

# ***Research Project***

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## **MBA 2005/6**

# **The impact of regulatory changes on the client service delivery strategies of a large multinational accounting firm in South Africa**

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A research report submitted to the Gordon Institute of Business Science,  
University of Pretoria, in partial fulfillment of the requirements for the degree of  
Master of Business Administration

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## ABSTRACT

The purpose of this study was to explore the impact of regulatory changes on the client service delivery strategies of a multinational accounting firm based in South Africa. These regulatory changes were implemented in an effort to avert corporate scandals such as Enron in future and now seek to govern, amongst others, the activities and conduct of accounting firms.

The focus of this research study is limited to a large accounting firm operating in South Africa in order to confirm and establish the extent of the impact of regulatory changes on client service strategies. Qualitative research was conducted through six face-to-face in-depth interviews with the top management of a large accounting firm. The single case study methodology was implemented using purposive, non-probability sampling and a semi-structured questionnaire as research tool.

The research confirmed the internal and external validity of regulatory changes on the client service strategies of the accounting firm and the profession. Although financial reporting regulations have forced accounting firms to become better acquainted with the client's business risk, frustration due to independence restrictions exists and affects the auditor-client relationship. Unfortunately, increased regulations have also caused accounting firms to adopt onerous risk mitigating measures, thus negatively influencing their efficiency.

## DECLARATION

I declare that this research project is my own, unaided work. It is submitted in partial fulfillment of the requirements of the degree of Master of Business Administration for the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other university.

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Date: 14/11/2006

**Rena Kuit**

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## LIST OF ABBREVIATIONS

APA	The South African Auditing Professions Act No.26 of 2005
CA	Chartered Accountant
CEO	Chief Executive Officer
E&Y	Ernst & Young
FDI	Foreign Direct Investment
FSS	Korean Financial Supervisory Services body
GAAP	Generally Accepted Accounting Practice
HR	Human Resources
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IOD	Southern African Chapter of the Institute of Directors
IRBA	Independent Regulatory Board of Auditors
ISA	International Standards of Accounting
ISQC1	The International Standard on Quality control for firms that perform audits
PCAOB	Public Company Accounting Oversight Board

PFMA	Public Finance Management Act
PSR	Professional Services Review
PwC	PricewaterhouseCoopers
S&P500	Standards & Poor's 500
SA	South Africa
SAICA	South African Institute of Chartered Accountants
SARBOX	The Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act of 2002)
SEC	The Securities Exchange Commission
SERVQUAL	Model developed by Parasuraman, Berry and Zeithaml to measure service quality.
US	United States of America

# CHAPTER 1: INTRODUCTION TO THE RESEARCH PROBLEM

## 1.1 Description of the problem and background

High-profile global corporate scandals in recent years have resulted in investigations into the reporting structures of corporates and management. As a result, the delivery of professional and business advisory services by accountants and auditors has also come under the spotlight with specific emphasis on the ability of accountants and auditors to provide an objective opinion on the accurate reflection of the financial affairs of a legal entity.

In order to protect stakeholders and shareholders alike, legislation covering issues such as corporate governance, risk management and more recently, the activities and conduct of accounting firms, has been promulgated by various governments in an effort to protect public interest. Young (2005: 20) refers to this as the “unprecedented onslaught on the stature of the profession through changes in regulation”.

This study explores the impact of regulatory changes on the client service delivery strategies of professional services firms by specifically focusing on a large, multinational accounting firm based in South Africa (hereafter referred to as “SA”).

Oosthuizen (2000:14) argues that uncertainty or turbulence in the external environment, in this case regulatory changes, is central to the development of a business strategy and can only successfully be done through consistent “internal flexibility”.

Baschab and Piot (2005: 6) define professional services as “work rendered by an independent contractor who has a professed knowledge of some department of learning or science used by its practical application to the affairs of others or in the practice of an art founded on it. A profession is a vocation founded on prolonged and specialised intellectual training which enables a particular service to be rendered. The word professional implies professed attainments in special knowledge as distinguished from a mere skill”.

Boyd and Walker (1990: 406) state that “service is critical in building a long-term profitable relationship with a client” and that the marketing of a services business is vastly different from that of a product-based business. Baschab *et al* (2005: 267) state that the “successful delivery of services and development of your client base is a continuous process – a never ending cycle embracing change”.

Professional services firms rely on high levels of quality client service to effectively and efficiently serve their clients in such a manner as to ensure an immediate and future profitable return on their investment.

Ismail, Haron Ibrahim and Isa (2006) investigated factors that influence the attitudes of Malaysian firms towards audit firms. They state that service quality, customer satisfaction and customer loyalty are all important factors that professional services firms should strive for. Ismail *et al* (2006) believe that service quality is essential to the sustainability and success of the professional services firm.

