

A Comparative Analysis of Auditor Independence in Economies in Transition

Katarzyna Kosmala MacLulich
Heriot-Watt University, Edinburgh

and

Pat Sucher
Royal Holloway University, London

Published by
The Institute of Chartered Accountants of Scotland
CA House, 21 Haymarket Yards,
Edinburgh EH12 5BH

First Published 2004
The Institute of Chartered Accountants of Scotland

© 2004
ISBN 1 904574-07-6

This book is published for the Research Committee of
The Institute of Chartered Accountants of Scotland.
The views expressed in this report are those of the authors
and do not necessarily represent the views of
the Council of the Institute or the Research Committee.

No responsibility for loss occasioned to any person acting
or refraining from action as a result of any material
in this publication can be accepted by the authors or publisher.

All rights reserved. No part of this publication may be
reproduced, stored in a retrieval system, or transmitted, in
any form or by any means, electronic, mechanical, photocopy,
recording or otherwise, without prior permission of the publisher.

RESEARCH REPORTS REFEREEING PROCESS

The Research Committee applies a rigorous refereeing process to all stages of its research reports. The refereeing process operates by sending the initial research proposal to two independent referees (one academic and one practitioner). The academic referee will either be a member of the Panel listed below or an *ad hoc* referee. All proposals are also reviewed by the Director of Research who remains in close contact with the project. The two referees are consulted on the academic and technical standard of the draft research report. In particular, they are asked to comment on:

- the academic rigour of the document;
- the validity of the approach taken in the report;
- whether the presentation of the report identifies the key issues and brings these to the attention of the intended reader; and
- whether the document will add to the knowledge and understanding of the interested reader.

PANEL OF ACADEMIC REVIEWERS

Professor J Bebbington	University of Aberdeen
Professor V Beattie	University of Glasgow
Professor J Broadbent	Royal Holloway, University of London
Professor J Haslam	University of Dundee
Professor J Holland	University of Glasgow
Professor W M McInnes	University of Stirling
Professor C Mallin	University of Birmingham
Professor H Mellett	Cardiff University
Professor M J Page	University of Portsmouth
Professor C Roberts	University of Aberdeen
Professor M J Sherer	University of Essex
Professor P Weetman	University of Strathclyde
Professor R M S Wilson	University of Loughborough

The Research Committee is grateful to all those who participate in the refereeing process.

CONTENTS

<i>Foreword</i>	<i>i</i>
<i>Acknowledgements</i>	<i>iii</i>
<i>Executive Summary</i>	<i>v</i>
1 INTRODUCTION	1
2 AUDITOR INDEPENDENCE: A LITERATURE REVIEW	5
Traditional research on auditor independence	5
Framework approaches	9
Culture	11
Summary	15
3 RESEARCH METHODOLOGY	17
Revision of a framework approach	17
Research methods	20
The data analysis	23
Conclusion	25
4 AUDITOR INDEPENDENCE IN THE CZECH REPUBLIC	27
Initial history of audit in the Czech Republic	27
Current institutional framework for auditor independence	29
<i>De jure</i> analysis	30
<i>De facto</i> compliance	37
Cultural context	54
Proposed changes in the IFAC Code of Ethics	60
Summary	61

CONTENTS

5	AUDITOR INDEPENDENCE IN POLAND	65
	Initial history of audit in Poland	65
	Current institutional framework for auditor independence in Poland	66
	<i>De jure</i> analysis	70
	<i>De facto</i> compliance	77
	Cultural context	92
	Proposed changes in the IFAC Code of Ethics	97
	Summary	98
6	CONCLUSION	101
	Development of the professional organisations' approach to auditor independence	101
	Economic competition	103
	Immaturity of the legal system	104
	Rules-based approach to auditing	104
	Provision of other services	104
	Auditors' approach to auditor independence	105
	Differences in <i>de jure</i> and <i>de facto</i> implementation	106
	Revisiting the framework	106
	Implications for policy makers	107
	Cultural context	109
	Summary	110
	REFERENCES	111
	APPENDIX 1:	
	LIST OF THE INTERVIEWEES IN THE CZECH REPUBLIC	121
	APPENDIX 2:	
	LIST OF THE INTERVIEWEES IN POLAND	123
	APPENDIX 3:	
	AN EXAMPLE OF THE INTERVIEW SCHEDULE	125

FOREWORD

O wad some Pow'r the giftie gie us. To see oursels as others see us

While the independence of external auditors is a long established and well understood concept in the Anglo-American business world, it was an alien and irrelevant concept in the countries of the Central and Eastern European region until the early 1990s. In those economies, there was no capital market, merely central capital allocation. Entities might produce and sell but they were not businesses in the sense that markets did not determine or influence capital inputs or outputs of products or services.

Naturally the Finance Ministry wanted to have reliable data to see how each entity was doing, and the accountants in many such organisations saw themselves as the Ministry of Finance or Taxation's 'man at the entity' with their primary loyalty being to the Ministry they reported to rather than the entity they worked at. For such entities then, their own accountants were the key – and often only – check on the management and control regime. Some, however, carried out this role with a keen eye on how best to present the results of the entity so as to keep the 'men from the ministry' at bay from their day-to-day colleagues and hence were mainly concerned with achieving an appearance of independence of mind.

However, the events of the late 1980s and early 1990s such as the fall of the Berlin Wall, the Velvet Revolution in Czechoslovakia and the demise of the Iron Curtain opened many of these economies up to greater interaction with the West and confronted them for the first time with the disciplines of the market. Western businesses sought to develop trade links with these economies and to invest in local companies. With their investment they brought a desire for objective

accountability and for the type of external audit of companies that they were accustomed to.

What had been an unknown concept therefore had to be implemented in a relatively short space of time in these “economies in transition” and an audit profession of a type that had developed over centuries in the West had to be created in only months or a few years. This necessitated the creation of chambers of auditors from a standing start whose founder members were those with some accountancy, but no audit, experience. These bodies have then sought to introduce Western style professionalism to their membership, and to develop the idea of the independent auditor.

Following from the words of Burns quoted above, this research is a fascinating insight into how this has been interpreted and developed in two of these “economies in transition”, Poland and the Czech Republic. Interviews with auditors, preparers and users of financial statements, academics and standard setters have ascertained how the concept of auditor independence, so familiar to us, is seen by people to whom it is a relatively new idea.

The Research Committee of The Institute of Chartered Accountants of Scotland has been delighted to sponsor this project. With the expansion of the European Community to include a number of these ‘economies in transition’ it is no longer just business pioneers who are doing business there, and more and more UK companies will need to understand something of the underlying business environment of our new economic neighbours. The Research Committee hopes that this project will make a valuable contribution to that knowledge as well as to helping those affected by audit to apply a fresh perspective to auditor independence issues.

Nigel Macdonald
Convener
Research Committee
October 2004

ACKNOWLEDGEMENTS

We would like to thank all those who agreed to participate in our study for their time and help during data collection process.

We would also like to thank Professor Christine Helliard, Director of Research at ICAS for her helpful comments and Isobel Webber, Personal Secretary to the Director of Research who typeset the report.

EXECUTIVE SUMMARY

Auditor independence has for many years been seen as a crucial aspect of the credibility of the external audit function which, itself, is an important monitoring device of organisations, but it has been conceived in a predominantly Anglo-American context.

In recent years, as the requirements for companies to have an external audit have been implemented in economies in transition, the requirement for auditors to be independent has also been introduced into their national laws, especially in the context of European Union (EU) harmonisation and accession. It is, therefore, appropriate to research how a construct of auditor independence has been implemented in these economies in transition. An analysis of auditor independence in a different context from much of the Anglo-American research enables this topic to be reviewed from a different perspective. This project has been undertaken to investigate how the concept of auditor independence is perceived, and has been implemented, in two economies in transition: the Czech Republic; and Poland. A basic premise of this project is that auditor independence is not a single-faceted concept, but a multi-layered and complex construct that should, therefore, be analysed holistically. Some of the issues concerning auditor independence raised in this report are also relevant for developed market economies.

The research was undertaken between June 2001 and April 2002 and involved two stages. In stage one a framework of requirements for auditor independence was established building on the research of Sucher and Bychkova (2001). In order to seek a comprehensive understanding of what was happening in these transition economies, where the external independent audit may have been seen as a new concept, all aspects of auditor independence, from the basic educational

provision for an auditor, to complex aspects such as the provision of non-audit services (NAS), were considered. From all of these aspects of independence, a framework of the requirements for independence was developed and is discussed in chapter three.

This stage of the research consisted of describing the economic, social and historical context for auditor independence in Poland and the Czech Republic and compared the current legislative and institutional frameworks for auditor independence in Poland and the Czech Republic; the *de jure* case. Any differences between the initial framework and the country's statutory regulations were identified as issues and formed the second stage of the research – the interview stage.

In stage two, semi-structured interviews regarding auditor independence were undertaken in both countries with: auditors; preparers; users of financial statements; academics; and standard setters. The local professional press was also reviewed for any coverage of issues of auditor independence. The interviews were designed to ascertain how the concept of auditor independence was perceived and how the processes for implementing and monitoring auditor independence operated in practice; the *de facto* case.

Findings

De jure analysis: country comparisons

Overall, there was a similarity in the path that both the Czech Republic and Poland had taken for dealing with auditor independence. In both countries, Chambers of Auditors had been established (Czech Republic 1992; Poland 1991) and all auditors had to be members of their respective Chambers. Chambers were responsible for the education, training, discipline and quality control of their auditors. An initial cohort of auditors, trained under the communist regime, but

not necessarily subject to the new examinations, were also brought into each Chamber. In both countries this group of auditors formed the vast majority of current registered auditors.

There were a number of similarities between the Czech and Polish Codes and the IFAC¹ Code (1999) regarding independence, in areas such as having direct financial interests, the percentage of fees from individual clients and the provision of goods and services. The Czech Code, however, included fewer requirements from the IFAC Code than the Polish Code. In both countries, however, the provisions in their Codes of Ethics were being revised to bring them into line with the new independence provisions in the IFAC Code of Ethics 2001.

Other *de jure* similarities between the two countries were in such areas as the requirement for audit standards, the education of, and assessment in, these standards and the necessity for legal liability insurance. Many of these similarities followed from the way in which both countries, as accession countries to the European Union, had sought to conform to the European Eighth Directive.

De jure and de facto implementation

From the interviews reported later, there was evidence that the societal, cultural and economic pressures, which might be threats to auditor independence in transitional economies, far outweighed any formal safeguards, either to maintain professional competence or to follow regulations on the provision of other services. Although there may be disciplinary mechanisms to ensure that all the regulations are followed, there are substantial issues in applying these enforcement mechanisms within the current immature legal framework and local traditions in accounting. These aspects appear to have had the most effect on the capacity of auditors to be independent.

In both countries there were issues of severe economic competition among auditors, an immature legal system, a strong influence of taxation

on financial reporting and low levels of enterprise liquidity, all of which could have a substantial impact on auditor independence.

In both economies a large proportion of qualified auditors were from the Communist regime, who did not have the necessary training in existing, originally Anglo-American, standards of auditing. However, there were requirements for continuing professional education in both countries and this may help to deal with this problem in the future.

There appeared to be a significant difference in the presence and press coverage of local auditor “scandals”. In the Czech Republic there has been quite extensive coverage of audit failures. Most of this coverage has related to the audit of large Czech banks by local Czech audit firms and the Big Five² audit firms. The lack of transparency that arose with the privatisation of Czech banks in the economic recession of the mid 1990s, resulted in some banks being forced into liquidation. Some of these banks went into liquidation with unqualified audit reports. However, there has been far less coverage of similar issues in the Polish press.

There were indications that, within the difficult economic environment, the local culture might have an impact on the ability of auditors to be independent. In particular, the emphasis on individual independence, comradeship and a rules-based approach to auditor independence in Poland could undermine the capacity for auditors to be independent. In the Czech Republic, the emphasis on the economic and rule-determined basis of auditor independence, allied with an adaptive approach to regulations and an emphasis on loyalty to friends and family, might mitigate against the problems of auditor independence.

Issues for consideration for policy makers

Enforcement

To establish a new institutional framework for auditor independence in the Czech Republic and Poland, it is important to have a strong, believable, enforcement mechanism that builds up trust in the audit process among users of financial statements, where there should be an emphasis on providing resources for the regulatory mechanisms, such as the Supervisory and Disciplinary Commissions, to ensure that they can enforce the regulations.

Although independence requirements based on the November 2001 conceptual approach of IFAC might be possible in these countries, if supported by adequate training, the implementation of independence would be enhanced if detailed examples of what undermined auditor independence were provided in a developing market context. This requires the commitment of auditors to an enhanced legal capability in the transition economies, with properly functioning courts of law, and trust in the justice system for being equally accessible to a lay person, so that actions can be properly pursued through the courts.

Economic competition

Given the opacity of the quality of an audit to outside investors, it is likely that many users of financial statements are likely to continue to use the size of the audit firm as an indicator of quality. Size means predominantly what is now the “Big Four”, where the large international consortia of audit firms, are seen as offering a higher quality of audit compared with local audit firms.

The issue of NAS is of a different order in smaller local audit firms than in the Big Four audit firms. With the Big Four audit firms, it may seem appropriate, at least, to disclose in the enterprise’s Annual

Report how much is paid as audit fees and how much as other fees, for users to assess the implications. A tougher issue is ensuring that auditors act in the public, rather than their own private, interest with or without the provision of excessive NAS. The rotation of audit partners within an audit firm may be an appropriate control as well as closer governmental supervision of auditors, such as the closer regulation of the Chamber of Auditors in Poland and the Czech Republic by a government department. This may be feasible, as there is a long tradition of state interventionism in the accounting profession in this part of the world.

Cultural context

Western accounting knowledge in the form of ‘best practice’ is a key theme in EU institutions and throughout their supporting legislative structures. This kind of approach has been imposed on developing markets through the harmonisation of national laws and practices with the requirements of the EU Directives. As a result, patterns of conduct, based on Western ideas in terms of best practice, travelled to the Central and Eastern European (CEE) region without the recognition that there were ‘differences’ in local culture and accounting traditions and that professional ethics were historically constructed by other sets of concerns. New levels of perceived normality have been established for professionalism without reference to any cultural constructions within the CEE. Conclusions on the readiness for the accession of associated countries have been determined according to Western European political ideas.

The framework for audit independence may be developed as a template to facilitate a dialogue between Europe and the accession countries, to establish what constitutes perceived normality in professional conduct and to define an appropriate time span to bring such conduct into line (as far as possible) with EU requirements.

ENDNOTES:

- ¹ IFAC = International Federation of Accountants.
- ² When this research was conducted, there was a Big Five of international audit firms. Therefore, unless making comments about the current situation in 2004, most references are to the Big Five.

CHAPTER ONE

INTRODUCTION

In recent years, in the context of European Union harmonisation and accession, external auditing has been introduced in economies in transition, with the western accepted norms of professional best practice and the requirements for auditors to be independent (Sucher and Zelenka, 1998). As auditor independence has been seen as key to the value of the external audit function (Mautz and Sharaf, 1961) and to the development of an accounting profession (Sikka and Wilmott, 1995), it would seem relevant to research how it has been implemented in two economies in transition, using the examples of Poland and the Czech Republic.

In this report, the authors have investigated how the concept of auditor independence is perceived by various stakeholders and how it has been implemented in these two economies in transition by focusing on:

- (1) the legislative and institutional requirements in place together with national auditing standards to ensure the independence of auditors in Poland and the Czech Republic (the *de jure* situation);
- (2) the issues that have arisen in practice with the implementation of legal and professional requirements to ensure auditor independence (the *de facto* situation);
- (3) the cultural economic, social and historical context; and
- (4) providing recommendations for the appropriateness and efficacy of provisions for auditor independence in economies in transition.

This research has been carried out by reviewing the regulations currently in place against a comprehensive framework for analysing auditor independence attending to the local milieu of the country, including the relevant sections of the IFAC Code of Ethics, and by comparing the *de facto* situation with the *de jure* regulations. The *de facto* condition has been studied through interviews with local auditors, regulators, academics and users of financial statements, and a review of the local professional press. This was supported by an analysis of auditor independence with reference to the local cultures and traditions. This then enabled a comparison to be made between the Czech and Polish approaches to auditor independence.

This research report is structured in the following way. Chapter two is a brief literature review of some of the research on auditor independence. Some of the more traditional aspects of academic research on auditor independence are discussed with a focus on the use of culture as an approach to researching auditor independence.

In the subsequent chapter the framework approaches to auditor independence are presented followed by recent attempts to develop a framework for analysing auditor independence in economies in transition, with suggestions as to how a new framework, with an emphasis on the local context, may be developed and extrapolated to analyse auditor independence in other economies in transition. This framework is laid out in Table 3.1.

In chapters four and five, this framework is used to analyse the *de jure* requirements regarding auditor independence in the law, the professional regulations currently in place and the extent to which they seem to be working *de facto* in the Czech Republic and Poland. In each chapter there is an analysis of the cultural discourse related to auditor independence that emerges from recent history in Poland and the Czech Republic. In each case this is related to the themes that emerge, regarding auditor independence, from an analysis of the interviews conducted in Poland (December 2001) and in the Czech

Republic (September 2001 and April 2002). Given the implementation of the new IFAC Code on auditor independence from November 2001, there is then a commentary on the new IFAC Code and how it might work in the two countries. The conclusions are presented in chapter seven.

CHAPTER TWO

AUDITOR INDEPENDENCE: A LITERATURE REVIEW

This chapter presents an overview of some of the auditor independence literature. There is a wealth of research on auditor independence and this chapter does not claim to be a comprehensive literature review but concentrates on two particular strands. First, the more additional aspects of academic research on auditor independence are examined. Second, the framework approaches to auditor independence are considered. The focus of the review is on the use of culture as an approach to researching auditor independence and the issues that arise in defining culture and its constituent elements in research.

Traditional research on auditor independence

Agency theory indicates that the management of enterprises may not always present full and fair financial information about their enterprises to the users of the financial statements. Therefore, there is a need for an independent, external system of attesting the financial statements to ensure that the information presented is reliable. The external system of audit, with its final product, the audit opinion, adds credibility to the financial statements so that users can rely on the information presented, and enhances the whole system of financial reporting.

The system only works effectively if the auditor is independent of both the company being audited and of its managers. Philosophically, auditors are supposed to serve society. Mautz and Sharaf (1961)

define auditor independence as a lack of bias in forming judgements, so that the auditor can be employed to report on the truthfulness of the managers' financial statements. They state that there is a 'social contract' between the auditing profession and the rest of society, which establishes the reasons for the auditor to remain independent. As auditor independence cannot be observed, however, the appearance of auditor independence is considered to be important to maintaining users' beliefs in the credibility of financial statements (POB 1994; Flint 1988). The auditing profession therefore recognises a dual connotation in the concept of audit independence; independence in fact and independence in appearance (Mautz and Sharaf, 1961), and this is reflected in the latest IFAC Code.

Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised. (IFAC 2001: 4).

Auditor independence has for many years been seen as a crucial aspect of the credibility of the external audit as a monitoring device and similar assertions to that above are included in the professional Codes of Ethics within the European Union.

Independence has been defined in terms of honesty, objectivity and a mental attitude. Shuetze (1994) argues that independence is an abstract concept, being defined by a state of mind partly synonymous with honesty, integrity, courage and character. He further states that the cynical world requires more from the auditor than mere declarations of independence. Accordingly, auditors are expected to

tell the truth as they see it and be capable of resisting any influence, either financial or sentimental, which could potentially turn them from that course. In other words, the auditor has to have an inner strength to report difficult issues (Percy, 1999). Some researchers argue that independence as an attitude of mind is only attainable for individuals who hold a deontological view of life, perceiving certain actions as morally obligatory, regardless of the consequences that may result from these actions (Moizer, 1991).

The concept of auditor independence has developed in a predominantly Anglo-American context and that is where the majority of the research has been conducted. Much of the research has focused on what is perceived to impair auditor independence and there have been various focuses for this research. Some of the research has looked at the impact on auditor independence of the client's financial condition (Palmrose, 1987); the size of the audit fee (Mautz and Sharaf, 1961; Knapp, 1985; Gul, 1991); practices of lowballing, whether or not the client calls for tenders for the audit work; and auditor switching. In summary, there are suggestions that if the client is in a bad financial condition, the auditor is likely to face a higher level of legal liability than when the client is in a good financial condition (Palmrose, 1987). Too high a level of audit fees obtained from one client could impair auditor independence (Mautz and Sharaf, 1961). Though some have argued from economic theory that lowballing would not affect auditor independence (DeAngelo, 1981), others have suggested that lowballing, through the initial need to recoup fees over the longer term, and audit tendering may impair the auditor's ability to be independent (Kunitake and White, 1986; Simon and Francis, 1988; Windsor and Ashkanasy, 1995). The likelihood of auditor switching in a severely competitive market for auditor services may also undermine the auditor's ability to be independent (Shockley, 1982 and Gul, 1991). Some authors have given some consideration to the nature of the accounting information being audited (its 'auditability') and how this may affect independence.

