but that does not stop in everyday life...” (Accounting director); “Independence without being well-informed, cannot function.” (Auditor)

All these lines uncover interesting aspects on the relationship between auditors and their clients, based on mutual expectations. More than that, in ex-communist countries such as Romania, the auditor-client relationship is also influenced, as previous literature shows, by such issues as corruption, lack of training of professionals and participants to the economic environment, as well as the need to attract foreign capital from more developed countries. The large accounting firms have entered quickly the market of these countries, understanding the business opportunities and becoming quickly involved in the creation and reorganization of the profession, and sometimes even in national standard setting processes (Kisch *et*

al., 2000). Along with their penetration in these countries, the large accounting firms have also brought an orientation towards accounting of Anglo-Saxon inspiration. For example, some authors (Delesalle & Dellesalle, 2000) regard large accounting firms as one of the driving forces to have contributed to the second wave of reform of the Romanian financial reporting model (1997-1999) towards International Accounting Standards – IAS) and accounting of Anglo-Saxon origin.

In such ex-communist countries a distinction is usually made between large accounting firms (and possibly other foreign firms) and local ones (Sucher & Zelenka, 1998; Sucher & Bychkova, 2001; Sucher & Jindrichovska, 2004; Sucher & Kosmala-MacLulich, 2004; Albu *et al.*, 2009). Previous studies show that local auditors are very concerned with maintaining their clients, and are hence viewed as less independent. Thus, the various actors involved in the accounting process (preparers, professional bodies, users) consider Big 4 more independent than local firms. In the Czech Republic (Sucher & Jindrichovska, 2004) large companies that have been audited by Big 4 have pre-tested IFRS before implementation, have set a calendar and have been supported by Big 4 in this respect. On the other hand, companies with local auditors have not set a calendar for IFRS implementation, and did not have training and pre-testing.

Also, in these countries, it is especially the large firms and foreign investors that implement IFRS and seek support from Big 4. Sometimes, due to the lack of qualified personnel, companies seek support and guidance from their auditors in choosing appropriate policies used to establish financial statements, as we will further show via interviews. This is usually due to the fact that Big 4 have significant financial resources that they invest in maintaining IFRSs competencies. As our data shows, interviewees consider it is normal that during the first years of IFRSs application, the auditors work with their clients to undertake this mission correctly. Sucher and Alexander (2002 cited in Sucher & Jindrichovska, 2004: 132) found evidence that “in some cases, with IFRS reporting, the Big 4 firms both prepare and audit the IFRS financial statements”.

Another significant issue in these countries is the importance of taxation and its impact upon financial statements. Usually, auditors believe that their role is to report that financial statements give a true and fair view in accordance with the relevant financial reporting framework (European Commission, 2010: 7), while their clients may consider sometimes that this process provides also consultancy on taxation matters and is a means to ensure conformity with accounting and taxation regulations. Hence, auditors are perceived as the lawyer of the entity they audit in its relationship with the tax controllers.

Big 4 are therefore perceived as having a special relationship with their clients, based on status and competence. In this respect, an auditor in one of the Romanian branches of one of the Big 4 shows that (Albu *et al.*, 2009: 21):

“Romanian audit firms do not have the authority and the power Big 4 have in imposing some treatments. Of course the managers may not be very happy about it, but we can nevertheless demand [...]”

A preparer in a large entity in Romania, subsidiary of a foreign group, audited by one of the Big 4, shows that (Idem: 19):

“Our company uses IFRS [...] The auditor requires that we use some of the requirements in IFRS in individual financial statements, drawn in accordance with national regulations”.

One of these treatments is testing for impairment of property, plant and equipment. An auditor we have interviewed shows that (Idem: 19):

“In practice no one calculates the value in use. They use an independent appraiser [...], and as long as they account for some impairment, it is good for the auditor”.

The same applies for the Czech Republic (Sucher & Jindrichovska, 2004: 126):

“Drive for impairment comes from the auditors. The auditor asks the company to perform the appraisal. [I] ... had never seen a company do it of its own volition.”

These examples demonstrate the positive role played by Big 4 in promoting appropriate accounting policies, leading to a move away from the tax treatment and to a focus on users’ needs. However, some argue that Big 4 are not necessarily driven by a concern for the public interest, but by their own financial interests; in this line, a former auditor in one of the Big 4 argues that:

“Some financial managers and accountants do not know what is going on [with IFRS]. They are only the passive receivers. In [X audit firm], there are templates that transform Czech accounting to IAS. The knowledge is kept in the audit company. It is big business [for the audit firm]” (Sucher & Jindrichovska, 2004: 132).

This evidence shows how Big 4 are perceived in these countries as enjoying a high level of IFRS competence, as having the power to impose adequate accounting policies, as benefiting from the acceptance of foreign investors and local entities, but sometimes also regarded as being driven by financial objectives.