The possibility of varying interpretations of financial accounting practices may adversely affect auditor independence (Lindsay, 1992; Magee and Tseng, 1990 and Knapp, 1985).

Much of the auditor independence research has focused on whether the provision by auditors of non-audit services (NAS) to clients affects the auditor's actual and perceived independence. (Kleinmann *et al*, 1998; Gul, 1989; Knapp, 1985; Shockley, 1981; Lavin, 1977). Various professional committees have investigated the matter in Europe and the US (SEC 2000; FEE 1998; GAO 1996; Sutton, 1997; Wallman, 1996 and POB 1994). Prior empirical research concerning the provision of NAS has produced conflicting evidence as to the effects of the provision of NAS on the perceptions of auditor independence (eg Mitchell *et al*, 1993; Gul, 1991; Pany and Reckers, 1988; Lindsay *et al*, 1987; Kilcommins, 1997). What emerges consistently from the research is that the perception of the risk of impairment of audit independence decreases when personnel providing NAS and audit services come from separate divisions in the audit firm. Jeppesen develops the work of Power (1997) on the epistemological basis of independence to suggest that, with the rise of new business-process-oriented audit procedures, this ability to be epistemologically independent is being lost as audit and consultancy become more intertwined (Jeppesen, 1998). The recent controversy over Enron in the US and the amount of NAS undertaken by its auditors have led to calls for a ban on auditors providing consultancy services to the clients they audit.

Analysing auditor independence in a different context from the Anglo-American approach enables a review of the above aspects of research on auditor independence, such as whether users of financial statements in a transitional economy see the provision of NAS as affecting auditor independence. However, it also provides an opportunity to approach the notion of auditor independence from a different angle.

The traditional research on auditor independence implies that individual issues should be examined, such as the competitiveness of the audit market, the size of audit fees, the impact of lowballing, the provision of NAS and the mental construct of the auditor and varying interpretations of financial reporting.

For Central and Eastern European (CEE) countries, auditor independence may be seen as a new concept imported into legislation and Codes of Practice as part of the country's preparation to join the European Union. Although the individual aspects referred to above should be considered, it is still necessary to consider the concept of auditor independence as an holistic concept. In a transitional economy, where much of the language of external audit may seem alien to that particular culture and society, some consideration should also be given to the cultural context as it may determine the meaning of auditor independence in practice.

Framework approaches

A framework approach to auditor independence may encapsulate an holistic approach to auditor independence, as it seeks to work from the principles underpinning auditor independence. There have been different attempts to develop frameworks (or a principles-based approach) for auditor independence in the professional and academic spheres. The relevant regulations regarding auditor independence in the Code of Ethics (CAJEC 1995) have taken a framework approach to auditor independence for some years. This has now been adopted by IFAC (2001) and has been taken up by the European Union (EU 2002). With each client, and in particular circumstances, auditors should consider the threats that may exist to their independence and note the safeguards in place. The onus is on the auditor to identify the threats and put in place the safeguards. The overall aims of such frameworks would seem to be to move away from an ever-lengthening

‘check-list’ approach to auditor independence and to appreciate the relative, rather than absolute, nature of auditor independence. As noted by a UK auditor in 1996:

Use of the shorthand word ‘independence’ on its own creates misunderstandings. It leads observers to suppose that a decider ought to be free from all economic, financial and other relationships that appear to entail dependence of any kind. This is manifestly impossible ... Indeed we often use the word ‘independent’ to applaud a decider who successfully defies the pressures he faces. (Brian Currie, quoted in Citron, 2002).

The European Union, in their consultative paper on auditor independence commented:

Such a principles based approach to statutory auditors’ independence is preferred to detailed rules because it provides greater flexibility to react promptly and effectively to new developments in business and the audit environment than is possible with a rigid, regulation-based regime. (EU 2001).

It must be noted, however, that with these frameworks there are long lists of specific examples of what may or may not be threats to auditor independence. Therefore often, in practice, these framework approaches are a combination of overall principles and detailed examples, such as the EU recommendation that auditors should not provide the consultancy service of designing and implementing financial information technology systems. (EU, 2002).

Academically, some authors have sought to present, ‘the antecedents and consequences of independence risk in a unified framework’ (Johnstone *et al.* 2001). Johnstone *et al.* identify the direct and indirect incentives and the judgement-based decisions that create an independence risk for auditors. These include direct incentives, such as financial dependence and contingent fees, indirect incentives

such as interpersonal relationships and auditing ones own work, and judgement-based decisions such as the pressure to accept difficult accounting issues, audit scope and conduct. All of these are the necessary environmental conditions that create independence risk.

This auditor independence risk can be mitigated by such aspects as corporate governance mechanisms, auditing firm policies, regulatory oversight, auditing firm culture and individual auditor characteristics. It is the interaction of all the above elements that produces the risk to auditor independence (Johnstone et al, 2001).

As noted by Sucher and Bychkova (2001), however, in a transitional economy there may be more economic instability than in an established market economy, and the concept of an external independent audit may take time to 'bed down'. There is also a need to develop the expertise necessary to undertake the external audit (Cohen *et al*, 1992). Often approaches to auditing will have been imported wholesale (for example as part of technical assistance projects) and may be merely translations of international auditing standards. It may take some time for these to be properly implemented. Much of the language of external audit may seem alien to the particular culture and society. Therefore some consideration of national culture and how it affects auditor independence is relevant.

Culture

Sucher and Bychkova (2001) renew some of the early research on the impact of national culture on auditor independence. Much of the research in this area has built on the research of Hofstede, such as McKinnon's research (1984) which is insightful in its proposition that there may not be the capacity for auditors to be independent in certain cultures.

Hofstede defined culture as the:

Collective programming of the mind which distinguishes the members of one human group from another (and) the interactive aggregate of common characteristics that influence a human group's response to its environment. (Hofstede, 1980; p.25).

Hofstede suggested that culture could be defined in terms of four dimensions and that cultures varied across these four dimensions: power distance; individualism; uncertainty avoidance; and masculinity (Hofstede, 1980).

Some researchers have taken an intuitive approach to build on Hofstede's model and suggest what implications there might be for accounting and audit (Gray, 1988; Cohen *et al*, 1992; Cohen *et al*, 1993).

In Cohen *et al*, 1992, the authors reviewed the impact of different cultures on international codes of ethics and state:

*Professional codes of conduct typically consist of fundamental principles which are general in nature; and detailed guidance on specific cases and issues. However, the effect of the codes on professionals' behaviours is moderated by both the cultural values and socio-economic conditions dominant in a professional's country. These constraints will result in a different degree of influence and acceptability of a code in various countries. (Cohen *et al*, 1992; p.689).*

In Cohen *et al*, (1993), the authors follow through the culture-based ethical conflicts that they suggest might confront multi-national accounting firms operating in different countries. Using Hofstede's framework, they suggest aspects such as 'In general, auditors from strong UA (uncertainty avoidance) cultures are more likely to equate "legal" with "ethical" responsibilities' (Cohen *et al*, 1993). Auditors from cultures with an emphasis on individualism are 'expected to ask tough questions of management and to report to them when the review of the organisation indicates control weaknesses' (Cohen *et al*, 1993).

Though much research on culture and auditors or accountants has followed that of Hofstede, as it is easy to understand, access and use, there are difficulties with taking a 'Hofstedian' approach to culture, and indeed there are difficulties generally about using culture as an explanatory variable. These conceptual difficulties can be summarised as issues of definition, boundaries, unit of analysis and static analysis.

Definitions of culture

As a concept, culture suffers from having been defined in various ways and as still being 'one of the most elusive terms in the social sciences' (Patel and Psaros, 2000). Cray and Mallory, (1998) make reference to a review of cultural research which has suggested that there are at least 164 separate meanings attributed to culture in the literature. One of the particular difficulties is defining it in such a way that it can be researched. This may be why Hofstede's work on culture has been such a key influence on research on the impact of culture on the professions, including accounting and audit. If culture is a multi-dimensional concept, evolving in time and space, one approach is to research only some dimensions of culture using Hofstede's framework. Another way of dealing with this conceptual difficulty of defining culture is to establish the objective and approach of the research and utilise the most appropriate definition, given the objective and approach.

Boundaries and units of analysis

In discussing culture, there has often been a tendency loosely to equate culture with nations, or nation states. With some countries this is particularly problematic, such as Canada and Switzerland. The boundaries, therefore, of a specific cultural group being researched need

to be clarified. In this report the focus is on particular professional groups of auditors within the Czech Republic and Poland.

In the context of a transitional economy, the issue of different age groups having different cultural values may be particularly relevant given the different life experiences and in particular the different levels of exposure to Communism.

Static analysis

There is also a particular problem with much research on culture as it is static; it takes culture as a 'given', a complete script imbibed at birth. Cultures evolve, however, and what may be regarded as a particular value of a culture, such as the emphasis on one's circle of friends as part of life under the Communists (Ledeneva, 1998), may change under different economic and political circumstances. This may be particularly relevant given the different life-experiences of those who have lived through Communism and those who have not.

It appears that a significant problem under the rubric of culture is that it lacks sufficient focus and depth in the exploration of meaning and symbolism; instead it drifts to a more 'superficial' study of social structures and behaviours (Alvesson, 2002). Key elements of Western culture, as identified in prior cultural research in organisations and professions, such as progress, efficiency, rationalisation, productivity, masculinity, control, and hierarchy, form an organisational ideology defining what is rational and effective in other locations, such as CEE. For today's CEE countries culture underlines discourses on the market economy, various forms of ownership, democracy, pluralism, professionalism, individualism and collectivism, the country's history, statehood and transformation of society (Barker and Galasinski, 2001). This study adopts a 'fluid approach' and accepts the evolving nature of culture and therefore consciously avoids any reliance upon Hofstede's model.

Summary

The traditional research on auditor independence has focused on individual economic issues such as the size of individual audit client fees, the impact of lowballing and wider economic issues such as competition in the market for auditor services as well as aspects of auditor behaviour that may affect independence, such as the provision of NAS. There is also some emerging research on the impact of the social and cultural context in which auditors are operating. These latter aspects are likely to be of particular relevance in a transitional economy context where the external independent audit is a new, imported, concept. As the Hofstede model is not suitable for a cultural analysis that is attentive to ‘fluidity’ and the evolving nature of the culture construct, a discourse-based approach to researching the impact of culture may be more appropriate.

To obtain a fuller understanding of what is happening with auditor independence in a transitional economy it is first necessary to consider, not just those aspects already identified from the literature review of the traditional research above, but all aspects of auditor independence, from the basic educational provision for an auditor, to appointment and resignation provisions as well as aspects such as the provision of NAS. The *de jure* elements (what formally is the case) should be analysed with the *de facto* elements (what actually seems to happen). In order to undertake this analysis, it is therefore appropriate to take a more holistic approach to auditor independence. This holistic approach should include some research on what auditors and other interested parties understand by auditor independence as well as a consideration of how Czech and Polish culture may or may not facilitate auditor independence. A richer source of evidence is likely to be written sources and interviews with those involved. The methodology for approaching this research is developed in the next chapter.

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter presents the research methodology adopted in this study. First, the framework approach to auditor independence used by Sucher and Bychkova (2001) is developed. Second, the research methods employed are discussed. Lastly, insights into how the data was analysed are provided.

Revision of a framework approach

Sucher and Bychkova (2001) developed a framework that was used to take a holistic view of auditor independence in Russia, another transitional economy. Drawing upon Mautz and Sharaf's original work in 1961, they looked at the necessary requirements for programming, investigating and reporting independence with regard to audit work and individual auditor independence and explored them in relation to Russia. The framework they developed covered more contextual aspects such as the societal and economic context. Developing such a framework allowed the authors to take a more holistic approach to auditor independence. There are several aspects that could, however, be clarified and/or extended from their framework.

First, in the model it was not always clear what the unit of analysis should be; whether it was the individual auditor or the profession. Second, the analysis could be structured according to three criteria affecting auditor independence; the process of undertaking the audit; the auditors themselves; and the perception by others of auditor independence. Although these might be inter-related, it might aid the analysis if different aspects of auditor independence were separated

out. Third, legal liability insurance was an essential pre-requisite for auditor independence in their Russian study but it would seem rather more suitable, however, if the *legal capability* for auditors to be sued for appropriate damages if they did not provide an independent audit report was considered instead. There may be many legal regulations concerning this, but if they cannot be enforced in a court of law for whatever reason, then this may undermine the whole legal edifice. Fourth, their framework could be extended to include the necessity for some type of system of control to ensure that auditors had sufficient expertise and were conducting quality audits.

Although there may be a body of auditing expertise, there needs to be some system for assessing whether auditors have technical competence in auditing expertise before they become auditors, and some system for ensuring that appropriate auditing expertise is being exercised by auditors in practice, such as by some means of quality control monitoring. Therefore, the added enforcement of quality, exams in audit expertise and a system for dealing with violations, as well as legal capability, has been added to the Sucher and Bychkova framework. Finally, there are also indications from previous research that local culture may have an impact on auditor independence. The framework has therefore been revised to take into account these suggestions, as shown in Table 3.1.

Table 3.1 Auditor independence - revised framework

Independence aspect	Fundamental requirements	Unit of analysis
PROCESS		
Programming independence	Competence in audit work	State/ Profession
	Appropriate training in audit work	Profession
	Enforcement of quality; exams in audit standards	Profession
Investigative reporting	No information closed to the auditor	State/ Profession
	Reputable audit report	State/ Profession
AUDITOR		
Credible audit opinion	Independence of mind: Laws regarding appointment and resignation	State/ Profession
	Codes re economic dependence	Profession/ Individual
	Codes re family relationships	Profession/ Individual
	System for dealing with violations	Profession
	Personal ethics	Individual
	Culture of audit firm	Organisation
	Size of audit firm	Organisation
	Legal capability	State
	State of the audit market	Context
	Professional ethos	Context
	Socio-economic	Context
	Culture	Context

How this framework has been used as a basis for the research is discussed in the next section.

Research methods

This framework has been used to structure the approach to auditor independence as a guide and as a route for exploration. The initial aspects of the framework, which may be regarded as more contained and structured, are used to assess the *de jure* and *de facto* situation around auditor independence, such as education and quality control, systems. A *de jure* analysis of the local legislation and the audit professions ethical codes are undertaken by reviewing how each aspect of the framework above, where the unit of analysis is at the level of the profession, has been included in local laws and regulations.

The above framework has been incorporated as a basis of the *de jure* analysis and as a basis for providing insights into the two-stages of the data gathering process. The first stage involved desktop-based literature and media reviews and the second stage consisted of interviews and a review of the local professional press. At the first stage, the authors investigated the economic, social and historical context for auditor independence in Poland and the Czech Republic. As the media, and in particular the mass media, are nowadays the main stream of communication of shared cultural meanings, data also came from the writings of various Czech and Polish intellectuals, newspapers, magazines and local television programmes. The existing literature on the immediate social, economic and cultural aspects in Poland and the Czech Republic, was also explored, both in English and in the native languages.

In the second stage of the data-gathering process, the authors undertook semi-structured interviews with local auditors, preparers, users of financial statements, academics and standard setters regarding auditor independence (a list of interviewees is noted in Appendices 1

and 2). Interviewees were either approached directly (*eg* the national Chambers of Auditing) or *via* local academic contacts (*eg* individual auditors). The local professional press was also reviewed for coverage of issues of auditor independence.

For the purpose of the interviews, a list of questions was devised to facilitate an understanding of how *de jure* aspects might be working in practice and to identify how the more contextual aspects, such as culture, and the state of the audit market, might affect auditor independence. Although many of these interview questions followed from the framework, some more open-ended questions were devised that would enable interviewees to raise any other issues and discuss the more contextual aspects outlined in the framework. The list of generic interview questions for the Czech Republic is given in Appendix Three.

Some of the questions were developed to elicit information directly, such as ‘How well do you believe the requirements on relations with other auditors are working?’ to seek to identify whether there were any initial indications of *de facto* issues. The aim with other questions, which were more general, was either to provide confirmation of other answers, such as ‘Can you give examples of areas where they both seem to be working well and areas where they are not?’ or to provide the opportunity for interviewees to define the situation as they saw it, rather than as the interviewers might see it, such as ‘What do you believe affects your ability to be independent?’ (Fielding, 1998).

The aim with the list of interview questions was to use them as guidance and not just as a schedule. Where appropriate, the authors took spontaneous decisions on ‘steering’ the discussion away from the prepared list, depending on the individual stories that emerged during the interview process.

Data from the interviewees were collected in the Czech Republic (in Prague and Kladno) and in Poland (in Warsaw and Gdansk) in the period between June 2001 and April 2002. The interviews lasted

between one and three hours, were tape-recorded where possible, and participant observation notes were taken. Through a spontaneous 'steering' of the discussion away from the prepared list, the interviews were more akin to 'guided conversations' (Gilbert, 1998). This was particularly the case with discussions of the economic, social and cultural context. Interviews were conducted both in English and native languages, Polish and Czech.

The interviewees were also asked how they would define auditor independence and any particular issues that arose with auditor independence. Separately, they were asked to discuss the culture of their country as they perceived it, their concept of themselves as Polish or Czech; their private and professional values and how they might perceive culture as affecting auditor independence. Given the significance of the context, the questions asked were not about what it means to be Polish or Czech *per se*, but what it meant to be independent for a particular set of informants located at a specific time and who represented a certain social (professional) grouping: accounting professionals in the transition economy. All interviewees were middle-class, graduates, in the age group between 30–60, with professional status in financial communities in Poland and the Czech Republic. The sample was representative of different occupational groups within financial communities, of different sizes of local audit practices and of the auditing regulators themselves.

The data analysis

Flowing from the desktop research on the social, cultural and historical context, a narrative analysis of the interviews with Polish and Czech practitioners and academics was conducted to try to identify the cultural themes and how these might or might not affect a particular realisation of auditor independence in Poland and the Czech Republic.

The interview transcripts were drawn up immediately after the interviews. In transcribing the data an attempt was made to render accurately the style and the content of the originals, thus retaining all imprecision, ambiguities and inconsistencies. Both authors, independently, took interview transcripts and coded the text for common themes that seemed to arise in the discussion on both culture discourse and auditor independence. These codes were then interpreted and reflected upon for cross-validity (Alvesson and Scoldberg, 2000). This reflexive process led to a reduction of the analysis to core codes, auditor independence codes and culture codes. The frames of reference acted as additional informants for the core codes. The summary of the categorisations is presented in Table 3.2.

This coding reflects the initial attempt to understand how the local socio-economic and cultural context affected the personal views of auditor independence.

Table 3.2: Core codes and frames of reference for auditor independence

Core Codes	Frames of Reference
Auditor Independence Dimension	
Economics based	Development processes; competition
Transition realms based	Our reality; legal capacity
Background of corruption	Corruption
Creative approach	Interpretation; freedom
Rules based	Lack of reflexivity
Culture Dimension	
Professional <i>vs</i> Private life worlds	Lack of barriers
Envy	Our reality; history
Modesty	Undervalued; community
Adaptability	Our reality

This was an initial codification that made a preliminary attempt to identify how culture was experienced by the interviewees, and how auditor independence was perceived. Such a codification of these dimensions might have been somewhat intuitive and exploratory in nature, such as issues of conceptual equivalence, of interviewer/interviewee interaction. However, an attempt was made to identify these dimensions to take a more holistic view of auditor independence incorporating *local* dimension (as opposed to the *elite* view represented by the Western worldviews) to the analysis (Alvesson, 2002). In other words, auditor independence definitions and dimensions were mapped onto the core culture codes thus providing a direction for writing up the findings through storytelling in the chapters covering the country studies. More detail of this is included in those chapters.

Conclusion

To obtain a fuller understanding of what was happening in a transitional economy it was first necessary to consider all aspects of auditor independence, from the basic educational provision for an auditor, to aspects such as the provision of NAS. A modified framework approach was adopted for the analysis, incorporating all aspects of auditor independence to form a basis for the *de jure* analysis and to provide guidance for the data gathering stage, the desktop literature based research and interviews. The *de jure* elements (what are supposed to be the case) are expanded and analysed with the *de facto* elements (what actually seems to happen) drawing upon interview data and the local professional press.

CHAPTER FOUR

AUDITOR INDEPENDENCE IN THE CZECH REPUBLIC

In this chapter, after a brief discussion of the history and institutional framework for auditing, the *de jure* requirements regarding auditor independence are compared with parts of the revised framework outlined in chapter three. Then there is an analysis of the extent to which the law and professional regulations currently in place for regulating auditor independence seem to be working *de facto*. In the following section there is a discussion of the possible impact of local culture on auditor independence. Given the implementation of the new IFAC Code on auditor independence from November 2001, there is a commentary on the new IFAC Code and how it might work in the Czech context. This is followed by a conclusion.

Initial history of audit in the Czech Republic

The immediate history of Czech audit has been covered by Sucher and MacLulich (2004) and Sucher and Zelenka (1998). Prior to 1989, there was no established profession of auditors or an association of auditors. The State governed all economic relations and there was no need for an independent external audit. With the commencement of the operation of joint ventures in 1989, Decree No 63/1989 on auditors set out the requirement that joint ventures with foreign participation should have their annual accounts verified by two auditors:

... at least one of whom had to be a Czechoslovak national figuring on the Auditor's List of the Federal Ministry of Finance. The

other auditor could be a national of another country meeting the requirements for an auditor's work in that country. (Langr, 1992: p.6).

Initially, the examination and registration of auditors was the responsibility of the Ministry of Finance. Its requirements for the registration of individuals as auditors were that, among other aspects, individuals had to:

- have at least ten years practice in accounting; and
- pass an oral examination on accounting and tax set by the Ministry of Finance.

There was therefore no requirement that this initial cohort of auditors had any training in audit.

The requirement for an audit was extended to all joint stock companies and large private companies from the end of 1992 (Act on Accounting 1991, section 20). In 1992, the Act on Auditors and the Chamber of Auditors of the Czech Republic (Act 1992) was passed.

The Act 1992 provided for the setting up of the Chamber of Auditors (henceforth Chamber) which would have responsibility for the education and examination of auditors, the setting of audit standards, the regulation of audit practice and the disciplining of auditors. All registered auditors in the Czech Republic had to be members of the Chamber. The Chamber had its inaugural conference in February 1993, the first exams for auditors were in November 1993 and the initial 17 auditing standards were promulgated by 1995. They were closely based on international auditing standards. Sucher and Zelenka (1998) give further detail.

This initial Act on Auditors was superseded by the Act on Auditors (*Zakon o auditorech*), No 254/2000 Coll, henceforth Act 2000¹ and took effect from 1 January 2000.

Current institutional framework for auditor independence

Development of the Act on Auditors, 2000

According to the Minister responsible for drafting the Act 2000, the background was that the Czech government wanted to ensure that they complied with the European Eighth Directive and any other relevant international conventions to which the government had subscribed. For example, Article 24 of the Eighth Directive states:

Member states shall prescribe that such persons shall not carry out statutory audits which (they) are required if such persons are not independent in accordance with the law of the Member State which requires the audit.

The Act 2000 specifies that:

... an auditor shall be independent when providing auditing services; he shall be bound by the statutory provisions and legal regulations. An auditor shall also comply with the auditing guidelines and professional regulations issued by the Chamber (section 2.5).

The Act 2000 specifies certain situations, which are discussed later, in which the auditor cannot carry out an audit. Similar requirements apply to auditing firms (section 4).

Between 1993 and 2000, the Chamber of Auditors became more established and there have been developments in the formulation of a Code of Ethics.

Development of the Code of Ethics

An initial Code of Ethics was implemented from 1 January 1996, modelled on the IFAC Code of Ethics extant at the time. The Code of Ethics was subsequently amended in 2000 (Code 2000

henceforth), approved at the assembly of the Chamber of Auditors in November 2000, and applicable from 1 January 2001 (Vrba, 2000a). The amendments were in such areas as:

- the other services that could be provided by auditors, as well as audit;
- how the audit fee must correspond to the extent of work done;
- the need to continue professional education;
- the principle that auditors should not present offers of auditing services to clients who do not seek them; and
- circumstances where possible refusal of the audit should be considered, *eg* if the client does not allow the auditor to contact the previous auditor.

Further modifications to the Code were proposed for comment during late 2002. The IFAC Code of Ethics, extant at November 2001, was to be translated into Czech in mid 2002 and posted onto the Chamber's website for comment from members.

***De jure* analysis**

Against this background, a *de jure* analysis of auditor independence was undertaken based on the professional unit of analysis requirements in the framework laid out in chapter three, Table 3.2. The independence of mind and contextual aspects of the requirements from the framework are covered in the *de facto* analysis. This *de jure* analysis is based upon a review of the Act 2000 and the Code 2000². It is laid out in Table 4.1.

Table 4.1: A summary of auditor independence requirements in the Czech Republic

Panel A: Process independence: programming independence

Requirements	Czech Republic - Comments
Competence in audit work	Auditing standards issued by Chamber of Auditors and based on international auditing standards. 30 audit standards (9/7/01). Auditor shall comply with them. Act section 2.5. Any new standards are noted in the monthly journal Auditing, which is sent to all auditors.
Appropriate training in audit work	Code specifies that auditors should undertake 40 hrs post-qualification training each year.
Enforcement of quality	Under Supervision Board of the Chamber, auditors and firms are visited on a planned basis to check compliance with standards and post-qualification training. Chamber may discipline if an auditor 'substantially or repeatedly breaches' professional rules or auditing guidelines, Act section 21.1.
Examinations in audit standards	Exams specified in Act section 8.2e; must assess candidates' understanding of audit standards. Delivered by Chamber.

Panel B: Process independence: investigative reporting and independence

Requirements	Czech Republic - Comments
No information closed to the auditor	Act section 15.2; Commercial code 39.2.
Reputable audit report	Act section 14.4 and 5. Must give an opinion on the financial position of the enterprise.

Panel C: Auditor Independence: credible audit opinion

Requirements	Czech Republic - Comments
Independence of mind	<p>Regulations regarding resignation. Code A.9 The general tone of Article 9 is that it is only suggested that auditors should contact previous auditors when taking over a new audit. An amendment to the Code for 2000 also suggests that: ‘If the client does not allow the new auditor to communicate with the previous auditor or if the client definitely requires that the new auditor should not communicate with the previous one, all risks arising with this should be considered, as should possible refusal of the job.’ (A.9, Code 2000). However, Czech auditing standard No.19 does specify that, when taking over an audit, the new auditors should contact the previous auditors (Vrba, 2000).</p>

Requirements	Czech Republic - Comments
Independence of mind	<p>Codes re individual economic dependence (eg provision of NAS; ownership of shares; employment; % of total fees one firm). Act section 18 and see IFAC comparison in Table 4.2. An auditor cannot keep accounts, prepare financial statements or provide tax declarations for the audited unit.</p>
	<p>Codes re family relationships See IFAC comparison in Table 4.2.</p>
	<p>System for dealing with violations A control committee, established in 1998, investigates any reported problems. The disciplinary commission deals with the results of the investigations.</p>

Sources: Czech Republic – Act on Auditors, 2000 (Act); Code of Ethics, Czech Chamber of Auditors, 2000 (Code)

Code re economic dependence and family relationships with the audit client

The economic dependence and family relationships with the audit client is covered in the Act 2000 and in the Code 2000. The relevant sections of the Code 2000 that cover economic dependence and family relationships have been compared with the IFAC Code of Ethics, 1999, to facilitate a *de jure* analysis. This is noted in Table 4.2.

Table 4.2: A comparison of the relevant aspects of the IFAC Code of ethics (1999) section 8, about auditor independence, with recommendations in the Chamber of Auditors Code of Ethics, 2000 in the Czech Republic (Code)

IFAC	Czech Republic
<p>Financial dependence: Auditor should not have:</p> <ul style="list-style-type: none"> (a) direct financial interest in a client (b) indirect financial interest in a client (c) loans to/from client (d) financial interest in a JV with client (e) financial interest in a non-client that has an investor/ee relationship with client. 	<p>No direct financial dependence on the client, eg debt owing by the client, loan from or to the client, interest in the client's company, financial interests of persons to whom auditor is closely related, receipt of commission for trade Code A.6.a</p>
<p>Employment. Auditor should not be:</p> <ul style="list-style-type: none"> (a) a member of the board, officer or employee of company; or (b) a partner of, or in employment of, a member of the board or an officer or employee of a company. 	<p>Cannot audit if holding a position in the client's business management in the period of the audit or immediately preceding (2 years) Code A.6.b or 'If partner, member or statutory organ of such a unit' (Act section18.3a).</p>
<p>Provision of other services. Should not perform management functions or make management decisions.</p>	<p>This is acceptable as long as the auditors do not assume responsibility for the client's decision. Code A.6.c.</p>
	<p>Cannot audit if a bankruptcy trustee, liquidator or administrator or draws up financial statements or prepares its tax return. (Act section18.3b).</p>

IFAC	Czech Republic
<p>Personal and family relationships. Those that always pose an unacceptable threat are where the auditor/fellow partner/employee is spouse, dependent child, relative in common household of client. In some countries the range of relationships may be wider.</p>	<p>It is not advisable to take a job from a client whose owners are persons in a family relationship with the auditor, or from a client whose bodies are such members. Code A.6.d. In addition, Act provides that members should not audit any unit if 'related to any person who is partner, member or statutory organ of unit' or 'is responsible for accounting unit's bookkeeping, draws up financial statements and prepares its tax returns' (Act section 18.3a&b). There is no definition of 'party related.'</p>
<p>Fees. When the receipt of recurring fees from a client or group of connected clients represents a large proportion of total gross fees of an auditor or of practice as a whole. Fees should not be payable contingent on the findings or results of professional services.</p>	<p>Code A.6.e 25% of income is from one client or from clients in a group or if there are unpaid fees. Should not audit if has 'income from such accounting unit for providing auditing services in the previous five years and this income exceeded one half of his total income in these five years' (Act section 18.3d).</p>
<p>Presents. Goods or services should only be accepted on business terms no more favourable than those generally available to others. Should be no undue hospitality from the client.</p>	<p>Generally the auditor should not accept goods or services. An exception may be when these are accepted on conditions that are not more advantageous than those generally provided; Code A.6.g.</p>

IFAC	Czech Republic
<p>Audit firm ownership. Majority of capital of audit firm and of voting rights should be owned by auditors.</p>	<p>The equity of the audit firm should belong, as far as possible, to the auditors themselves. Code A.6.h. To be registered as an audit firm, 50% of voting rights must pertain to authorised auditors. (Act section 4.1a). Other non-auditors in the audit firm may not ‘interfere with the auditing services, which are being provided, in a manner which could jeopardize the auditor’s independence’ (Act section 2.6).</p>
<p>Former partners. When a partner goes to work for a client, they should be careful about any unfunded retirement benefits due to the partner, and the former partner should not participate or appear to participate in practices’ business.</p>	<p>No comment.</p>
<p>Litigation. The auditor should have regard to the circumstances when litigation between the auditor and client may be perceived to affect auditor independence..</p>	<p>No comment.</p>
<p>Long association. When the same senior personnel are used on an audit engagement over a long period of time, the auditor should take steps to ensure that objectivity and independence are maintained on the engagement..</p>	<p>No comment.</p>

Czech Republic - all references are to the – Code of Ethics, Chamber of Auditors 1994, Czech Republic 2000 (accessed 17/7/2001 (Code) or the Act on Auditors No.254/2000 Act).

The comparison between the relevant aspects of the IFAC Code of Ethics (1999), Section 8, and the Czech Chamber of Auditors, Code of Ethics, Section 6, indicates that the *de jure* situation with regard to the local Code of Ethics requirements in the Czech Republic is similar to the IFAC Code of Ethics section 8, with regard to the provision of other services and employment. There are some differences of detail, and the latter parts of the IFAC Code section 8 have not been implemented in the Czech Code of Ethics, section 6. The latter may be due to their lack of relevance, such as the issue of unfunded retirement benefits where there is not yet a developed system of private retirement benefits in the Czech Republic

***De facto* compliance**

In this section of the chapter, *de facto* compliance with the professional aspects and the individual and contextual aspects as laid out in the framework in Table 3.1 are studied, in relation to the application of the audit report legislation. Also covered are the other requirements of the framework which are necessary for auditors to be independent, such as individual aspects of independence of mind as well as the contextual aspects. The section is structured to follow the framework requirements as laid out in Table 3.2. Initially, therefore, it follows the same order as the *de jure* analysis in Table 4.1 as the *de facto* situation is discussed. Subsequently, the individual and contextual aspects of the framework, such as independence of mind, are discussed. This section is based upon the interviews and a review of some of the local English-language business press and *Auditor*, the professional journal of the Chamber.

Audit process - programming independence

Body of auditing expertise, appropriate training, enforcement and examinations

Where there is a body of auditing standards based on international auditing standards, there would seem to be an adequate body of auditing expertise. Those wishing to become auditors have to complete exams where their auditing expertise is assessed. The Chamber monitors, through its system of visits to auditors, whether they are subsequently complying with these standards. However, there are a number of auditors, registered when the first Act on Auditing was implemented, in 1992, who have not sat these exams. There were 595 auditors in this category when the Chamber was established. As at 31 December 2001 there were 1,313 auditors registered with the Chamber³. Table 4.3 shows the growth of the membership of the Chamber since inception.

Table 4.3 Auditors in the Czech Republic

Year	Auditors	Assistants	Audit firms
31.12.92	0	0	0
31.12.93	595	128	59
31.12.94	802	202	137
31.12.95	1002	354	161
31.12.96	1127	499	195
31.12.97	1255	548	241
31.12.98	1272	789	272
31.12.99	1280	926	283
31.12.00	1318	1065	307
31.12.01	1313	1156	307

The statistics indicate that there are very few audit firms in the Czech Republic with a large number of auditors. In the interviews, some of the auditors presented the interviewers with the guidance on

working papers that they had received from the Chamber. Individual auditors did comment that, despite the requirements of the relevant auditing standard, there was sometimes not enough time to keep a written record of all work with smaller clients.

No audit firm has been removed from the Chamber's list of auditors due to the standard of its audit work. This is discussed further under the comments on the *de facto* aspects of the system for dealing with violations later, see also Table 4.4.

Audit process - Investigative and reporting independence

Access to information and audit report legislation

Though investigative independence is obviously difficult to examine, all interviewees except one commented formally that access to papers and obtaining representations was not a problem. One interviewee, an auditor of small enterprises did comment that:

There are no problems with [the] data for bookkeeping, but a problem when [you] ask for [a] copy of ... non-bookkeeping documents. And small entrepreneurs do not do it. (C₃)

A much more complex aspect of investigative independence is the extent to which it is feasible to audit the financial information provided. This was not mentioned as a problem by the auditors who were interviewed. Most of these auditors were auditing small or medium-sized enterprises where there might be limited complexity.

Czech accounting is generally highly prescribed (Sucher and Zelenka, 1998) and follows tax law, particularly the income statement. Therefore there is less likely to be a problem of imprecision in accounting regulations, as discussed in the review of the literature (Lindsay, 1992; Magee and Tseng, 1990). At the level of the smaller enterprise, the issues tend to be more about interpretation of the tax

laws. Indeed, it maybe more of an issue that auditors may be signing off accounts which, though they follow the tax legislation, are not ‘true and fair’ as required by the Act on Accounting 1991. As interviewee C₁₀ at the Chamber commented:

Qualification [of the audit report] is about risk; amount of reserves; provisions; individual issues. Companies generally do not like to put any items in accounts which are not tax deductible. This is about true and fair and it is for the auditor to explain.

Therefore, one may speculate that although there is little difficulty in auditing the accounting information for smaller companies, there may be a greater emphasis on ensuring that there has been compliance with the tax legislation rather than on ensuring that the companies are going concerns. Further, although lack of liquidity is an issue among many Czech firms, there has been a surprising lack of going concern qualifications. As one Czech auditor at the Chamber commented:

If [auditors] had followed the principle of going concern in the 1990s, only ten firms would have continued [ie without a going concern qualification]. (C₆)

There are clear requirements in the Act 2000 (sections 14.3, 14.4 and 14.5) for auditors to provide audit reports expressing an opinion on whether the information in the financial statements fairly presents the position of the accounting unit’s assets and liabilities. There is also now a new specific requirement for auditors to express an opinion, with evidence, on the financial position of the company. According to the official at the Ministry of Finance responsible for drafting the Act 2000, this was implemented to deal with a particular problem in the 1990s. Various Czech banks received an unqualified audit report, and then were subsequently declared bankrupt (eg IPB Bank). As the EBRD has also commented:

... the number of bankruptcy cases exceeded 2,000 in 1999, but it is estimated that more than 10,000 companies are technically bankrupt and about one-third of Czech companies have overdue debts. (EBRD 2000).

This issue of firm liquidity had therefore probably undermined reporting independence. There may, however, be even more subtle aspects at work. It may be that auditors are not predisposed to exercise judgement over 'true and fair' and would prefer to take a rules-based approach which may undermine their capacity to be independent. This is developed in the later section of this chapter on cultural context.

The local business press has covered the issue of tunnelling⁴ in the Czech Republic, a practice that is likely to affect the reliability of financial statements. This would seem to be a greater problem for larger enterprises. Ideally the information about all possibly controlled entities should be provided to the auditors. It does not seem to be part of the Czech business culture, however, to be transparent about what the business is undertaking or which companies it may control. As Sucher and Alexander (2001) comment, this lack of transparency may be linked in turn to the lack of a powerful group of external financial statement users who require transparency in the financial reporting of large organisations⁵.

Auditor's individual independence

Regulations regarding appointment and resignation

The appointment of auditors was seen as a decision for the company depending on their articles of association⁶. In practice, the directors of the companies appointed the auditors most of the time. Indeed the chairman of the disciplinary commission of the Chamber had said in a press interview that:

... auditors report to the company management, which has the power to hire and fire, and if the manager does not like the outcome of an audit, he or she can simply fire the auditor, no questions asked. (Prague Post, 2000)

This was seen as an issue by interviewee C₈ who noted that:

One great problem with auditor independence. In the general model exist shareholders, management and auditors. Shareholders vote and the audit report is to shareholders. In very much smaller companies, shareholders and management are the same person. It means audit problems with independence. If the auditor makes a report to management and gives a qualified opinion, [there is a] problem of who pays.

In interviews with the auditors it became clear that Code regulations on auditor resignation and contacting previous auditors did not seem to be working. This related in a major way to the competitive nature of the audit market for smaller auditors and audit companies. Some of the comments made in interviews on the subject were as follows:

(I) will respect what the client says to me about contacting [the] previous auditor (C₁)

Article 9 does not work (C₅)⁷

My clients are my new clients. [I have] no relationship with previous auditors because [it is] a big problem with this work because I had their reports because [the] company does not speak [with previous auditors]; it does not pay them. (C₃).

Among smaller audit firms and individual auditors, contact was not made with previous auditors when an auditor took on a new audit client. This aspect of the Code had caused some debate among auditors at the Eighth Assembly of the Chamber where the Code 2000

had been discussed. The evidence from the interviews indicates that maintaining the confidence of the client may be regarded as more important than contacting the previous auditors. Interviewees stated that this was related to the highly competitive nature of the audit market (see below).

Separately, there was also a particular problem of non-payment of audit fees by enterprises to individual auditors. Individual auditors generally obtained half their audit fee in advance with the balance to be paid after completion of the audit. However, sometimes the enterprises did not pay the second half of the audit fee. The auditors then did not continue to audit the enterprise. What was of more concern was that other auditors were then willing to take over the audit of these enterprises. This seemed to have been the case with auditor C₅.

In the new *Accounting Law*, 2001, the lower limit for the audit of enterprises has been lifted from net business assets of 20 million Czech krona (Kc) and net sales of 40 million Czech Kc to net business assets of 40 million Kc and net sales of 80 million Kc⁸. As this removed a large number of smaller enterprises from the requirement to be audited, it may also have removed some of the more problematic enterprises. One interviewee at the Chamber suggested that this increase in the audit threshold would lead to a reduction of up to 30% in the number of companies and up to 50% in the number of private individuals that needed to be audited. This was likely to lead to an increase in competition among auditors.

Chamber Codes re individual economic dependence

Over-dependence on fees

Many auditors commented that economic independence from clients was key to their auditing independence.

Obviously the auditor must be independent as far as income. (C₂)

I think that it is important that one firm, one client is only a small percentage of my fees. (C₄)

There was no indication from the interviews that this was an issue.

Provision of other services to clients

In the interviews there were three aspects to the provision of non-audit services: disagreements over certain aspects of the requirements; misunderstandings about the meanings of the requirements; and external user perceptions of the issues, particularly in relation to the Big Five audit firms.

There seemed to be some ambivalence among the individual auditors interviewed about how to translate the Act's requirement that auditors should not prepare the company's tax return. Many auditors provided their clients with taxation and accounting advice as well as carrying out the audit. This was not an unusual situation in many countries. The Act's requirement might therefore seem unduly restrictive. One auditor interviewed, who prepared the tax return and audited the accounts for her clients, insisted that she did not know about the Act's requirements. Other auditors had arrangements with fellow auditors that one of them would do the audit for a client, the other would prepare the tax return and *vice versa*. This was an arrangement mimicked in the larger audit firms where there were separate departments for tax and audit. It would seem that the spirit, as well as in some cases the substance, of this requirement, was being ignored.