CONCLUSION, DISCUSSION AND FUTURE RESEARCH

As mentioned from the very beginning, the role of this research note is to contribute the debate on the role of auditors in general and in the context of IFRSs application in particular, and to invite to reconsider the hidden aspects (both positive and negative) of the role they assume and actions they undertake. We provided evidence from literature or from our previous studies (Albu *et al.*, 2009) suggesting an important role and an interesting position of Big 4 in IFRSs

application in general and in Romania and other ex-communist countries in particular.

The first issue we advance here is how big auditing firms promoted IAS/IFRS and supported their implementation in countries generally lacking competencies in this area. Big 4 were generally considered as “keepers of best practices” and they played a role in mimetic and normative isomorphism leading to an increased quality of IFRSs implementation (Albu *et al.*, 2010). In this case, we consider useful to investigate how Big 4 actually participate in this process: how important were their financial interests?; how easily they spread their knowledge on IAS/IFRS implementation?; how did their relationship with clients affect the auditing process and the quality of their audit report?; did the quality of IAS/IFRS implementation prevail over the quality of the audit report?; was the relationship the same across all ex-communist countries or particular aspects/different actors emerge? We believe that answering these questions is necessary in order to understand how the IFRSs implementation get where it currently is, which were the sensitive aspects and how may the past influence the future.

Secondly, we wonder about the involvement of Big 4 in the standard setting and/or regulatory processes of each country. They have an important experience in this area and they tend to fulfill this role gladly. For example, in China the main consultant in the development of the accounting system by the Ministry of Finance towards IFRSs was Deloitte Touche Tohmatsu (Nobes and Parker, 2008: 275), with this country being presented in literature as an example of a successful convergence process (Peng & van der Laan Smith, 2010). Which was then the role of big auditing firms in the reform of accounting models? Their actions lead to adopting IFRSs or to a better national accounting model?

Thirdly, the issue of independence is becoming increasingly important nowadays, especially in the context of financial crises (Humphrey *et al.*, 2009; Sikka, 2009). However, there is evidence (Richard, 2006) that clients expect close relationships with their auditors, especially in the context of IFRSs implementation. The main questions in this context are: how could and/or should the auditors' competence and IFRS experience component be used by their clients without impacting independence? Sikka (2009) and the European Commission (2010) for example advance some solutions for increasing independence, such as reconsidering the institutional arrangements for auditing and finding alternative models without directly involving accounting firms. In this context, we may ask if the role of Big 4 should be in consulting or in auditing? It is already advanced in literature that attempts to separate them (such as the Sarbanes-Oxley Act of 2002) were resisted and the change was not significant in this area (Sikka, 2009: 871).

Fourthly, how do these debates on expertise and independence affect the image of auditors in particular, and the image of the accountancy profession in general? For example, Reckers *et al.* (2007) found out that the attitudes of judges, law students and MBS students towards auditors is more negative in recent years, probably because the press revealed some cases in which the auditors issued unqualified audit reports for companies shortly experiencing severe financial problemsⁱⁱⁱ (Sikka, 2009). These cases raised questions about the role of auditing, and the competence and independence of auditors, not always in the best of terms^{iv}, proving that the image of the accounting profession in general is negatively affected. If this image was seriously affected in developed countries, what is then the case in ex-communist countries? Have the big firms kept an intact image, based on the representation their clients have of them? Also, knowing that the accounting profession in such ex-communist countries is less developed than in their western counterparts, does the intervention of international firms in these countries contribute to the development of the profession irrespective of the current competence-independence debates in more developed countries?

Fifthly, but at least of the same importance as above, since IFRSs are principle-based, and firms will search somewhere for direction and guidance (Schipper, 2005: 105), are the big auditing firms the best place to look at? Also, are Big 4 acting for a single set of accounting standards and/or a single interpretation of such standards? What practices does an ex-Big 4 employee promote? If international firms and their former employees promote a single set of standards, does it mean that they strive to overcome the national “barriers” such as culture and tradition? How long will the national differences endure?

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ⁱ Details regarding the interviews (interviewed persons, duration etc.) are offered in the original paper.

ⁱⁱ We thank David Alexander for his suggestion of referring here to the history of using this word in relation to auditors. This word is linked to a quote by an English judge: "an auditor is a watchdog, not a bloodhound." Details may be found for example at http://www.rohanchambers.com/Courses/Auditing/auditors_watchdog_or_bloodhound.htm

ⁱⁱⁱ The example provided in Sikka (2009) is Lehman Brothers; it received an unqualified audit opinion on its annual accounts on 28 January 2008, followed by a clean bill of health on its quarterly accounts on 10 July 2008. However, by early August it was experiencing severe financial problems and filed for bankruptcy on 14 September 2008.

^{iv} For example (Sikka, 2009), a former minister in Ireland, has described auditors as a "joke and a waste of time. They are lick-arses for the management of companies, because corporate governance doesn't work in our society ... the banks are in difficulty because of their auditing".