The issue of the provision of other services was commented on by the interviewees at the banks, as users of the audited financial statements. In these interviews it was clear that references were to the Big Five audit firms, as they were the auditors for nearly all Czech and overseas banks. The issues about the provision of non-audit services seemed

to be of a different order to those for smaller audit firms. One bank interviewee defined auditor independence in a purely economic way as not being dependent on one client for a large proportion of fees or as not being affected by undertaking other consultancy for the client. The same interviewee went on to say that he thought that the first aspect had improved tremendously in the Czech Republic. However, the second aspect was of concern personally to him.

The role of the audit as a door opener for other business is much more important [for the auditor]. ... Sometimes they offer those services quite aggressively. (Interviewee C₁₂)

Another interviewee, C₁₃, at the National Bank, who dealt with banking regulation and supervision, commented as follows about how auditors approached the situation in his experience:

There is a thin line between consultancy and audit work. In the bank [it can be] a problem of [what is] on the balance sheet and looking at the way to conceal it. If [you] do it this way [we] can give you a clean audit report [says the auditor].

In other words, in a consultant's role, the auditor would provide advice on how best to present something, so that there would be no issue with the audit.

In this section, what was of concern was the way in which some individual auditors were just ignoring the legal requirements regarding other services even when the law was quite specific. There was also some evidence – although admittedly only from interviews – that auditors in the larger audit firms were seen to be overstepping the line between consultancy and audit.

Codes re family relationships

This Czech approach, to family and related party relationships, seemed to work reasonably well, as far as could be gathered from

the interviewees. One very large audit firm commented that they sent round a questionnaire to members of staff twice a year on the subject.

However, there might have been an issue, arising from the small size of the professional community in the Czech Republic. As a Czech academic put it:

In many professions everyone knows everybody. In [the] auditor's profession ... everyone knows everybody. It is almost impossible to find anyone who is really independent.

This aspect is pursued further in the section on the cultural context below.

System for dealing with violations

When reviewing the system for dealing with violations, Chamber investigations in the last three years had been as follows.

Table 4.4: Chamber investigations

Year	Number	Complaint/issue
1998	1	Breach of independence found by Disciplinary Committee
	1	Quality of audit (complaint)
	10	No insurance cover
1999	1	Quality of audit – fined
	4	No insurance cover
2000	2	Breach of independence found by Disciplinary Committee
	10	Quality of the audit (warnings and fines)
	7	No insurance cover

Statistics provided by Chamber of Auditors, September 2001.

A review of the English language business publications in the Czech Republic over the last five years indicated that there had been widespread concern about the activities of some of the Big Five audit firms and other Czech auditors.

In 1997, Ernst and Young took over the audit of *Investicni a Postovni* Bank (IPB), from Coopers & Lybrand. It was alleged in the press (PBJ, 2000a) that Coopers & Lybrand were requesting additional provisions to cover bad debts for the 1996 year end. The bank sacked Coopers & Lybrand and brought in Ernst and Young, who carried out a fresh audit for the 1996 year end. The subsequent accounts for IPB for 1996 showed the bank earning a profit. KPMG were also asked to tender for the same audit, but according to one of its partners, 'in the time that we were given, we refused to do it', (PBJ, 2001). In June 2000, IPB went into liquidation.

Individuals involved in the Chamber did comment that, in some of the more high profile bank auditing scandals, there had been no complaint to the Chamber. Without a complaint on the quality of the audit, the Chamber could not take any action. According to the Deputy Minister of Finance, under legislation at the time (August 2000):

... audit work could only be questioned by a lawsuit filed by the shareholders, or by the auditors' self regulatory body, the Chamber of Auditors. (PBJ, 2000b)

There was also some individual concern expressed by interviewees within the Chamber, however, about whether it had the resources to undertake a full investigation of an audit firm's work. While this report was being written there was still an ongoing investigation by the Chamber into the work of Ernst and Young over its audit of IPB Bank (Kriz, 2002). This had been in progress since 2000.

Auditor and independence: Independence of mind

As noted in much of the English and American professional literature, auditor independence is mainly conceived as ‘a state of mind’ (Mautz and Sharaf, 1961; Flint, 1988). As such, it is not easily susceptible to investigation. The interviewees were asked how individual auditors might or might not see independence as a state of mind, and their own personal ethics, by asking them what professional values they considered most important as an auditor and what they perceived as auditor independence. If auditor independence was seen as a ‘state of mind’ then this might arise in the audit interviewees’ description of the professional values that they espoused and their definitions of auditor independence.

The answers to the first question about their key professional values varied, but key *motifs* among many auditors interviewed seemed to be freedom and monetary gain.

I like that I am an auditor [on my own] as I am free [to do] what I want. (C₈)

To be best as [an] auditor and to have lots of money. (C₅).

[To be] quite free in my profession ... [and] I can make money if I want. (C₁)

Given recent history, the lack of individual independence and the lack of access to many material items, these *motifs* can be understood. These aspects and their implications for auditor independence are explored further in the discussion below on the cultural context.

Culture of the audit firm

The majority of auditors interviewed were from the smaller audit firms. Their emphasis in the interviews was on providing a service to

their clients in order to keep their audits. As one interviewee, C₆, at the Chamber suggested:

Generally the auditor should serve the public interest, but the situation in the surroundings when the market has contracted quickly [make this difficult]. There are significant obstructions against public interest. It's a question of moral ethics ... It's the struggle to get rich quickly.

This focus on client service is likely to undermine individual auditor independence unless there are other factors that safeguard independence.

Size of the audit firm

As noted in the literature review, there is some research that indicates that independence is perceived to be linked to the size of the audit firm. Nowadays, this would seem to be shorthand for perceived differences between the Big Five and other audit firms.

The three bank interviewees (who were Czech) all commented that they perceived the Big Five as more independent than local Czech audit firms. However, they might not have had much experience of Czech audit firms. As one bank interviewee, C₁₁, noted:

Basically I trust all the Big Five – to some more and some less. I don't trust too much [in] Czech auditors.

It was clear in the interviews, however, that one of the Big Five firms had been perceived as noticeably less independent than others. Sometimes this was alluded to indirectly, sometimes there was a very direct statement about the relevant audit firm. In relation to this audit firm one bank interviewee, C₁₂, said:

It was well known in the market that they were not so strict [in their audit].

The interviewee at the Czech National Bank, C₁₃, commented in more detail as follows:

A few years ago we were suspicious of the work of one of the Big Five auditors. We signalled to them that there might be a problem⁹. The partners from New York and London came and there was a conference to discuss it. All (integrity) is in the people, not in the firm name. There were experienced foreigners with no local knowledge [in this audit firm] and Czech locals with local knowledge. [There is an issue here of] how a firm controls its franchise, how it controls its name. Maybe McDonalds has a better franchise policy.

This Big Five firm had subsequently changed all the top management of its local office.

Legal capability

An aspect in the framework in Table 3.1, was that of legal capability, and this had been commented on in the professional press. There was an issue about what might be called the general ‘Institutional commitment’ to laws and rules. There were problems with the enforcement of Czech law, as in the case of non-payment of audit fees noted above. It could take years for cases to be heard in court:

Despite the legislative improvements ... enforcement remains the key to achieving tangible results, as the justice system is overly bureaucratic and slow. (EBRD 2000)

In an interview in 2002, the new head of the Chamber of Auditors commented to the press as follows about suing audit firms:

From my position with the Chamber, I would never discourage any client of an auditor from suing anyone. It might create a precedent within the profession. First, there’s a perception that court cases here take too long. There are results that are unpredictable in many cases.

And the judges have very little experience because they haven't dealt with this in the past. And this is basically a full circle. There are not enough cases, so we will not sue, we don't know how this happens, so we have no cases. (Kriz, 2002)

There could also be problems about the interpretation of laws, that had changed several times over recent years, for example in taxation and accounting regulations.

State of the audit market

As noted in Table 4.3, in 2001 there were 1,313 auditors and 307 audit firms listed on the register of auditors at the Chamber¹⁰. In the discussion with interviewees on the state of the audit market three aspects arose: the growth in Big Five audits owing to changes in ownership of many Czech enterprises; the decline in the 'middle market' Czech audit firms; and the competition (or lack of it) among smaller Czech auditors.

Among the individual audit practitioners interviewed, the responses about competition in the market varied. The issue of competition manifested itself through concerns about price, the provision of other services, the soliciting of new audit clients and the qualification of audit reports.

All individual auditors, or small audit firm practitioners, commented that price was an issue.

If [I] would like to raise [the] price [of the audit it] could be a problem. Clients are not interested in overheads. They want the same price as years ago. It is also [the situation] when [the] opinion [is] not unqualified ... could be a problem with client. Could mean [that] client could replace him with another. ... Usually it's [the audit] for banks and asking for loans. If the audit report is qualified it could be a problem. (C₃)

Interviewee C₅ commented that he tried to provide an additional service of telephone advice for clients so that he could provide more added value than other auditors. It was important to provide other services to the client aside from audit. Taxation advice was particularly important.

The issue of qualified audit opinions and their impact on the client was discussed with individuals at the Chamber. One individual commented that it was difficult for Czech auditors to issue a qualified opinion on their clients, particularly if the client's bank were to look at the audit report: 'Anything in the audit report is seen as a problem'. It might lead to the company changing its auditor. Thus the issue of the ability of Czech auditors to prepare a relevant and reliable audit report has been seen as closely linked to the competition in the market place.

Professional ethos

The professional ethos of auditors was difficult to tease out from the interviews, but based on the discussion with the president of the Chamber of Auditors and the individual auditors, there did seem to be a disinclination to discuss the issue of ethics in a professional context and the emphasis was on earning profits. As interviewee C₉ at the Chamber stated in September¹¹:

People do not understand ethics. [Instead] there are a lot of negotiations about profit requirements.

He went on to comment that people did not seem to understand the idea of conflict of interest and no one was particularly interested in courses on ethics.

There had been some debate on the issue of auditor independence in the congresses held by the Chamber and in the columns of the Chamber's journal, *Auditor*. In January 2000, there was an article

covering some of the disagreements over the new draft of the Chamber's Code of Ethics. The discussion focused on the issue of what other duties auditors could perform that would not conflict with their independence, and the ambiguity in the 1992 Act on Auditing.

At a Chamber Council meeting held on 27 November 2000, there was also an impassioned plea from an individual auditor for the Chamber to deal with the issue of auditors who signed off 'clean' audit reports when the clients had problems.

We know that many of us refused a certain audit report for this company and other auditors give a clean audit report to this company.

The auditor then went on to comment about the background of negative media coverage of auditors' work, that:

Yes, [we can say to journalists] we have followed all [the] rules; we have all the auditors' guidelines. Therefore all is OK. [However,] afterwards we have to say to ourselves that we care more about form, about whether we have every [document]. [When] really what is most important for us, as independent highly professional specialist is that ... [we should make a statement] on the health of the business. (Council minutes, Chamber of Auditors 27 November 2000)

The overriding impression was that many members of the Chamber were more concerned about the form and detail of regulations, and monetary aspects, than about substantive issues of independence. Some members of the Chamber were aware of the implications of this approach. Ing.Vrba, a member of the Chamber, wrote in January 2000 regarding the proposed amendments to the Code of Ethics:

We will have to choose. Either we will consider ourselves to be an elite of independent professionals and follow all moral principles whose complete list can never be established beforehand, or we will

start giving in to some group interests, up to the moment when no one is going to respect our profession. (Vrba, 2000, p.1).

Cultural context

Background

Surveys of Czech national character after the Velvet revolution of 1989 have indicated that 37% of Czechs still do not think that there is such a concept as the 'Czech national character', though they are willing to agree to some of the negative characteristics possessed by Czechs such as envy and submissiveness (Smidova, 1992; quoted in Leff, 1997). This has been emphasised by a Czech academic, Leff, researching in the area. She comments that, in general, Czechs are not very reflective about themselves but tend to emphasise any negative aspects, such as *Zavist*, (envy) of others.

The Czech is no hero who sacrifices nobly for the cause, but rather a canny realist more accomplished in political and diplomatic judo than swordplay, constantly confronting superior German or Russian power, and trying to survive. (Leff, 1997)

This has led some authors to suggest that the myths, symbols and traditions that make possible the identification of people as members of the Czech nation and create a Czech national consciousness may be drawn upon two main images: that of the great Czech nation; and that of the little Czech person as *maly cesky clovek*, a character so popular that he has acquired his own acronym, MCC. The little Czechs are not motivated by great ideals. Their life-world is delineated by family, work and close friends, and they approach anything that lies beyond these with caution and mistrust (Holy, 1996). Drawing on newspaper sources and opinion polls, common traits that Czechs perceive themselves as having are those of envy, conformity and, often,

egotism. When referring to positive traits, Czechs are proud of being hardworking and skilful and having a sense of humour, and of being 'members of an inherently democratic nation ... highly cultured and well educated' (Holy, 1996).

Various authors have suggested that there is also a tradition of a 'Czech way of doing things'. The Czechs consider themselves, 'unique and self-sufficient' alongside a tradition of having 'quiet resistance'. (Edwards and Laurence, 2000). There is an emphasis on being adaptive, given Czech history. In more recent times, this adaptiveness has had some bad connotations for the Czech public.

Through the privatisation process in the early 1990s, a large part of the economy became dominated by the state-owned Czech banks (Anderson and Done, 1997). There was a lack of transparency in the new corporate governance structures, which led to high-profile scandals (Boland, 1997) and contributed to the withdrawal of overseas investment in the late 1990s. In a survey conducted by Charles University in 1998, more than 'half of entrepreneurs approached for comment admitted that they had given bribes in order to save their business' (*Prague Post*, 1999). In an EBRD survey in 1999, 26.3% of firms stated that they regularly paid bribes and equated this to a tax of 4.5% (EBRD, 1999). This was not substantially different from the equivalent figures for Russia of 29.2% and 4.1%.

This may have contributed to a perception, among Czechs, that a large number of Czechs were taking economic advantage of others, and this might have affected how auditors and business people in general were perceived. In the following section the interviews with Czech auditors are analysed to identify if any of these themes arise.

Interviews

As discussed in chapter three, Table 3.2, five core codes arose in the interviews as being central to an understanding of what was meant

locally by 'auditor independence'. Four codes central to local culture and relevant to auditor independence could then be identified. The first core code for understanding what was meant by auditor independence was economics based.

The majority of interviewees referred to the economic conditions in the country and in particular to the inadequate economic conditions of the average household when defining auditor independence. Professionals appeared to want to 'get rich quickly'. Interviewee C₅ noted:

I think that it's fine if the independent auditor has lots of money or has some possibilities to have money as an accountant. Another view, if one has revenue then one is independent. If I have some financial reserves, I can be independent. It is not possible now of course because auditors in my profession need to have more money. They depend on their clients.

The interviewees linked dependence on fees to auditor independence in the context of the current economic situation in the Czech Republic and to the second core code, the transition from Communist times. As the following interviewees noted:

I see the question of independence anchored in personal and family situations so that the person must be organised in his own personal life. And the person should not be uniquely dependent only on the income from the audit firm and audit work. The person who does the audit should be more or less freely settled within his environment and be content. He should be choosing his partners, his clients, and also be able to say no sometimes. (Interviewee C₆).

[An] auditor is more independent in Germany because he is better paid. In this country you are dependent on the client for income. (Interviewee C₂).

And Communists in the past were the only people who were in the top management of Czech companies and I don't think they had such knowledge of how to deal in ethical matters, or commitment. Such people [are] now in high positions in corporations everywhere. (Interviewee C₁₁).

It was considered that independence would improve over time. A common theme in the interviews was that the Czechs had only had eight years as a profession; in the UK they had had over 100 years to develop as a profession. This reflected the perception of CEE transition reality.

It could be argued that given the economic context of the contemporary Czech Republic, a climate of giving bribes to authorities might undermine the idea cited from existing regulations of 'providing a professional independent opinion'. Auditors were very aware of the issue of pervasive corruption, however, which was the third core code for auditor independence. As interviewee C₂ noted:

There are two groups. One group are those who try to comply with the law ... The second group avoid all regulations and very often (it is the) case when business goes bankrupt and [the] Court finds out that there was no accounting and [the] judge says how terrible and that's all they do. But I am afraid that this is a large group.

The prevalent belief was that only a few had power in the country and were the same as those from the former regime: 'those who prospered under totalitarianism were destined to prosper under the market economy'. (*Prague Post*, 1995).

The fourth core code of the 'Czech way of doing things' arose in interviews, either as a comment that Czechs would find their own way of interpreting the law or as a perception, generally, that Czechs saw themselves as more creative or adaptive than others. This might have implications for how regulations on auditor independence were

interpreted, as noted in the interviews above, where some individuals seemed to ignore specific regulations on NAS.

However, some of the interviewees also emphasised the fifth core code, the rules basis of the concept of auditor independence. Auditor independence was referred to in relation to the regulations in the Code of Ethics. As the following interviewees suggested:

There is the ethical code. Obviously the auditor must be independent as far as income is concerned. Must not be part of management or statutory body. One person cannot do tax and audit for the same company. Audit independence is very important because you can get in a conflict with the law. In some ways the activities of companies are on the border of legality. (C₂).

The basic is anchored in the ethical code. The basics of discretion are described in [the] ethical code. (C₆).

I am quite independent. It means I must obey all conditions of the law. I can't take part in some companies where a member of the Board is my husband, and so on and so on. This is basic list for my business: section six, Code of Ethics. (C₁).

Therefore, there is likely to be a tension between this 'rules-based' approach, which was emphasised in the interviews, and the local perception of being adaptive. This may mean that some auditors took a creative approach to these rules. Given the substantial economic competition, there might be a stronger emphasis on being creative than in following the rules.

The culture core codes outlined in Table 3.2 that are pertinent to the Czech Republic, aside from the issue of adaptability raised in the creative approach noted above, are a lack of separation between professional and private life-worlds, envy and modesty.

The lack of separation between professional and personal, arose in the discussion of familiarity or friendship. Following from the

Communist period, there was a perception that loyalty was to one's friends and family, rather than to any externally imposed sense of what was right and wrong. Loyalty was more important and this might affect adherence to Codes of Conduct. This trait was part of the emphasis on relationships and exchanges of favour (Ledeneva, 1998) that was necessary under the Communist system (where obtaining resources through friends was important as they were not always available through commercial or public sources). It was also considered a part of being Czech, as the Czech Republic was such a small country. Prague, which holds a large part of Czech enterprise activity, was seen as a large village. As one academic, interviewee C₁₄, put it:

Everyone is a schoolmate of everyone else.

The following quotes from the interviews in September 2001 may give some indication of how these ideas have diffused through to auditors and how they relate to auditor independence.

Czech auditors are about relationships. (C₁₀).

There are particular problems with Czech auditors' independence. [There are] some suspicions that firms are too connected to the client ... In presenting the financial position of the company better than [it] really was, it seemed like a pattern of a concrete audit team. Same bunch of individuals [caused problems with the audit of small banks]. (C₁₃)

From Communist years [there] is the problem of family ties. (C₁₄).

A common attribute that interviewees named as being particularly Czech was that of *zavost*, or envy. It was felt by several interviewees that this might affect how much individuals would be willing to share with each other, for fear of making others envious, as interviewee C₆ noted:

[It is] ... *Czech nature that people are afraid that the auditor may be either greedy or just by mistake communicate details to someone. So clients really do not like to disclose anything about themselves. Because if they disclose you can make a picture about [the] position of the man to the surroundings [ie tell other people about the person's wealth].*

This might conflict with the trait of familiarity that was identified in some interviews; both were likely to make it more difficult for local auditors to be independent in their audit of clients, given the other adverse influences on auditor independence.

The term modesty means the concept of the 'little Czech person' (Holy, 1996). The cultural concept of the little Czech person may indicate a person who just 'gets by' as an unnoticed part of a community. There is less emphasis on individual judgement and great ideals. In general discussion, one interviewee, C₉, summed up the ordinary Czech auditor's attitude to ethics in a way that reflected this approach.

I am not sure what level of business I can give, I don't know what [is] ethical or not. I don't want to know anything, and I don't want to know anything as I would have to think about it¹².

Proposed changes in the IFAC Code of Ethics

Given international concerns over what constitutes auditor independence, there have been moves towards a more conceptual, or 'framework' approach to auditor independence. In this way, as the chair of the IFAC Ethics Committee has stated:

The users of assurance reports, and audits of financial statements ... will benefit because principles are straightforward and more understandable to the public than a maze of different, complex and sometimes unenforceable rules. (Pendergast, 2001, p.145).

Currently, the Czech Chamber's Code of Ethics is based on the IFAC Code 1999, which is 'rules-based' in its approach to auditor independence. Interviewees were asked about the proposed¹³ changes and how these might work in the Czech Republic. Many auditors had not heard of the proposals, but the general view among interviewees seemed to be that a 'principles-based' Code would not work very well in the Czech Republic. As the Chair of the Ethics Committee at the Chamber, interviewee C₈, stated:

I think it is a general problem in Europe. What is written I can do. What is not written causes problems.

Another interviewee, C₄, auditor commented:

I think [it is] not necessary to do new specifics, but in general I think more exact formulations or expressions are easier for practice. (C₄)

One auditor commented that there had been so much debate about even the specific meaning of the reasonably detailed rules that a general approach would cause even greater problems. It has already been noted that there was an issue about enforcement of the law through Czech courts. Therefore any changes that make Czech legal requirements more vague and open to dispute could cause even further problems of enforcement.

Summary

This chapter has found that many of the *de jure* requirements facilitating auditor independence are in place, but the research identifies some issues with the *de facto* practice of auditor independence. Fundamentally, auditor independence is perceived by many Czech auditors as an economic concept, namely the excessive reliance on fee income from an individual client. It is not perceived as a state of mind characterised by an objective approach to professional work. There are indications that the latter is not a natural Czech interpretation of

auditor independence. There is also evidence from the interviews that some of the legal requirements on the permitted provision of other services are being flouted either in form or in substance by certain auditors. There are particular issues among the smaller audit firms and their clients concerning changes in auditors. There is little evidence that the Code regulations regarding procedures for auditor appointment and resignation are being followed. There is substantial concern about non-payment of audit fees. The audit market can be divided into several different segments. There is substantial competition among individual and small-firm auditors for business. Price is an issue, as is the pressure not to provide a qualified opinion in any respect.

The small number of investigations, combined with the concerns expressed in the local press, may suggest that the Chamber has not been able to deal in a sufficiently robust manner with concerns about auditor independence. There are indications that certain auditors may still be undertaking low quality audits where they are not sufficiently independent of management. This is not a problem solely attributable to individual auditors and small audit firms.

Although there is a perception among those users interviewed that the Big Five audit firms are more independent than local Czech audit firms, there are some opinions, based on the audit work of one Big Five audit firm, that this was not always the case. An analysis of the media coverage of high profile failures seem to support this. It is possible that the local Chamber does not have the power, the resources or the willingness to deal with such issues in Big Five firms.

The professional context for enabling auditor independence is somewhat mixed. There are indications that individual freedom is considered more important than high professional standards. There may also be a tendency to follow the 'form' of ensuring all audit procedures are followed without ensuring that the substance of the audit has been properly achieved.

Following on from this, based on the interviews, any move in the Czech Republic towards a more ‘principles-based’ Code of Ethics, rather than a rules-based approach, is unlikely to provide a sounder basis, on its own, for a supported and enforceable Code of Ethics.

ENDNOTES:

- ¹ Except in Tables 1 and 2 where it is ‘Act’.
- ² All translations of the Act 2000 and Code 2000, are either those provided by the Chamber of Auditors or Trade Links publications.
- ³ Komora Auditoru Ceske Republiky 2002. It was not possible to ascertain how many were in this category as as 31 December 2001, though obviously the number will diminish over time.
- ⁴ Tunnelling is where profits are transferred from one enterprise to another through unrealistic low pricing of sales.
- ⁵ This paragraph was written before Enron. It now has a certain topicality for other countries not originally anticipated.
- ⁶ Interview, Ministry of Finance.
- ⁷ Article 9 is the Code requirement on relations with other auditors.
- ⁸ Rate of exchange at 1 April 2002 was £1 = Kc45.
- ⁹ It is presumed that this means there might have been a problem with renewing the licence to audit banks.
- ¹⁰ Statistics provided by the Chamber of Auditors.
- ¹¹ Since November 2001, there has been a new president at the Chamber.
- ¹² This quote reflects the perception of the ordinary Czech as a little person, unreflective of larger issues, just pursuing his ordinary life.
- ¹³ As at the time of the interviews in September 2001, these were the proposed changes to the IFAC code.

CHAPTER FIVE

AUDITOR INDEPENDENCE IN POLAND

This chapter discusses how auditor independence in Poland is realised in the context of the existing regulatory framework. First, the audit environment and regulatory requirements in Poland before transition (prior to 1991) and after the establishment of the independent audit profession by the Audit Act 1991 are presented. Second, the current regulatory framework is presented. Third, the *de jure* requirements regarding audit independence in Poland currently in place and those in the implementation stage are discussed. Fourth, an analysis of how these regulations seem to be working *de facto* is carried out. Fifth, there is a discussion of the cultural context and how it might affect auditor independence locally. Sixth, a commentary on the proposed changes in the Code of Ethics is presented and the implications of how these changes may be working in practice are discussed. Finally, conclusions are presented.

Initial history of audit in Poland

In 1957 the institution of audit experts was created to verify accounts of state-owned enterprises, as each enterprise had to appoint a state-authorized accountant (SAA). They were employed on a full-time basis in the finance and/or accounting divisions of state enterprises. The role of the SAAs was agreeing appropriation of profits and verification of the achievements of centrally planned targets (Jaruga *et al*, 1996; Jaruga, 1979). Annual and five-year plans were extremely complex and detailed. The immediate problem for the SAAs was a difficulty in the

arithmetical and technical reconciliation of targets. While inspecting the accounts, the SAA was concerned with the proper construction of the accounting records; that is, with a usage of the appropriate documentation and the *correct* accounting procedures. The audit was focused on certifying the agreement of financial statements with the law through the means of certificates of correctness (Ministry Decree 1973) ensuring that all procedures were correctly followed and the enterprise had correctly accounted for all transactions with the state budget (Kosmala MacLulich, 2003).

Current institutional framework for auditor independence in Poland

Auditor independence in Poland is regulated by the provisions of the Accounting Act 2000, the Audit Act 2000 and the Code of Ethics 1999 of the Chamber of Auditors. Auditing procedures are dealt with in the national standards and guidelines, not in the Audit or Accounting Acts. All laws related to audit are prepared in collaboration between the Chamber and the Ministry of Finance. In issues unregulated by the national standards, the ISA should be followed (the national auditing standards no. 1, Art. 1).

Development of the Accounting Act 2000

In Poland the concept of auditor independence is defined in the Accounting Act 1994.

An audit of financial statements shall be carried out by a registered auditor who meets conditions which enable him/her to issue an impartial and independent opinion on the said financial statements (Accounting Act 1994, Art. 66.1).

These provisions refer to the auditor as a physical and legal entity. In the Accounting Act 2000, applied as from January 2002 (superseding the Accounting Act 1994), amendments were made to Article 66. This article emphasises that the independent auditor complies with rules of independence. The principle of independence is now extended to Directors and Board members of the practice (Accounting Act 2000, Art. 66.3).

The Accounting Act 2000 increased the thresholds for the preparation of simplified financial statements. Hence, under the new Act 2000, the obligation, specified by the Act 1994, for companies not meeting the conditions to be audited every three years, has been cancelled as from January 2002.

These changes released a significant number of companies from compulsory annual audits and reduced the number of companies that were subjected to audit every three years (as per the 1994 Act), effective from January 2002, so that competition in the audit services market, already severe, will increase. These changes are generally perceived as a threat to Polish auditors. As interviewee P₃ stated:

Until now I have 200 clients, all are smaller entities, that is those who have to be audited annually and also those which are audited every three years. Now, after the changes in thresholds I estimate, I will have half less clients. (audit partner, Polish audit firm).

As the number of companies that were required to be audited under the 1994 Act has decreased significantly, some Polish auditors argue that they might lose up to half their SME current client base.

Development of the Audit Act 2000

Krajowa Izba Biegłych Rewidentów (the Chamber of Auditors) and an independent audit profession were set up in Poland in June 1992 (the Audit Act 1991, the Ministry of Finance). The Act 1991 defined the Chamber's tasks, set up the constituent bodies of the Chamber and defined the rules of their appointments. All Polish auditors are registered as members of the Chamber, the self-governing body of all authorised auditors. The National Council of Statutory Auditors, a constituent body of the Chamber, entitles auditors to carry out audits. The role of the Chamber is the representation, qualification and protection of auditors' rights. The Chamber establishes the national auditing standards and guidelines and the Code of Ethics. The Chamber also has a supervisory role; it monitors the appropriate fulfilment of auditors' duties and compliance with the Code of Ethics (Audit Act 1994, 2000).

The Audit Act 1994 was superseded by amendments brought in by the Audit Act of 2000 (Audit Act 2000), applied from November 2000. The Chamber argued that the changes were initiated by changes in the IFAC Code and the EU discussion on amendments to the Eighth Directive (the Green Paper). The Act 2000 built on the Act 1994. The Act 2000 excluded legal entities from the Chamber of Auditors and as a consequence only individual auditors can act as members. The new Act clarified the duties of the Chamber of Auditors and its constituent bodies: the National Assembly of Statutory Auditors, the National Council of Statutory Auditors, the National Audit Commission, the National Disciplinary Court, and the National Disciplinary Spokesmen. Also, the National Supervisory Committee, a new constituent body of

the Chamber, was set up to ensure compliance with legal provisions and professional requirements as to the procedures of the audit process. The new Act also extended the nature of provisions regarding disciplinary proceedings.

Polish auditors are obliged to follow national auditing standards issued by the Chamber. As the new Accounting and Auditing Acts 2000 were introduced, the existing auditing standards were also under the process of adaptation to fit the ISA framework. In areas unregulated by the Act, the international standards should be followed (Accounting Act 2000).

Development of the Code of Ethics

The first Code of Ethics of the Chamber of Auditors was approved at the Extraordinary Assembly of the Chamber in August 1996, and applied from January 1997. The Code was modelled on International Standards of Auditing and the IFAC Code of Ethics, drafted in 1994 but not approved until 1996. It was agreed that further work would continue and the following year an Extraordinary Annual Meeting would be called to deal with issues of ethics. The Code 1996 superseded the Temporary Provisions on Auditors' Ethics 1992.

The Code 1996 was amended at the Fourth Assembly of the Chamber in June 1999. Significant changes were considered in relation to the practice of lowballing. These proposals sharpened the wording of the Code; in areas of audit independence an emphasis was put on integrity and ethical behaviour as well as compliance with ethical provisions. The proposed changes referred also to cases of serious misstatements where requirements for auditors to resign and inform relevant authorities were made more explicit. These proposals were not approved. The only changes approved included issues that made the wording of the Code more understandable and readable. Regarding changes as to the communication between auditors, IFAC provisions

were largely ignored; individual auditors were left to decide whether or not to follow the provisions regarding communication between auditors when a client appointed a new auditor.

In the Code 1999, on provisions with regard to independence (section 2.4) auditors were defined as persons and legal entities entitled to audit financial statements. In December 2001–January 2002 a new draft of the Code of Ethics, drawing largely from the IFAC Code 1999 and incorporating a framework approach to independence, was sent to regional branches of the Chamber and Ministry of Finance for comments.

***De jure* analysis**

Taking into consideration the current developments in regulation in Poland (above), a *de jure* analysis of auditor independence can now be undertaken using part of the suggested framework laid out in chapter three. This analysis is based upon a review of the Accounting Act 2000 and Audit Act 2000 and in the Code of Ethics 1999¹. It is summarised in Table 5.1.

Table 5.1: A summary analysis of auditor independence requirements in Poland

Panel A: Process independence: programming independence

Requirements	Polish Rules
Competence in audit work	Issued by the Chamber and based on international auditing standards. Five comprehensive audit standards and auditing guidelines. Auditor shall comply with them (Audit Act 2000 art.17). Any new standards and changes in regulation are noted in the <i>Bulletins</i> , which are sent to all auditors and discussed in the journal of <i>Accountancy</i> (published by the Polish Accountants Association).
Appropriate training in audit work	The Audit Act 2000 specifies that auditor should undertake 30 hrs post-qualification training each year. Adherence to post-qualification training is checked by a one-hour-long examination at the completion of each module (KIBR Decrees 315/22/2001).
Enforcement of quality	The Supervisory Committee of the Chamber (the National Supervisory Committee) monitors auditors' and audit firms' performance and compliance with best practice at least every two years. In the case of irregularities or breaches of law, the Committee reports to the Disciplinary Spokesperson in order to institute disciplinary proceedings (Audit Act 2000, Art. 27).
Examinations in audit standards	Exams specified in the Audit Act 2000 art 5-8 assess candidates understanding of audit standards. Delivered by Chamber. Detailed provisions about qualification (KIBR Decree 310/22/2001) and apprenticeship (KIBR Decree 311/22/2001).

Panel B: Process independence investigative reporting and independence

Requirements	Polish Rules
No information closed to the auditor	Legal requirements re access to documents/ representations. Accounting Act 2000 Art 67.1.
Reputable audit report	Accounting Act 2000, Art. 4, Art. 65 Auditing standards

Panel C: Auditor independence: credible audit opinion

Requirements	Polish Rules
Independence of mind	Regulations regarding appointment. 'Approving body of an audited enterprise' shall appoint the auditor (Accounting Act 2000, Art. 66.4). The managing director of the enterprise shall sign a contract for an audit engagement in advance and that audit fees are to be borne by the auditee (Art. 66.5).
	Regulations regarding resignation. Accounting Act 2000, Art. 6; The Code of Ethics 1999 section 5.3.1: 'auditors should contact previous auditors when taking over a new audit'. Section 5.3.2, however, states that 'the auditor on his/her own responsibility can decide not to contact previous auditors'. The resignation procedures are covered in the Code 1999 in section 2.4.8.
	Codes re individual economic dependence (eg provision of NAS; ownership of shares; employment; % of total fees one firm). Accounting Act 2000, Art 66 and relevant section of the Code 1999 see IFAC comparison in Table 5.2.
	Codes re family relationships. See IFAC comparison in Table 5.2

Requirements	Polish Rules
	<p>System for dealing with violations. The National Supervisory Committee was set up in 2000 to ensure compliance with laws and professional requirements as to the procedures of the audit process. The National Disciplinary Court and Spokesperson deal with the results of the investigations.</p>

Sources: Poland – the Accounting Act 2000 and Audit Act 2000 and in the Code of Ethics 1999.

Code regarding economic dependence on, and family relationships with, the audit client

This is covered in the Accounting Act 2000 and Audit Act 2000 and in the Code of Ethics 1999. The relevant sections of the Code of Ethics 1999, which cover economic dependence and personal relationships, have been compared with the IFAC Code of Ethics, 1999, to facilitate a *de jure* analysis. This is noted in Table 5.2.

Table 5.2: A comparison of the IFAC Code 1999 and Polish regulations

IFAC Code Section 8 ²	Polish regulations (Accounting Act 2000, The Code of Ethics 1999)
<p>Financial dependence: Auditors should not have:</p> <ul style="list-style-type: none"> (a) Direct financial interest in a client (b) indirect financial interest in a client (c) loans to/from client (d) financial interest in a JV with client (e) financial interest in a non-client that has an investor/ee relationship with client. 	<p>No direct financial dependence on clients; <i>ie.</i> investment in a client's company, specific details about associates, superior and dependent entities (Accounting Act 2000, Art 66.2.1), financial interest of persons to whom auditor is closely related (Code 1999, section 2.4.4). No indirect financial interest; <i>ie.</i> debts, loans from the client entity (Code 1999, 2.4.4). No commissions for obtaining assignments (Code 1999, 4.7).</p>
<p>Employment. Auditor should not be:</p> <ul style="list-style-type: none"> (a) a member of the board, officer or employee of company or (b) a partner of, or in employment of, a member of the board or an officer or employee of a company. 	<p>Cannot audit if, in the last three years, s/he held a position in the supervisory body of the client entity or its associate, parent, subsidiary (Accounting Act 2000, Art. 66.2.1). Cannot audit if, in last three years, took part in the preparation of financial statements or bookkeeping in the client entity (Art. 66.2.3).</p>
<p>Provision of other services. Should not perform management functions or make management decisions</p>	<p>The Code states that auditors should not get involved in any activities impairing their independence (section 3.2). Acceptable with regard to preparation of tax returns (Code 1999, section 3.4). In cases where expertise or guidance given to the client can result in legal/practical effects, it should be documented in writing (Code 1999, section 3.5).</p>

IFAC Code Section 8²	Polish regulations (Accounting Act 2000, The Code of Ethics 1999)
<p>Personal and family relationships.</p> <p>Those that always pose an unacceptable threat are where the auditor/ fellow partner/employee is spouse, dependent child, relative in common household of client. In some countries the range of relationships may be wider.</p>	<p>It is stated that auditors and their assistants should not take a job from the client who is a spouse, a relative or in a fostered, in-custody relationship, and from clients in whose bodies and management of such bodies are such family members (Accounting Act 2000, Art. 66.2.5), or 'if related is responsible for accounting, bookkeeping, preparation of financial statements' (Code 1999, section 2.4.5).</p>
<p>Fees.</p> <p>When the receipt of recurring fees from a client or group of connected clients represents a large proportion of total gross fees of an auditor or of practice as a whole. Fees should not be payable contingent on the findings or results of professional services.</p>	<p>Cannot audit if earned, in at least one year out of the last five, more than 50% of annual income from the client, parent, associate or subsidiary (Accounting Act 2000, Art. 66.4), or for the assignments in which the audit client has more than 20 % of equity (Code 1999, section 2.4.3.3). This condition shall not apply to the first year of a registered auditor's career' (Art. 66.2.4). Remuneration of auditors should be related to scope and quality of audit (Code 1999, section 4.1) and remuneration should be stated in signed contracts with the clients (Code 1999, section 4.5). Remuneration for audit cannot depend on the opinion provided or the client taking additional advantages as a result of suggested corrections in the financial statements (Code 1999, section 4.6).</p>

IFAC Code Section 8²	Polish regulations (Accounting Act 2000, The Code of Ethics 1999)
<p>Presents. Goods or services should only be accepted on business terms no more favourable than those generally available to others. Should be no undue hospitality from the client.</p>	<p>Auditors should not accept goods and services from the client or anyone associated with the client on any more favourable conditions than generally available to the public (Code 1999, section 2.4.7).</p>
<p>Audit firm ownership. Majority of capital of audit firm and of voting rights should be owned by auditors.</p>	<p>The equity of the firm should belong as far as possible to the auditors themselves. Also, the majority of the voting rights must be retained by the auditors if the entity is to be registered as audit firm (Audit Act 2000, Art. 10.2).</p>
<p>Former partners. When a partner goes to work for a client, should be careful about any unfunded retirement benefits due to the partner and the former partner should not participate or appear to participate in practices' business.</p>	<p>Auditors or partners can give up their work and take up employment with the existing client under the condition that prior audit of the client has been completed (Code 1999, section 2.4.8). Section 2.5.2.3 also deals with circumstances of conflict of interests (general provisions).</p>
<p>Litigation. The auditor should have regard to the circumstances when litigation between the auditor and client may be perceived to affect auditor independence.</p>	<p>It is responsibility of the auditing firm (practice) to specify the point at which it would become improper to render professional services to the client because of threatened objectivity (Code 1999, section 2.4.9).</p>

IFAC Code Section 8 ²	Polish regulations (Accounting Act 2000, The Code of Ethics 1999)
<p>Long association. When the same senior personnel are used on an audit engagement over a long period of time, the auditor should take steps to ensure that objectivity and independence are maintained on the engagement.</p>	<p>Advantageous for both sides but in case of associations continuing for a number of years personnel involved in the audit should be rotated or other control action undertaken (Code 1999, section 2.4.10). Recommended, but not mandatory.</p>

Sources: Poland - the Accounting Act 2000 and Audit Act 2000 and in the Code of Ethics 1999.

De facto compliance

In this section *de facto* compliance with the aspects noted in the tables is studied. Subsequently, the other aspects of the framework laid out in Table 3.2, are covered. This covers a discussion of such areas as personal ethics and the background issues of the economic and cultural context. The analysis in this section is based upon interviews (a list of interviewees is noted in Appendix 2) and a review of some of the local business press and the professional journal of the Chamber, *Accountancy*.

Audit process – programming independence

Body of auditing expertise, appropriate training in it, enforcement and examinations

Those wishing to become auditors have to complete exams where there is an assessment of auditing expertise. Although there are requirements for examination, in 1991 the Audit Act allowed the former SAAs to be registered as independent auditors without sitting

the exams and without adequate apprenticeship. A vast majority of auditors in Poland fall into the category of former SAAs. Out of 7,700 registered auditors, only 500 were qualified under the new scheme of the independent audit profession (the Audit Act 1991). There are 4,300 active practising auditors, and the remainder are either retired or not working³. There are about 1,400 auditors as individual persons and 630 auditing firms. There are also 1,500 auditors currently in the process of training under the new framework.

Audit firms take responsibility for internal training; one of the audit partners (from a medium-sized firm) mentioned the importance of in-house training and the socialisation aspects of training necessary in building confidence and motivation at the work place.

As the Supervisory Committee has been newly established (the Act 2000), there is not much data on its operations. The President of the Chamber argued during the interview that the work of the Committee was satisfactory, however more resources could improve the effectiveness of its performance. It was agreed by the membership of the Chamber that provisions with regard to enforcement mechanisms in this area would be discussed at the Assembly meeting in July 2002. The proposed changes were incorporated in the statute of the Chamber (drafted Statute, the project of February 2002). Art. 6 introduced obligatory financial contributions from each auditor to cover the Supervisory Committee's costs regarding control of compliance with laws, the Code of Ethics and the appropriateness of fulfilling audit duties. This was believed to have strengthened monitoring and legal enforcement.

To strengthen independence, there were also governmental proposals to establish the new Supervisory Committee, independent from the Chamber. The proposal specified that all 15 members of the new Committee, from outside the profession, would be elected by the Chamber. The President of the Chamber expressed some scepticism as to the government's new proposals and argued that these proposals

were aimed at interference by the Ministry of Finance and control over the regulatory role of the profession.

Audit process – investigative and reporting independence

Access to information and audit report legislation

Interviewees confirmed that on the whole there was access to all documentation and that there were no problems with obtaining management representations during an audit. Interviewees indicated that there were some problems in accessing managerial documents such as the minutes of Board meetings and business controls issues.

The areas where the management does have problems, at times, is in disclosing information [which] including agreements that support the business operation but not the source of the journal entries, as these cover a period of time. They set the framework for the transactions. Or there are things like reports on budgets that are internal documents and provide us with assurance on controls over the business. Local management do not realise that aspects of audit methodology are to look at business controls. So it is a lack of understanding and a lack of knowledge in one what an auditor is about, and to what rights we have as auditors. (Audit partner, Big Five).

Interviewees (Polish and Big Five auditors) argued that clients sometimes did not realise that auditors had the authority to be provided with the required information and that the client had an obligation to deliver these documents. Also, at times, clients claimed secrecy over the information given and that they were not aware of the existing confidentiality rules for auditors. At times, auditors needed to assure clients that they were obeying these rules before they were allowed to access certain documents.

One of the Polish auditors (in a Polish audit firm) mentioned the need for auditors to be aware of the possibility of hidden information in the context of severe liquidity problems or potential bankruptcy.

The interviewees (Polish and Big Five auditors) argued that one of the weakest areas in regulation regarding investigative independence was in the area of working papers. There was very little guidance as to what audit working papers should be included. Interviewees argued that this was why audit files were sometimes far from complete.

During the course of interviews, Polish auditors referred several times to 'transition reality', which delineated a particular bonding with the client, where 'the client expects to be helped, advised on accounting matters, expects the auditor to know up-to-date regulation, this is a part of the package and the auditor cannot deny help'. In other words, the clients appeared to expect a 'wide' dimension of auditors' expertise under a contract for an audit service. Interviewees agreed that in some cases such relationships might violate aspects of the Code of Ethics, but stated that it was impossible that following a mere rule would ensure independence.

Interviewees also referred to the economic side of independence in the Polish transition context. Ethical conflicts often appeared to be related to financial issues; in particular, interviewees referred to the problems of lowballing and opinion shopping, practices that tended to lower the price for audit services below an economically viable level.

Although the Accounting Act 2000 emphasised substance over form, practice was still very much tax driven and accountants were perceived as being concerned with not doing anything against the tax law that would lead to fines or jail. Therefore, during the course of interviews, Polish practitioners admitted to take, in the main, a formal rather than a commercial approach to accounting practice.

Interviewees argued that there appear not to be many qualified audit reports, in particular of a going-concern type, given the context

of liquidity problems that many companies faced and the overall economic instability of the country. Interviewees argued that auditors often needed to understand the ‘struggle with transition’ the clients experienced, especially in relation to capital deficiency problems. There were cases where smaller auditors, afraid of losing a client, decided to issue the ‘except for’ opinion as a compromise with the client in a financial distress context.

The tendency was to disclose the minimum required information about an enterprise. The Chamber members mentioned that auditors found it difficult to put ‘openly’ in writing information about the management, about the management’s policies and systems; in the final audit stage there appeared to be negotiation on disclosure issues between auditors and management. As a result there was a lack of full disclosure and companies sometimes collapsed with a clean audit report (Polish bank, Tax Dept).

Auditor’s individual independence

Regulations regarding appointment and resignation

Article 9 of the Audit Act 2000 defines the rules for auditor appointment and change but these are of a very general nature. In practice, the auditors were effectively appointed by the directors of the company, especially in smaller companies. Interviewees stressed a general need for stricter monitoring and enforcement mechanisms in this area.

There appeared to be no tradition of long-term engagements; audit contracts were based on annual agreements in written form, often not renewable. A practice of auditor switching was common for Polish audit firms and was based primarily on pricing. The ‘cheaper’ auditor replaced the existing auditor in the context of a lack of capital or liquidity on the part of the client. At times, audits were regarded solely

as a cost for the firm, having no additional value from the management point of view. Also, what happened as a result of the severe competition was that some auditors took on specialised engagements for example, in banks and insurance companies, without adequate expertise to conduct the specialised audit.

The Code 1999 provisions regarding auditors' contacts with previous auditors were not working effectively in practice. These rules were perceived as not persuasive enough. On the whole, there was no contact and therefore no access to any prior audit files. Section 5.3.2 (Code 1999) left the decision whether to contact the previous auditor to the current auditor's discretion. This section was incorporated in the Code so as to reflect the reality of the socio-economic conditions. The President of the KIBR argued that:

It was better to loosen up the rules than to keep the fiction.

The lack of contact with previous auditors on the commencement of a new engagement raised concerns in the profession and resulted in proposed changes to the Code 1999 (drafted version of the Code 2002).

Under the proposed, revised Code 2002, before accepting the offer, the new auditor is obliged to inform the client about the requirement of the Code to contact the previous auditors and to ask the client to write to the previous auditors for access to the prior year audit files. When the client refuses, the auditor should not accept the engagement (Art 10.9). If the auditor does not receive a response from the previous auditors within 14 days and there are no other obstacles as to the new engagement, the auditor can accept the offer (Art. 10.11).

The Accounting Act 2000 has released small enterprises from compulsory annual audits and from audits every three years. The percentage of production from enterprises released from compulsory audits is estimated as 70% of GDP. This is likely to lead to even more severe competition on audit market.

Chamber Codes re individual economic dependence

Over-dependence on fees

There seemed to be over-dependence on fees from a few clients. For the majority of Polish auditors who were interviewed this was perceived as a key obstacle in maintaining *de facto* independence.

[At least 50% of] *the Revenues in my firm ... come from clients whose fees cover 15-20 % of my total income, and believe me it is not uncommon in the context of transition market.* (Audit partner, medium-sized firm).

Such practices, although perceived by practitioners as damaging for independence, were still allowed under the Code of Ethics. The auditors could not audit if they had earned, at least in one year out of the last five, more than 50% of their annual income from the client, parent, associate or subsidiary (Art. 66.4), or for the assignments in which the audit client had more than 20% of the equity (the Code 1999, section 2.4.3.3). Also, members of the Chamber confirmed that, owing to a lack of capital in their practices, auditors were particularly dependent on their fee income.

Provision of other services to clients

On the whole, the clients expected advice on accounting treatment or tax issues from the auditor as a part of the audit service; an added value. There were heavy penalties for a lack of compliance with tax regulations; therefore clients were sometimes 'obsessed' with the appropriateness of the tax return calculations. There did not appear to be similar penalties for non-compliance with accounting regulations. Collaborations with clients and advice given as part of an

audit in this area might make the auditor lose some degree of *de facto* independence.

Overall there appeared to be a misunderstanding as to the meaning of the notion of ‘other services’. There was a disagreement over the interpretation of certain legal requirements on how to define non-audit services (NAS). In particular, there was confusion with regard to the interpretation of the provisions that defined ‘bookkeeping’ services (the Code of Ethics 1999, section 2.4.3.2) under circumstances where ‘one person prepares the accounts and another signs’.

There was evidence from the interviews that the statutory and professional provisions provided leeway for auditors to provide certain NAS for their clients, especially tax-related and accounting treatment advice. Poles had a tendency to provide private interpretations for existing legislation as they:

... tend not to accept things as they are (The Accountants Association).

I see the Polish practice with too many rules and too few areas where you can exercise your judgement and I think a lot of people could do it [exercise judgement] very well here. (the Chamber).

Some Polish practitioners believed that the provision of additional services to their clients did not impair independence if the contract for an audit engagement was signed. In the light of this interpretative conflict, there was no initiative from the Polish profession to facilitate and promote interpretative solutions in the area of Non-Audit Services. Also, this might be in part attributed to an inability to take on board the essence of the regulation.

System for dealing with violations

Complaints to the Chamber are dealt with within the profession. Since the establishment of the Chamber in 1991 there have been in

total 390 disciplinary proceedings (including 81 complaints) of which 234 came to completion. Table 5.3 presents a summary of disciplinary investigations by the Chamber between 1991 and 2001⁴.

The Chamber does not disclose the nature of the offence in disciplinary proceedings.

Table 5.3: Disciplinary investigations: a summary⁵

Proceedings completed by Spokesperson	234
Proceedings completed by Disciplinary Court of 1 st Instance:	81
Admonition	42
Not liable	12
Reprimand	15
Suspension from performance of duties for 2 years	1
Defendant [sued at law] but no penalty given	6
Complaints	5
Proceedings completed by Disciplinary Court of 2 nd Instance:	12
Admonition	4
Not liable	5
Reprimand	2
Suspension from performance of duties for 1.5 year	1
Proceedings pending (in progress)	55

As Table 5.3 indicates, there have been 234 disciplinary investigations since 1991 (on average 23 cases per annum). The Chamber has been concerned about not having adequate resources to undertake a proper investigation of audit work.

Auditor and independence: Independence of mind

How individual auditors might or might not see independence as a state of mind allied to their personal ethics were investigated in the interviews by asking them what professional values they considered to be most important as an auditor and what they perceived to be auditor independence. If auditor independence was seen as a state of mind, this might arise in the audit interviewees' description of the professional values they espoused and their definitions of auditor independence.

The answers to the first question about their key professional values varied, but key motifs among many auditors interviewed seemed to be individualism, freedom and monetary gain.

Culture of the audit firm

Socio-political instability and recent history predispose Polish people to a particular way of relating to change, including changes in legislation. *'If something changes it is no big deal because Poles have been through so much'* (audit partner, small firm). As a result, some degree of passiveness can be observed in the Polish professions. In such a context, auditor independence was perceived as a novel concept *'imported to national laws from Europe'* (Academic). As one of the interviewees expressed:

Accounting policies and a conservative slant makes it sometimes difficult to convince people to meet the provisions of law [regarding true and fair]. (Audit partner, medium-sized audit firm).

In Poland, where there appeared to be a compliance-based approach to regulation *'more [changes in] rules could mean more problems on how to apply ... and how to interpret them'*. In other words, there were problems with the rationalisation of the substance of the construct.

The ways of doing business in the communist years tended to influence the business context; people debated issues and talked about various alternatives, but making a decision as to what was the most appropriate solution for a given situation was not a strength. There was a tendency to debate and just interpret established orders being a creative approach to compliance with rules.

Polish people negotiating ... talk for a long long long long time. It is not a decision-making culture (Audit partner, medium-sized Polish firm).

One of the Big Firms partners argued:

Poles [expend] ... lots of energy [in] ... negotiat[ing] and to discuss points back and forth but are very reluctant to make decisions on the spot. I find that if it is Polish management I am dealing with they really need time to contemplate things before they give me a final answer on things. Much longer than I am used to coming from North America (Audit partner, Big Five).

Poles are very individualistic by nature and therefore it is difficult for Poles to adapt to group-work environments (teams). Individualism and debating, as well as attitude of envy, has resulted in the segmentation of the audit market. There are very few medium-sized Polish firms and many auditors practice on their own with an insufficient financial base and technological infrastructure.

Size of the audit firm

In Poland there are approximately 8,000 registered auditors (not all actively practising) and 2,500 audit firms⁶. There are two distinct segments in the audit market: the foreign firms (mainly Big Five) and the Polish firms. The Polish firms suffer from a lack of capital inflow and cannot afford to invest in a computing and information technology infrastructure. Low fees for audit services reflect the liquidity situation

of Polish clients, who are at times unable to meet the high costs for audits. Practitioners often referred to transition or 'our' reality while discussing these issues. As a consequence, in the competitive market:

... the prices for audit services are dictated by the clients in ratio 1:5 in comparison with the Big Five. Also, the practice of switching is more common with Polish auditors who do not have enough established bargaining power (Audit partner, medium-sized firm).

Polish auditors were divided between medium-sized firms and very small companies, including sole traders. Many very small auditors relied heavily on fees from a small number of clients.

Independence issue in Poland is perceived as being correlated with the size of the firm. (President, the Chamber of Auditors).

What emerged from the interviewees was an indication of sporadic practices of smaller clients failing to pay fees, although this was more of a problem in the 1990s in the early stages of transition. Word of mouth among local auditors counteracted such practices. Interviewees argued that as a result, 'delinquent' customers would not be taken on.

There is a generally held view that independence is related to issues of economies of scale; 'the smaller the practice, the independence problem is more explicit' (Audit partner, medium-sized firm).

The Big Five companies covered the audits of listed companies or larger plc companies (SAs).

Larger auditing firms are dealing with more risky clients and they are automatically forced to adhere to a stricter Code of Ethics and they take it a lot more seriously than a smaller firm. The big firms have established mechanisms for making sure they are independent and that they document being independent. Smaller firms, in many cases, are not concerned about independence [and] allowing any mechanism to ensure that they are independent (Audit partner, Big Five).

Procedural superiority translated into a very structured audit process. However, it did not always appear to prevent the big firms from being sued (as may be indicated with the case of Enron).

Legal capability

The interviewees pointed out the problems with enforcement of laws. It took years to be heard in the courts. Also the legal system remained bureaucratic and inefficient.

Auditors were required by law to have insurance cover. There seemed to be an economic issue related to a lack of capital in the Polish audit firms. One of the interviewees, an audit partner, illustrated the problem of economic dependence from his practice:

If you audit clients with a turnover of 50m–200m PLZ, net assets of 50m PLZ, having yourself net asset of 0.5–0.7m PLZ, you appear low, vulnerable to clients you audit. We are not able to take indemnity insurance higher than 2m PLZ (Audit partner, Polish medium-sized audit firm).

This paradox illustrates the incidence of the relationship of inequality between the auditee and the auditor on the competitive market, as the auditor could not afford to be reasonably protected by indemnity insurance.

State of the audit market

The Polish economy has been hit by recession and budget deficit problems. This has led to a severe decrease in foreign investment. On the whole there has been a lack of stability for auditors in the market, where the fees for their services do not reflect the work done. Short-termism and a tendency to hover around the breakeven point, seem to prevail in very small practices.

Lots of SME managers do not have a long-term outlook on their own business (Polish bank, Monitoring).

Few Polish medium-sized audit firms had a long-term vision. Forward-thinking younger management believed in image creation if the firm was to be sustainable in a very competitive market. The audit partners (Polish firms) stressed the importance of investing time in building up their clients' trust.

On the whole, from a business point of view, the audit fees reflected the value that the clients saw in the audit and therefore the risk that they saw in their business was not necessarily the same as the risk the auditor saw. The concern was that if the fees were too low, as interviewees argued, the auditor did not always behave in the proper and professional manner; this has an economic dimension of the auditor independence problem. As a result, a particular way of thinking about 'doing audit as quickly as possible as opposed to as effectively as possible' appeared common in practice.

Professional ethos

On the whole, the interviewees referred to the immaturity of the newly established profession in Poland, with its roots in the SAAs' tradition and taxation focus.

Most of the reporting issues are tax issues and tax regulations are so strict and sometimes so out of the accounting commercial context that it is very difficult to adhere to them. A lot of companies in the past have prepared the books according to the tax regulations. This is still the case today. If I have a question regarding accounting treatment of a certain item and I ask for the [accounting] treatment [from] an older chartered accountant here, the immediate answer I get is the tax perspective. (Audit partner, medium-sized firm).

The quality of the audit was questioned in both segments of the audit market: Polish firms and the Big Five. The problem with professionalism in the Polish firms might be related to over-familiarity with clients, which affected the level of thoroughness in audit investigations. Referring to Polish audit firms, one of the Big Five partners argued:

The auditors are under more pressure keeping their advice objective versus being biased towards what the client wants because they converse much more. (Audit partner, Big Five).

On the whole, Big Five firms in Poland were well regarded in the business community for the organisation of their business and their formalised procedures. In the Big Five, however, the problem with professionalism related to the capacity of audit teams. The Big Five employed lots of audit assistants and left them to do the fieldwork with little support from qualified and senior auditors. There was thus an issue of the quality of the service provided; mainly regarding matters related to quality control.

I met several assistants who are not able to do the audit, especially in the Big Five [where] their policies are to keep their business running. Assistants [in Big firms seem to] do the companies' audits. (Polish bank, Monitoring group).

An audit partner from one of the Big Five mentioned that they did not follow national auditing standards issued by the Polish Chamber, although under Polish jurisdiction auditors ought to comply with these standards, assuring best practice, and explained that:

We [the Big Five] follow the international standards based on audit manuals and adhere to them. In the international audit you are covering a Polish audit ... I never actually have seen an English translation of the national auditing standards. (Audit partner, Big Five expatriate).

The Big Five firms' auditors also had to complete lengthy annual independence declarations for their firms. One of the interviewed audit partners from the Big Five argued that '*specifics in our independence and ethical rules are much more extensive than what is in the Polish Code of Ethics*'.

Interviewees argued that what characterised the Polish audit profession was a differentiation in approach to audit, with regard to knowledge base and the ways of doing an audit, between the 'older' generation of auditors, trained under SAAs, a majority, and the younger generation of newly trained individuals.

Cultural context

Background

Poles are characterised with individualism, personal respect, independence, freedom, religion, selfishness and integrity (Shen, 1991) where values for public accountability are given less attention than personal ethics.

Independence was often referred to as freedom from (foreign) supervision or intervention. On the whole, Poles rebelled against dependent positions, whether imposed from without, from foreign frameworks or from a domestic economic condition with which they did not identify. This was particularly relevant for the harmonisation of law in the context of transition, when a multitude of Western notions, including those of audit independence, were being imported to the national frameworks without substantial rationalisation. There might often be an appearance of compliance, but *de facto* imposed frameworks were translated into local ways of doing things *na chlopski rozum* (with a peasant's mind).

'Economic freedom' was often referred to as freedom from wanting what should be there but is not. Freedom to be oneself was

cherished. Individualism, a trait cultivated in contemporary Poland, has had an historical evolution (Kolankiewicz and Lewis, 1988). The desire to be independent has been interrelated with individualism. In contemporary Poland, during their formative years, young people were given the freedom to explore their strengths and weaknesses, to make their own choices, to be their own masters in life. From such an atmosphere, Polish youths matured to be individuals. Therefore values, beliefs, or practices imposed, in some way, from above, needed to be palatable to these personal convictions, if they were to have the desired effect, MacLulich and Sucher (2003).

Bartminski (1993) writes that perhaps what distinguishes the Polish attitude is an acceptance of national freedom (*wolnosc*) and independence (*niezaleznosc*) as the most basic values, and Poles deduce from these a set of obligations of the individual towards society.

Interviews

An analysis of these Polish interviews indicated that the core codes for understanding how auditor independence was interpreted were freedom-based, rules-based and transition-based mingled with an issue with corruption. In defining auditor independence, there was frequent reference to auditor independence having its grounding in a notion of freedom, as a creative approach to auditor independence.

Auditor independence is I think to be free from limitations; professionalism in other words. (President, Chamber of Auditors)

Also freedom from politics; left wing, right wing, changes of Boards of Directors in public companies. Auditors must not be political at all. (Ethics Committee, Chamber of Auditors).

A sense of freedom from any external influences that affect quality and objectivity. (Audit partner, medium-sized Polish audit firm).

There were also frequent references to rules.

I understand auditor independence in the same way as I learned it from the Code of Ethics. (Polish auditor).

I define audit independence by [the] way in which it is regulated in the Accounting Act and Code of Ethics. There are specific rules on audit independence. But very important in my opinion is indescribability of auditor independence as independence in mind. (Stock Exchange).

The second quote implies that although a rules-based approach underlies best practice, it is not sufficient on its own for achieving a state of independence. The rules-based approach was emphasised as the tradition in Poland.

The basic rule is that [the] auditors cannot in any way be connected or linked to the audited company, certainly cannot keep books of that company. It is sort of our tradition, Polish habit. In our country accountants have professional procedures and accountants have always dealt with accounting, tax and auditing ... During socialist times regulation was strict and [an] auditor was not allowed to audit the same industry he was advising. So I believe independence in Poland has some rule-based tradition. (Accountants Association).

Other interviewees cited regulations; for example, one of the interviewees cited the regulation inherent in the Code of Ethics:

Independence the auditor confirms through behaviour; the auditor cannot have direct financial dependence on clients; such as investment in the clients' company, financial interest of persons to whom the auditor is closely related. The Code states that auditors should not get involved in any activities impairing their independence (section 3.2). Also, they cannot audit if they earned at least in one year out of the last five more than 50% of annual income from the client, parent, associate or subsidiary. (Academic).

Interviewees agreed that in some cases financial-based or familiar relationships might violate aspects of the Code of Ethics. In practice, the rules-based approach might not be a sufficient safeguard for problems that occurred in the context of transition. Interviewees referred to the economic side of independence in the Polish transition context. Ethical conflicts often appeared to be related to financial issues; in particular interviewees referred to problems of lowballing and opinion shopping.

There appeared to be another problem with the rules-based approach. Some interviewees stated that it was an impossibility that following a mere rule would ensure independence, as Poles have a tendency to provide their own private interpretations to new legislation, and might also apply to the auditor independence construct, as they “*tend not to accept things as they are*” (President, the Accountants Association).

In interpreting the regulation of the Code of Ethics (section 3.2), some Polish practitioners argued that the provision of additional services to their clients did not cause an impairment of independence if the contract for an audit engagement was clear and signed.

Certain traditions persisted in accounting practice, such as the influence of the Ministry of Finance in accounting regulation, the importance of reporting financial results to the Central Statistical Office, and a sense of bureaucratisation and formalism.

In Polish realms, the rules do not protect either an auditor or the profession. There is no tradition of private ownership. Firms do not believe in audit and therefore do not want to pay for audits. (Polish auditor).

The interview evidence indicated that the tendency was to disclose the minimum required information about an enterprise. This might be connected with the former interrelation between the restrictive tax law and accounting and also with a national hidden jealousy (envy) of

good performance in the private business – attitudes that came from the experience of a centrally planned economy.

Some interviewees referred to a need to analyse the auditor independence construct in the context of ‘our [local] reality’:

There are different stories with auditor independence, in our reality it depends very much on audit firm, the auditor and auditee. There are ethical audit firms who care for their name and also corrupted firms which sometimes make certain ‘concessions’ simply for money. (Academic).

The relationships in a professional context were still defined, to some extent, by favours and comradeship.

During and after the war the society was fighting an enemy, the government was an enemy in the communist times, therefore everything, including non-ethical behaviour, was accepted. (The Chamber).

People in the professions were perceived as being more susceptible to manipulation or influence than they would be in developed markets.

Bribery or some other favours are a much bigger issue. Cheating to some extent, unless harmful, is acceptable here. (Commercial Bank, Director of Equity Research).

Given the fact that it is an emerging market there is a risk that beside all hospitality, there are incidents of accepting bribes or trying to bribe and so on – this is a problem in Poland still. It is difficult to deny it ... Often though we are not talking about big bribes ... a box of chocolates or a bottle of alcohol. (Audit partner, Polish audit firm).

The interview evidence indicated that, on the whole, individual consciousness of being honest in professional spheres still appeared to be low and it was left to one's own set of moral values.

Proposed changes in the IFAC Code of Ethics

On the whole, given the Polish environment, compliance with the existing Code 1999, which was based on the international Code, appears unlikely. The Code 1999 does not recognise the capital requirements and economic dependency issues that drive competition and define, in large part, auditor-client relationships in Poland.

The new draft of the Code of Ethics 2002, based on the IFAC Code 1999, appears more in line with new international developments. *Significant changes were made in areas of independence and the proposed provisions are even more general than in the IFAC Code* (The Ethics Committee of the Chamber).

In this new draft of the Code, section 7 on audit independence is based on the IFAC Code checklist. The Code 2002 provides a list of situations (points 7.1–7.9) that might threaten independence including: (1) finance-based relationships; (2) employment; (3) NAS; (4) personal relationships; (5) fees and gifts; (6) capital structure (audit firm ownership); and (7) re-appointment issues (21.11.2001 version, KIBR). The new proposal for the Polish Code avoids giving examples. The assumption is made that if auditors want to consult on a specific issue, they should refer to the examples included in the IFAC Code⁷.

Section 10 'relationships with other auditors' has also been extended. The new proposals are aimed at dealing with issues of price shopping, lowballing and unfair competition. Art 10.7 emphasises that any acts of an auditor that threaten the interest of another auditor and/or the client, or limit access to the audit market through price dumping and unfair competition, are unethical.

In short, the new IFAC Code is perceived as a 'good approach but needs to be supported with the interpretation and enforcement mechanisms' (the Ethics Committee of the Chamber). The new approach is envisaged as more effective in 'softer' areas such as audit competence and integrity.

The framework approach will allow an understanding of what exactly is the independence concept. (Deputy Director of Corporate Finance Dept, PSEC).

An overall view emerging from the interviews was that one either 'complies with the new Code or not' and the 'details of how, do not matter'. (Chamber).

The Chamber's Committee recognised the need for an interpretative mechanism and expected to prepare this after the Code's approval. On the whole, the framework approach was believed to improve the quality of service and its marketability. The concern was raised, however, over fundamental understanding in this new context.

Poland needs to get people going through the qualifications and getting them with the holistic type of learning as opposed to memorising the rules and regulations. They need to develop the understanding of the theory behind accounting and auditing. (Academic).

Also, the profession needed to gain a certain worldwide status to 'evolve into a self standing profession'. (Academic).

Summary

For over 40 years (until 1991) auditors (SAAs) examined financial statements for tax purposes; hence Polish accounting has traditionally been tax dominated. In 1991, the independent auditing profession was introduced (by the Audit Act 1991) to carry out compulsory audits of financial statements. The role of an audit was redefined as

an independent examination of financial statements and to report on whether the accounts reflected the economic realities fairly and truly. Former SAAs were entered on a list of auditors. There were a small number of new auditors who educationally and professionally met the new regulatory requirements of the independent profession.

Actual practice still appears to be dominated by tax requirements, especially as a majority of practising auditors were the same accountants who had examined financial statements as representatives of the fiscal authorities. Although, formally, accounting has been separated from the tax law, and the relationship between tax and accounting has been lessened through the new 2000 legislation, a tax approach is still present, especially among the accountants with long seniority.

In short, despite the new laws, certain traditions persist in practice, such as the influence of the Ministry of Finance in accounting regulation, the importance of reporting financial results to the Central Statistical Office, and the continuation of the previous SAAs as members of the Chamber of Auditors and as the mainstay of the emerging auditing profession. The tendency is to disclose the minimum required information about an enterprise. This may be connected with the former interrelation between the restrictive tax law and accounting and also with a national hidden jealousy (envy) of good performance of private business; attitudes that come from the experience of a centrally planned economy.

Hence, what emerges from the interviews is a sub-categorisation of Polish auditors: those operationally dependent and those operationally independent, a segmentation based on attitudes towards independence and their knowledge base. The former group comprises the older generation of auditors trained as SAAs under the centrally planned economy. The latter group is represented by a new generation of auditors, trained and qualified under the new framework (post-1991 regulation).

The regulatory role of the Chamber of Auditors (KIBR) appears to be influential; work by the Ethics Committee on the new IFAC Code of Ethics (in progress) is advanced. The new IFAC Code has been explored and is viewed optimistically. Ongoing reform in professional education is required to facilitate learning processes so that auditors can find out how to construct their own judgements.

On the whole, the concept of auditor independence in Poland is perceived as an ethical issue, and although seen as a novel concept, it is interpreted as a state of being free from any influences from the client. What appears to prevail is a rules-based approach to its realisation; the current socio-economic and political situation of 'our' reality (*ie* market recession) and the regulatory changes have narrowed the perceived concept of independence to its economic dimension.

ENDNOTES:

- ¹ All laws were accessed in both the original version in Polish and in an English translation version provided by the Chamber of Auditors.
- ² For a fuller description of the sections of the IFAC Code, see table 4.2.
- ³ Statistics supplied by the Chamber of Auditors, interviews December 2001 and <http://www.kibr.org.pl>.
- ⁴ As on 13 December 2001.
- ⁵ Statistics supplied by the Chamber of Auditors.
- ⁶ Statistics supplied by the Chamber in December 2001.
- ⁷ Interview with the Chamber in December 2001.

CHAPTER SIX

CONCLUSION

In this concluding chapter the general themes that have emerged from the previous chapters are presented and the usefulness of the framework for the analysis is assessed. The independence requirements in the Polish and Czech Codes of Ethics are compared, as well as the development of the professional organisations' approach to auditor independence. The issue of pressures from competition in the market, the immaturity of the legal system, the tendency to adopt a rules-oriented approach in auditing, the impact of the provision of other services and the auditors' perceptions of auditor independence are noted. Subsequently, the *de jure* and *de facto* approaches to implementing auditor independence are compared. The emphasis is on the similarities and the differences between the two countries' approaches. The framework used to structure the analysis is reviewed. The implications for policy makers are then considered. This is followed by a discussion of the impact of the cultural context on auditor independence with a comment on some general issues for consideration.

Development of the professional organisations' approach to auditor independence

There are some similarities between the Czech and Polish Codes and the IFAC Code 1999 regarding independence, in areas such as direct financial interests, percentage of fees and the provision of goods and services. However, there are differences, such as there is no provision in the Czech Code regarding the employment of former

partners or the rotation of auditors, although there is a provision similar to that of the IFAC Code 1999 in the Polish Code. Indeed, as noted in chapters four and five, the Czech Code generally includes fewer requirements from the IFAC Code than the Polish Code.

There is also a similarity in the path that both countries have taken towards dealing with auditor independence. In both countries, Chambers of Auditors were established (Czech Republic 1992; Poland 1991) and all auditors have to be members of the respective Chambers. Chambers are responsible for the education, training, discipline and quality control among their auditors. An initial cohort of auditors trained under the communist regime were brought into each Chamber. Codes of Ethics have been drafted for each country based on the IFAC Code of Ethics, adjusted for local circumstances. In both countries, in 2002, the provisions in the Codes of Ethics were being revised to bring them into line with the new independence provisions in the IFAC Code of Ethics 2001. The interviewees expressed concerns, however, as to whether the more conceptual approach enshrined in the IFAC Code 2001 would be effective in either country.

Other *de jure* similarities between the two countries are in areas such as the requirements for audit standards, education and assessment in these standards and the necessity for legal liability insurance. Many of these similarities follow from the way in which both countries have sought to conform to the Eighth Directive as accession countries for the European Union. However, there are other similarities between the two countries in the areas of economic competition, the immaturity of the legal system, the influence of taxation and low levels of enterprise liquidity that may have a substantial impact on auditor independence.

Economic competition

An overwhelming issue in both transitional economies is that of economic competition among smaller audit firms and auditors. This is reflected through the *de facto* comments on several aspects of the framework used as a guide in discussing auditor independence. In particular there are issues of price, with some evidence of lowballing by auditors; issues of how new audits are taken on, where the requirements to contact previous auditors are either ignored or have been watered down; issues regarding the provision of other services and issues regarding going concern qualifications. In the latter two areas, there are indications, for example in the Czech Republic, that the Code 2000 requirements regarding the provision of other services are ignored owing to the pressure to keep clients. There were also comments in interviews that many auditors in both countries did not wish to qualify their audit report, even though it might be warranted, as they were more interested in whether their clients had complied with tax regulations, and they were concerned about keeping their clients. These concerns were also related to economic reality (transition issues). The removal of many of the smaller companies from the obligation to have an audit in both countries (effective from 2001) may remove the most problematic of these clients, being those with the lowest public interest, but it is likely to increase competition among smaller auditors. This is not to state that there is no competition among larger audit firms, but as the emphasis of this research has been on local auditors and firms, this is where the responses were concentrated.

Immaturity of the legal system

The immaturity of the legal system is an issue in both countries. There is evidence that it is difficult to pursue any case against auditors for negligence through the courts. Therefore auditors may not see this threat of legal action as serious and the threat of litigation is not a significant safeguard to support auditor independence.

Rules-based approach to auditing

Concern was expressed in the interviews in both countries that local auditors might take more of a rules-based approach to auditing, with a focus on compliance with regulations and taxation legislation rather than an emphasis on the economic substance of the business. There had been a large initial problem in both economies with many enterprises that were not a going concern. Rather than publishing audit reports with a going concern qualification, there were indications that many auditors had focused on compliance with tax legislation and accounting regulations rather than the going concern problem. Clients were also more concerned with taxation legislation.

Provision of other services

Among the smaller auditors, there was an emphasis on providing clients with valued-added services, especially with regard to taxation advice and accounting advice on the treatment of items. This was done in the context of evolving laws and conflicting interpretations of tax and accounting laws regarding possible accounting treatments. This focus on other services might be seen as detrimental to the provision of independent audits, although it is not unique to transitional economies. There seemed to be evidence that the spirit, if not the fact, of certain requirements in the Chambers' Codes regarding the provision of other

services was being ignored under the pressure of economic competition. This was happening in both the Czech Republic and Poland.

The issues arising with the Big Five audit firms, where the provision of consultancy advice might affect what is included in the audit report, were noted in the Czech Republic, and to some extent in the interviews in Poland. It is an issue that is being studied elsewhere since Enron, and may not be considered unique to the Big Five firms in transitional economies.

Auditors' approach to auditor independence

In the interviews in both countries there were similarities in one aspect of the way auditors defined auditor independence. Auditor independence was seen as an economic concept, where lack of independence would result from an over-reliance on audit fees from one source.

In the interviews in Poland, however, there was much more emphasis on individual freedom; the freedom from interference in any way. This may be seen as a reaction to the Communist regime pre-1989, but it may also cause problems when it comes to the regulation of auditors. There were some indications in the Czech Republic that some auditors saw freedom as an important aspect of auditor independence.

It appears from the country studies that there was a perception among those users interviewed that local auditors were not independent of their clients. Although larger international audit firms were generally seen as more independent than smaller audit firms, this was not always the case¹.

In both economies, a significant number of qualified auditors have transferred from the Communist regime, without full training in recently introduced standards of auditing, which are Anglo-American in origin. Thus, although there is a system in place of education and

examinations in audit, a lot of auditors have not been through this system. There are, however, requirements for continuing professional education in both countries that may help deal with this problem in a formal manner.

Differences in *de jure* and *de facto* implementation

Although the similarities in the Czech and Polish situations seem to be very strong, there are differences. One of the large differences is in the presence and press coverage of local auditor ‘scandals’. In the Czech Republic there has been extensive coverage of auditing failures (as noted in Chapter 4). Most of this coverage has related to the audit of large Czech banks by local Czech audit firms and the Big Five audit firms. Despite receiving unqualified audit reports, some of the Czech banks went into liquidation. This has raised questions about the quality of bank audits.

There have not been any similar issues in Poland, but the economy has been stronger than in the Czech Republic over the same period of time, and there has been less privatisation of the banks.

Revisiting the framework

As this study reviews auditor independence in economies in transition, the analysis has been based upon a comprehensive framework developed for this research incorporating all *de jure* and *de facto* aspects that might be in place to facilitate auditor independence. To recap, from table 3.1 in chapter three, the authors suggested that there must be the *ability* to undertake the audit work, based on audit expertise and the availability of evidence that can be audited (programming independence). Then there must be the *capacity* to be independent in investigating and reporting. Furthermore, individual auditors must *perceive themselves* as being independent. To facilitate these three criteria

there is usually a panoply of enforceable regulations covering these areas embedded in the local economic, societal and cultural context.

The framework developed for this research is comprehensive but it does not prioritise aspects of auditor independence according to what is considered most important and what *most* affects auditor independence in a transitional economy.

There is evidence from the interviews that the societal, cultural and economic pressures which are suggested as threats to auditor independence in transitional economies far outweigh any formal safeguards about professional competence, or the provision of other services. Although there may be disciplinary mechanisms to ensure that all regulations are followed, there are substantial deficiencies in the application of these enforcement mechanisms within the immature legal framework and local traditions in accounting.

Implications for policy makers

Enforcement

The notions of audit and auditor independence are relatively new in Poland and the Czech Republic. In both countries an independent profession has only been in existence for just over ten years. So it is all the more important to have strong, believable, enforcement mechanisms in order to build up trust in the audit among users of financial statements. There should be an emphasis on providing resources for regulatory mechanisms (such as the Supervisory and Disciplinary commissions) to ensure that they can enforce regulations. Better enforcement is not just a question of resources, however, it also needs a commitment to the establishment of clear regulatory and legal requirements that leave less room for argument. Although introducing independence requirements, based on the November 2001 conceptual approach of IFAC may be possible, its implementation would be aided if there were

very detailed examples of what undermines auditor independence in the developing market context. Extensive local training, using suitable case studies and emphasising the importance of auditor independence as an attitude of mind, could provide a solid basis for changing local auditors' mind-sets regarding independence. There is also the larger issue of the commitment to enhance the legal capability in transitional economies with properly functioning courts of law and increased trust in the justice system, as equally accessible to layman, so that actions can be properly pursued through the courts.

Economic competition

Economic competition is a substantial issue and it is likely that in the short term, particularly with the decrease in the number of companies that need to be audited, that there will be a surfeit of auditors. Gradually, there is likely to be a decline in the number of auditors and the competition between firms may lessen. Nonetheless, there still may continue to be competition among enterprises for the lowest quality and/or cheapest audit available from those auditors still in operation. Given the opacity of the quality of the audit to outside investors, many users of financial statements are likely to continue to use the size of the audit firm as an indication of quality. This is hardly desirable as it will hamper the growth of local audit firms and a local profession where the 'Big Four'², with some of the large international consortia of audit firms, compete with the local audit firms. An emphasis on the enforcement of audit quality and auditor independence is necessary.

Auditor change is particularly problematic. Local regulations concerning the resignation of auditors and liaison between incoming and outgoing auditors have not worked, probably because of the competition in the market. There needs to be better regulation and enforcement. With the Big Four audit firms, it might seem appropriate,

at least, to disclose in the enterprise's Annual Report how much is paid as audit fees and how much as consultancy fees, in order that the user can assess any implications.

Cultural context

One of the key considerations for national and international policy makers is the cultural context. Possible recommendations for dealing with issues of auditor independence in transitional economies have been presented. However, the implications for policy makers need to be contextualised further. The idea of professional ethics and what is perceived as 'normal' for professional conduct encapsulate the notions of calculable efficiency, pragmatism and liberal individualism.

These notions are imposed on developing markets through the harmonisation of national laws and practices with the requirements of EU Directives. As a result, patterns of conduct (based on Western ideas of best practice) travel to the CEE region without the recognition that there are 'differences' in local culture and accounting traditions, and that professional ethics are historically constructed by other sets of concerns. New notions of perceived 'normality' have been established for professionalism without any reference to cultural constructions within the CEE.

In discussing auditor independence and culture, themes emerged of auditor independence being based on economics, such as having no clients that provided a large amount of income, determined by given rules (the regulations of the Code of Ethics) within a context of national economic transition. There was also evidence from the interviews that what was conceived as a creative approach to rules was applied to the auditor independence regulations. In Poland there was an emphasis on individual freedom as applied to auditor independence. These themes cannot be ignored in determining what

may be appropriate drafting, and then successful enforcement, of local auditor independence regulations.

On a last note, where a culturally determined concept such as auditor independence is being implemented in a new context, there is a necessity for an exchange of ideas dialectically and not simply through a cause-effect relationship from power at the centre (Europe) to the periphery (CEE). The framework for auditor independence used here may be developed as a template to facilitate a dialogue between Western Europe and accession countries to establish what constitutes perceived normality in professional conduct and to define an appropriate time span to bring such conduct into line (as far as possible) with EU requirements.

Summary

Both countries have followed similar paths in developing local Codes of Ethics based on the IFAC Code and in establishing education, training, disciplinary and quality control procedures to support auditor independence. However, there are issues of concern about the impact on individual auditors of operating in a very competitive economic market within a newly established legal system. Auditor independence seems to be conceived locally as satisfying the rules laid out in Codes and regulations and, in particular, ensuring that there is no over-dependence, economically, on any one client. However, there is also a perception that the current situation is part of a transitional stage of economic development. It has only been just over ten years since the revolutions in Poland and the Czech Republic. It will be interesting to see how the concept of auditor independence develops in both countries in the next ten years.

ENDNOTES:

¹ See chapter four 'Size of the audit firm'.

² In this chapter the researchers are referring to the Big Four as they are looking at policy issues in the summer of 2002.

REFERENCES

- Accounting Act (2000), Parliamentary Act of 9 November 2000 on Accounting (*Ustawa z dnia 9 listopada 2000 r. o rachunkowości*).
- Act on Accounting (1991), No.563/1991 Coll. (*Zakon o učetnictví*), Trade Links Publications, Prague.
- Act on Accounting (1994), Parliamentary Act of 29 September of 1994 on Accounting (*Ustawa z dnia 29 września 1994 r. o rachunkowości*).
- Act on Auditors and the Chamber of Auditors of the Czech Republic (1992), No 254/1992 Coll. (*Zakon o auditorech a Komore auditoru Ceske republiky*), Trade Links Publications, Prague.
- Act on Auditors (2000), No.254/2000 Coll. (*Zakon o auditorech*), Trade Links Publications, Prague.
- Alvesson, M (2002), *Understanding Organisational Culture*, Sage, London.
- Alvesson, M and S Scoldberg (2000), *Reflexive Methodology*, Sage, London.
- Anderson, R and K Done (1997), 'A Year of Growing Uncertainty', *Financial Times*, 1 December, pp.I.
- Audit Act (1991), Parliamentary Act of 19 October 1991 on the Audit and Publication of Financial Statements, Statutory Auditors and Their Self Regulation (*Ustawa z dnia 19 października 1991 r. o badaniu i ogłaszaniu sprawozdan finansowych oraz biegłych rewidentach i ich samorządzie*).
- Audit Act (1994), Parliamentary Act of 13 October 1994 on Statutory Auditors and Their Self Regulation (*Ustawa z dnia 13 października 1994 r. o biegłych rewidentach i ich samorządzie*).
- Audit Act (2000), Parliamentary Act of 20 July 2000 on Statutory Auditors and Their Self Regulation (*Ustawa z dnia 20 lipca 2000 r. o biegłych rewidentach i ich samorządzie*).

- Auditor (2002), 'Hard Moments for Auditors are Not Over Yet', (*Těžké chvílky pro auditory jeste nekonci*), Vol.3, pp.29–32.
- Barker, C and D Galasinski (2001), *Cultural Studies and Discourse Analysis: A Dialogue on Language and Identity*, Sage, London.
- Bartminski J. (1993), *Pojecie Ojczyzny we Wspolczesnych Jezykach Europejskich*, (A Notion of Fatherland in Contemporary European Languages), Ed., Instytut Europy Srodkowo-Wschodniej, Lublin.
- Bhabha, H. (1994), *The Location of Culture*, Routledge, London.
- Boland (1997), 'An agency to fight the abuses', *Financial Times*, 1 December, pp.IV.
- Chartered Accountants Joint Ethics Committee CAJEC (1995), *The Framework – A New Approach to Auditor Independence*, CAJEC.
- Chow, C, M Shields and Y Chan (1991), 'The effects of management controls and national culture on manufacturing performance: an experimental investigation', *Accounting Organisations and Society*, Vol.16(3), pp.209–26.
- Citron, D (2002), 'The UK's framework approach to auditor independence and the commercialisation of the accounting profession', *Accounting, Auditing and Accountability*, Vol.16, No.2, pp.244–74.
- Code (2000), Code of Ethics, Chamber of Auditors, Czech Republic (*Eticky Kodex, Komory auditoru Ceske republiky*, 2000), Praha.
- Code of Ethics (1999), *Code of Ethics, Krajowa Izba Biegłych Rewidentow*, Warsaw.
- Code (1996), Chamber of Auditors (KIBR) (1996), *Code of Ethics, Krajowa Izba Biegłych Rewidentow*, Warsaw.
- Code (2002), Chamber of Auditors (KIBR) (2002), *Code of Ethics, Krajowa Izba Biegłych Rewidentow*, Warsaw, draft.
- Cohen, J, L Pant and D Sharp (1992), 'Cultural and socio-economic constraints on international codes of ethics: Lessons from accounting', *Journal of Business Ethics*, Vol.11(9), pp.687–702.
- Cohen, J, L Pant and D Sharp (1993), 'Culture based ethical conflicts confronting multinational accounting firms', *Accounting Horizons*, Vol.7(3), pp.1–13.

- Commercial Code (2000), Parliamentary Act of 15 September 2000 Commercial Code, (*Ustawa z dnia 15 września 2000 r. Kodeks spółek handlowych*).
- Cray, D and R Mallory (1998), *Making Sense of Managing Culture*, International Thomson Business Press, London.
- DeAngelo, R (1981), 'Auditor independence, low balling and disclosure regulation', *Journal of Accounting and Economics*, August, pp.113–127.
- EBRD (1998), *Transition Report 1998*, European Bank for Reconstruction and Development.
- EBRD (1999), *Transition Report 1999*, European Bank for Reconstruction and Development.
- EBRD (2000), *Transition Report 2000*, European Bank for Reconstruction and Development.
- Edwards, V and P Lawrence (2000), 'Czech and Slovak management' in *Management in Eastern Europe*, Palgrave MacMillan, London.
- European Community (1984), *Eighth Council Directive*, (84/253/EEC) 12/5/84.
- EU (2001), *Consultative Paper On Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, European Commission Internal Market DG, March.
- EU (2002), *Commission Recommendation of ... Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, Commission of the European Communities, June.
- FEE (1998), *Statutory Audit Independence and Objectivity*, July.
- Fielding, N (1998), 'Qualitative interviewing', in *Researching Social Life*, by N Gilbert, Sage, London.
- Flint, D (1988), *Philosophy and Principles of Auditing: an Introduction*, MacMillan, London.
- GAO (1996), *Improving Business Reporting: A Customer Focus, Meeting the Information Needs of Investors and Creditors*, AICPA, New York.
- Gilbert, N (1998), *Researching Social Life*, Sage, London.

- Gray, S G (1988), 'Towards a theory of cultural influence on the development of accounting systems internationally', *Abacus*, Vol.24(1), pp.1–15.
- Gul, F A (1989), 'Bankers' perceptions of factors affecting auditor independence', *Accounting, Auditing and Accountability Journal*, Vol.2(3), pp.40–51.
- Gul, F A (1991), 'Size of audit fees and perceptions of auditors' ability to resist management pressure in audit conflict situations', *Abacus*, Vol.27(2), pp.162–70.
- Hofstede, G (1980), *Culture's Consequences: International Differences in Work-Related Values*, Sage Publications, Beverly Hills, CA.
- Holy, L (1996), *The Little Czech and the Great Czech Nation*, Cambridge University Press, Cambridge.
- IFAC Code of Ethics (1999), *Technical Pronouncements*, IFAC handbook.
- IFAC (2001), *IFAC Code of Ethics for Professional Accountants*, International Federation of Accountants.
- Jaruga, A (1979), 'The accountancy profession in a centrally planned economy: The Polish case', *Accountant's Magazine*, Vol.880 pp.428–30.
- Jaruga, A, E Walinska and A Baniewicz (1996), 'The relationship between accounting and taxation in Poland', *The European Accounting Review*, Vol.5 (Supplement), pp.883–97.
- Jeppeson, K K (1998), 'Reinventing auditing: Redefining consulting and independence', *European Accounting Review*, Vol.7(93), pp.517–39.
- Johnstone, K, M Sutton and T Warfield (2001), 'Antecedents and consequences of independence risk: Framework for analysis', *Accounting Horizons*, Vol.15(1), pp.1–18.
- KIBR Decree no 310/22 (2001), [*Uchwała nr 310/22/2001 z 5 lutego 2001 r. w sprawie warunków uznawania egzaminów uniwersyteckich i równorzędnych w postępowaniu kwalifikacyjnym dla kandydatów na biegłych rezydentów*].

- KIBR Decree no 311/22 (2001), [*Uchwała nr 311/22/2001 z 5 lutego 2001 r. w sprawie programów i zasad odbywania praktyki i aplikacji przez kandydatów na biegłych*].
- KIBR Decree no 315/22 (2001), [*Uchwała nr 315/22/2001 z 5 lutego 2001 r. w sprawie obligatoryjnego doskonalenia zawodowego biegłych rewidentów w roku 2001*].
- Kilcommins, M (1997), *Perceptions of auditor independence and the effects on the perceived reliability of financial statements in Ireland*, PhD Thesis, The University of Wales.
- Kleinman, G, D Palmon, D and A Anandarajan (1998), 'Auditor independence: A synthesis of theory and empirical research', *Research in Accounting Regulation*, Vol.12 pp.3–42.
- Knapp, M (1985), 'Audit conflict: An empirical study of the perceived ability of auditors to resist management pressure', *The Accounting Review*, No.2, pp.202–11.
- Kolankiewicz, G and P G Lewis (1988), *Poland: Politics, Economics and Society*, Pinter, London.
- Kosmala MacLulich, K (2003), 'Reflections on the Last Millennium: Accountability Construct in Poland', in *Values in an Era of Transformation*, ed. Stasiak, M K Publishing House of Academy of Humanities and Economics in Lodz WSHE, Lodz.
- Kosmala MacLulich, K (2003), 'The True and Fair View Construct in the Context of Polish Transition Economy: Some Local Insights', *The European Accounting Review*, 12(3), pp.465–487.
- Kosmala MacLulich, K and P Sucher (2003), 'A Local Realisation of Auditor Independence Construct in Poland: Counteracting "Iron Curtain" Syndrome in Academic Writing', *Critical Perspectives on Accounting*, available online <http://dx.doi.org/10.1016/j.cpa.2003.08.002>.
- Kriz, P (2002), 'Called to account', *Prague Business Journal*, 28 January, www.pbj.cz/user/article.asp?ArticleID=140092, accessed 29 January 2002.

- Kunitake, W K and C E White (1986), 'Ethics for independent accountants', *Accounting, Auditing and Accountability*, Summer, pp.222-31.
- Langr, L (1992), *Auditing in Czechoslovakia*, paper presented at the Czech-British Accountancy Association, November.
- Lavin, D (1977), 'Some effects of the perceived independence of the auditor', *Accounting, Organisations and Society*, Vol.2(3), pp.237-44.
- Ledeneva, A (1998), *Russia's Economy of Favours*, Cambridge University Press, Cambridge.
- Leff, C S (1997), *The Czech and Slovak Republics*, Westview Press, Oxford.
- Lindsay, D, M Rennie, G Murphy and H Silvester (1987), 'Independence of external auditors: A Canadian perspective', in K S Most (Ed.), *Advances in International Accounting*, Vol.1, pp.169-189, London.
- Lindsay, D (1992), 'Auditor-client conflict resolution: An investigation of the perceptions of the financial community in Australia and Canada', *International Journal of Accounting*, Vol.27 pp.342-65.
- Magee, R and M Tseng (1990), 'Audit pricing and independence', *The Accounting Review*, Vol.65(2), pp.315-36.
- Mautz, R and H Sharaf (1961), *The Philosophy of Auditing*, American Accounting Association, New York.
- McKinnon, J (1984), 'Cultural constraints on audit independence in Japan', *International Journal of Accounting*, Vol.20 pp.17-43.
- Mitchell, A, P Sikka, A Puxty and H Willmott (1993), *A Better Future for Auditing*, Working Paper, University of East London.
- Moizer, P (1991), 'Independence' in M Sherer and S Turley (Eds), *Current Issues in Auditing*, 2nd ed., Paul Chapman Publishing Ltd: London.
- Palmrose, A (1987), 'Litigation and independent auditors: The role of business failures and management fraud', *Auditing: Journal of Practice & Theory*, Vol.6, pp.90-102.
- Pany, K and P M Reckers (1988), 'Auditor performance of MAS: A study of its effects on decisions and perceptions', *Accounting Horizons*, Vol.2(3), pp.31-8.

- Patel, C and J Psaros (2000), 'Perceptions of external auditors' independence: Some cross-cultural evidence', *British Accounting Review*, Vol.32, No.3, September.
- PBJ (2000a), *Prague Business Journal*, 'Ernst & Young's local operations are folded into regional audit efforts', 22 May, accessed on line at <http://www.pbj.cz/common/article.asp?id=76164&amsearch+&site=1> 16/02/01.
- PBJ (2000b), *Prague Business Journal*, 'Auditors mandated into "adequate" insurance by new law', 14 August, accessed on line at <http://www.pbj.cz/common/article.asp?id=85747&amsearch+&site=1> 16/02/01
- PBJ (2001), *Prague Business Journal*, 'KPMG's new managing partner talks about the bumpy ride of the past decade', 14 May, accessed on line at <http://www.pbj.cz/common/article.asp?id=118627&amsearch+&site=1> 29/06/01
- Pendergast, M (2001), 'Strength through harmony', *Accountancy*, August, pp.144-145.
- Percy, I (1999), *The Future of Auditing*, conference paper, BAA, University of Dundee.
- POB (1994), *Strengthening the Professionalism of the Independent Auditor*, Public Oversight Board, USA.
- Power, M (1997), *The audit society: Rituals of verification*, Oxford University Press, Oxford.
- Prague Post* (1995), 'Accountability makes a debut appearance on the political stage', 21 June accessed on line via webmaster@newton.cz. 18/07/01
- Prague Post* (1999), 'Svoboda detention impresses few critics', 1 December, accessed on line via webmaster@newton.cz 18/07/01
- Prague Post* (2000), 'New law is passed to thwart embezzling', 7 June, accessed on line via webmaster@newton.cz 18/07/01
- SEC (2000), *Independent Consultants' Report on PricewaterhouseCoopers*, Securities and Exchange Commission, January.

- Shen, R (1991), *The Polish Economy: Legacies from the Past, Prospects for the Future*, Paeger, New York.
- Shockley, R (1981), 'Perceptions of auditor independence: An empirical analysis', *The Accounting Review*, October, pp.824–35
- Shockley, R A (1982), 'Perceptions of Auditor Independence: a Conceptual Model', *Journal of Accounting, Auditing and Finance*, Vol.5(2), pp.126–43.
- Shuetze, W P (1994), 'A mountain or a molehill?', *Accounting Horizons*, Vol.8(1), pp.69–78.
- Sikka, P and H Willmott (1995), 'The power of independence: Defending and extending the jurisdiction of accounting in the UK', *Accounting Organisations and Society*, 20(6), pp.547–81.
- Simecka, M (1990), *Koniec Nehybnosti (End of Aimlessness)*, Lidove Noviny, Prague.
- Simon, D T and J R Francis (1988), 'The effects of auditor changes on audit fees: Tests of price cutting and price recovery', *The Accounting Review*, Vol.63 (April), pp.255–63.
- Smidova, O (1992), 'Svejk after Slovakia: Czech national identity now', cited in *East European Reporter*, Vol.5: 5 (September–October), pp.14.
- Sucher, P and D Alexander (2001), *Checking out IAS: A case study in the Czech Republic*, unpublished paper.
- Sucher, P and S Bychkova (2001), 'Auditor independence in economies in transition: A study of Russia', *European Accounting Review*, Vol.10(4), pp.817–41.
- Sucher, P and I Zelenka (1998), 'The development of the role of the audit in the Czech Republic', *European Accounting Review*, Vol.7(4), pp.723–51.
- Sucher, P and K MacLulich (2004), 'A Construction of Auditor Independence in the Czech Republic: Local Insights', *Accounting, Auditing and Accountability Journal*, 17(2), pp.276–305.
- Sutton, M (1997), 'Auditor independence: The challenge of fact and appearance', *Accounting Horizons*, Vol.11(1), pp.86–91.

- Vrba, J (2000), 'Thoughts on the Ethical Code: What next after the VIII Assembly' (*Zamysleni nad etickym kodexem: Jak dal po VIII. Semun?*), *Auditor 1*, Komora Auditoru Ceske Republiky, pp.1.
- Vrba, J (2000a), 'Some notes on the new version of the Ethical Code' (*Nekolik poznamek k nove verzi Etickeho kodexu*), *Auditor 1*, Komora Auditoru Ceske Republiky, pp.10-12.
- Wallman, S (1996), 'The future of accounting, Part III, reliability and auditor independence', *Accounting Horizons*, Vol. 10(4), pp.76-97.
- Windsor, C. A. and Ashkanasy, N. M. (1995), 'The effect of client management bargaining power, moral reasoning development and belief in a just world on auditor independence', *Accounting, Organizations and Society*, Vol.20(7), pp.701-20.

APPENDIX ONE

LIST OF THE INTERVIEWEES IN THE CZECH REPUBLIC - SEPTEMBER 2001

Role	Interviewee	Organisation
Audit partner	C1	Small* Czech audit firm
Audit partner	C2	Small Czech audit firm
Auditor	C3	Sole practitioner
Audit partner	C4	Medium-sized Czech audit firm#
Auditor	C5	Sole practitioner
Audit partner	C6	Medium-sized Czech audit firm
Audit partner	C7	Large Czech audit firm
Academic and chair of Ethics committee	C8	Chamber of Auditors
Audit partner and former President	C9	Chamber of Auditors
Audit manager and member of international committee	C10	Chamber of Auditors
Equity analyst	C11	Overseas bank
Head of risk management	C12	Large bank
Head of banking regulation and supervision	C13	National Bank
Academic	C14	Prague School of Economics
Deputy Minister of Finance responsible for Law on Audit	C15	Ministry of Finance, Czech republic
Finance Director	C16	Large Czech company
<p>* Small means fewer than ten employees; Medium means more than ten employees.</p> <p># Interviewed April 2002</p>		

APPENDIX TWO

LIST OF THE INTERVIEWEES IN POLAND

Interviewees - December 2001	Affiliation
Audit partner	Small Polish audit firm
Audit partner	Small Polish audit firm
Audit partner	Medium-sized Polish audit firm
Audit partner	Medium-sized audit firm
Academic and Member of the Audit Committee in Polish company	University of Gdansk
Deputy Director of Corporate Finance Department	Polish Securities and Exchange Commission
Audit partner	Big Five
Audit manager	Big Five
President	Chamber of Auditors (KIBR)
Head of Ethics Committee	KIBR
Ethics Committee, audit partner	KIBR Small Polish audit firm
President	Polish Accountants Association (SKwP)
Financial analyst	Overseas Bank
Tax department	Large Bank
Manager of Group Monitoring	Large Bank
Director of Equity Group	Investment Bank

It was not possible to interview anyone at the Ministry of Finance.

APPENDIX THREE

AN EXAMPLE OF THE INTERVIEW SCHEDULE

For auditors from the Czech Republic

Personal background

Culture of the audit firm

How would you summarise the service provided by your firm/
practice?

State of the audit market

How competitive is the audit market for you?

- Number of firms
- Audit pricing issues
- Quality of audit

Body of auditing expertise

How do you comply with the Chamber of Auditors auditing standards?
Are there any particular areas that cause problems?

Access to information

The Law on Audit (section 15.2) states that you may have access to all necessary documents to express an opinion. How does this work in practice?

Appointment and resignation

How well do you believe the requirements on relations with other auditors are working (section.9)?

Codes re economic dependence and family relationships

How well do you believe the regulations on auditor independence included in the Chamber's Code of Ethics are working (section 6)?

The Law on audit (section 18) states the activities that are incompatible with being an auditor. How do these work in practice?

How do you ensure that your staff are fully informed about all aspects of the requirements on auditor independence in the Code of Ethics?

Can you give examples of areas where they (the codes and requirements) both seem to be working well and areas where they are not?

Personal ethics/Professional ethos/culture/socio-economic context

How would you describe the concept of auditor independence?

How important do you believe auditor independence to be?

What do you believe affects your ability to be independent:

- as an individual?
- as a member of the profession?

Can you give specific examples from your knowledge of other auditors where there may have been problems with auditor independence?

How do you believe auditor independence works in general in CR, given recent history?

To what extent do you consider particular or general economic issues in CR have any impact on your ability to be independent?

What general problems do you see with auditor independence (*ie* not just in CR)?

To what extent do your clients want you to be independent? What do you think clients understand as auditor independence?

Do you think there any particular problems in the CR in expressing an adverse opinion on a client?

Cultural context and professional ethos

What does it mean, in your view, to be Czech?

What cultural values are important to you, first as a professional and secondly to you as a private person?

In the professional context, what characterises Czech ways of doing business? Do young people have a different approach to business conduct than more experienced, older people?

General comments

Have you heard about the new IFAC framework on auditor independence and if so how do you think such a principles based approach could work in CR?

Do you think that a detailed rule based approach to auditor independence is preferable in the CR and if so why?

General cultural, historic and economic aspects

Can you suggest any specific aspects of Czech culture, history or current economic conditions that may impact on auditor independence?

With the questions below, given the amount of time taken, answers were sometimes submitted subsequently via fax.

Auditor independence specifics – list

Research has indicated that the following factors might affect auditor independence. To what extent and why do you believe that any of them would affect auditor independence in the CR in reality?

- Research – Factors affecting ACTUAL or PERCEIVED Auditor Independence.
- Regulations.
- Flexible accounting regulations; disputes about accounting.
- Lack of detailed auditor regulations re appointment and resignation.
- Codes of ethics for auditors re auditor independence.
- Strong enforcement of audit regulations, Code and disciplinary procedures.
- Detailed regulations on specific aspects of auditor independence, eg gifts from clients; family relations.

General issues with the audit

- Degree of expertise in audit.
- Auditors in place for a long period of time.
- Professional culture.
- Importance of non-audit services (% of firm's revenue; relation to audit fee for same client).
- Who pays the audit fee.
- Who appoints (audit committee?).
- Risk of loss of reputation of auditor.
- Risk of litigation against auditor.

Economic issues

- Economic significance of the client (percentage of firm's fees).
- Client in a weak financial condition.
- Size and status (listed or not) of client-company.
- Cost of changing auditor to client (therefore will be willing to accept negative opinion).
- Competition among audit firms, *eg* lowballing.

Audit firms/audit profession

- Size of audit firm.
- National or regional firm.
- National or international audit firm.
- Budget pressures.