Although the extent and reach of regulation changes vary from country to country, common threads can be identified that guide/prescribe the most appropriate conduct for professional governing bodies and professionals. The new regulations are focused on companies of public interest and have as their primary goal the protection of the financial well-being of shareholders and stakeholders through a move towards the internationalisation of financial reporting standards. The objectives of internationalisation (Brody, Moscove and Wnek, 2005) of reporting standards are: a) to improve the quality of audits; b) to improve corporate internal control and management processes and c) to avoid future corporate scandals such as Enron, Worldcom, Ahold, Parmalat and in the case of SA, Leisurennet.

It would therefore be interesting to establish the extent to which accounting firms have adapted their client service delivery strategies as a result of the legislative changes and how have partners in accounting firms dealt with balancing legislative and client demands.

In order to fully comprehend the impact of accounting and financial reporting regulations, the secondary effect of regulatory changes on auditing and accounting firms and their underlying business processes has to be understood.

The term “auditing/accounting firm” will be used interchangeably throughout this study and refers to firms that deliver audit and accounting and related services. Auditing in this study refers to the evaluation of information provided in the financial statements of a company in order to determine whether or not the financial statements are a true and fair reflection of the company’s financial standing (Ismail *et al*, 2006).

Client service in the context of accounting firms therefore refers to the extent to which firms have adapted their service delivery to clients (e.g. increased hours and a focus on quality) to seize the opportunities created in the market.

### **1.1.1 Global and local overview of the Big Four Accounting firms**

The global and SA accounting and auditing profession is dominated by four large multinational firms: Deloitte, Ernst & Young (hereafter referred to as “E&Y”), KPMG and PricewaterhouseCoopers (hereafter referred to as “PwC”).

The demise of the fifth largest global accounting firm, Arthur Anderson, in 2001, following the Enron corporate reporting failure, led to the remaining Big Four firms buying the Arthur Anderson country practices. This contributed to a



substantial boost in revenue for each of the Big Four accounting firms from 2002 onwards as they received a phenomenal boost in clients and accompanying potential revenues.

In many cases clients chose to remain with the client service team responsible for client service delivery due to relationships and industry expertise regardless of the firm with which they were associated.

The Big Four accounting firms reported a collective global revenue of US\$71,1 billion for 2005 (unfortunately the financial results for KPMG for 2006 was not yet released at the time of submission of this document, so this figure could not have been updated for 2006 despite the fact that three of the Big four firms have already released their results). This represents a year-on-year increase of 15,26% for total Big Four revenue from 2004 to 2005, up from a year-on-year growth of 10,71% from 2003 to 2004, a trend that PwC does not foresee leveling off (2005).

The global turnover of the Big Four accounting firms is illustrated in Figure 1:

**Figure 1: Revenue growth by the Big Four Accounting firms from 2002 to 2006**

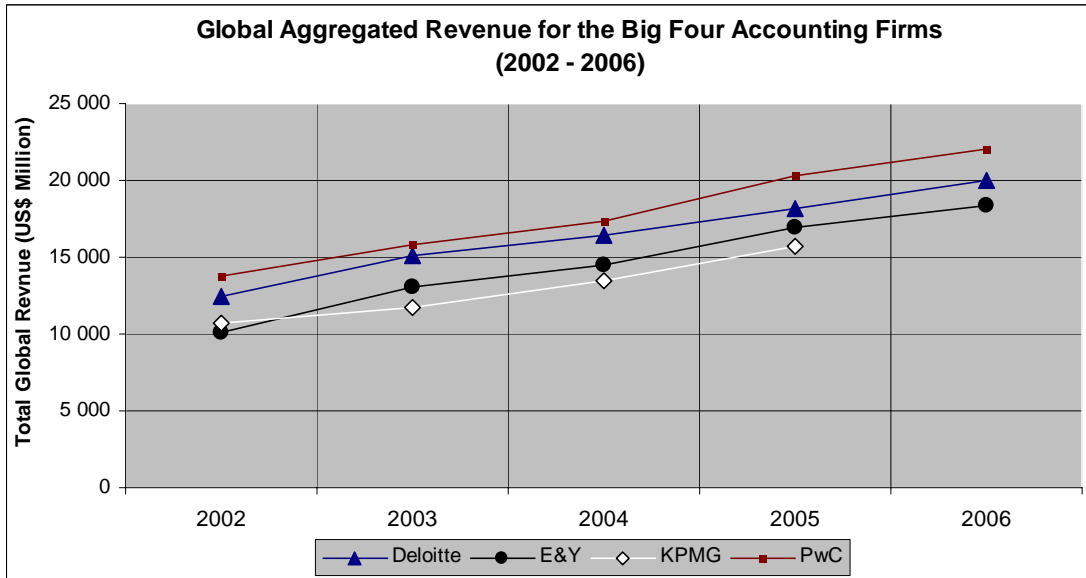


Table 1 describes the current status and footprint of the Big Four:

**Table 1: Capacity and footprint of the Big Four accounting firms in 2006**

Firm	Deloitte	E&Y	KPMG**	PwC
Active representation in countries ***	136	140	148	149
No. of offices	N/A	700	717	771
No. of employees	132,400	114,000	104,000	142,162
Global aggregated turnover (2005)	US\$20,0 billion	US\$18,4 billion	US\$15,7 billion	US\$22,0 billion

\* Data was compiled based on the 2006 Global Review documents published by respective firms. In cases where data on offices and personnel was not published in the 2005 Global Reviews, figures from the 2004 Global Reviews were used.

\*\* Denotes the 2005 results of KPMG.

\*\*\* Active representation: offices and personnel resident in a country.

It is clear that the Big Four firms have shown consistently strong growth since the Enron corporate scandal in 2001 despite the profession being subjected to great scrutiny.

### ***1.1.2 Regulations relating to financial reporting and duties of audit and accounting firms***

In order to understand the challenges that face accounting firms, the regulations impacting the industry must first be understood. These regulations can be divided into regulations governing the conduct of legal entities, such as corporates, and regulations primarily governing accounting firms. These regulations will be covered in more detail in chapter 2 and Appendices A and B of this study.

Unfortunately the full extent of these regulations, as with any other regulations, has only been fully comprehended after the fact.

The new legislation has led to fundamental changes in the way auditors now serve their clients.

Although accounting firms are responsible for the implementation and application of accounting and financial reporting legislation, the onus rests of the corporate to decide whether they will comply. Examples are the Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act of 2002, hereafter referred to as “SARBOX”) and International Financial Reporting Standards (hereafter referred to as “IFRS”) in jurisdictions where they are not required to do so by law. IFRS compliance is compulsory in the case of JSE-listed entities, in the case of United States of

America (hereafter referred to as the “US”) listed entities compliance with SARBOX is compulsory.

The legislative bodies of certain countries have also opted not to implement IFRS, but rather to continue under the auspices of long-adopted regulations, e.g. US GAAP. Approximately 74 countries have opted to implement IFRS or an IFRS equivalent (as is the case with New Zealand and Australia) as a reporting standard ([www.iasplus.com](http://www.iasplus.com), 2006).

In order to cope with the increased responsibilities placed on auditors, accounting firms have had to nominate highly experienced partners as Quality Assurance Partners to deal with risk management queries/issues. Audit quality reviews such as Professional Services Reviews (hereafter referred to as “PSR reviews”) have also become common whereby an additional measure of quality control has been built in to the post-audit review system to ensure that proper procedures and standards have been applied. Small- and medium enterprises and smaller accounting firms alike have had to make dramatic changes to their internal business processes and business will in future place unprecedented demand on their auditors and resources.

## **1.2 Purpose of the study**

Accounting firms have been tasked with not only implementing and applying regulatory changes, but also informing clients and the market of the practical

implications of the new legislation. However, as was shown earlier in this Chapter, accounting firms have benefited financially as a result of these changes due to the higher demand for professional services from corporates wishing to comply with new legislation. The higher demand for compliance has put strain on the resources already employed within the industry. A number of sources (Pretoria News, 2006; Sehoole, 2006; Bruce, 2005) refer to the global shortage of skills. However the legislation demands higher levels of communication between the client and the auditor than in the past.

The purpose of this study is to analyse the **impact of regulatory changes** on the **client service delivery strategies** of a large multinational **accounting firm in South Africa** through qualitative research.

This study will attempt to answer the following key questions:

- How have regulatory changes influenced accounting firms to adapt their client service strategies and their related product offerings?
- How have regulatory changes and independence requirements influenced the client relationship?
- How have accounting firms managed the change internally and have regulatory changes led to greater efficiencies?

### 1.3 Relevance to South Africa

The accounting industry has been the subject of a number of regulatory changes and controversy due to a number of public corporate scandals where financial reporting was identified as a possible early warning system, but failed. Global corporate scandals since 2001 include Enron, Worldcom, Xerox and Parmalat.

In a court case decision in the US in 2003, E&Y was suspended for six months from accepting new, SEC-registered audit clients after the SEC sued E&Y over its dubious actions relating to the PeopleSoft Inc. audit. The sentence also included a fine (BBC News, 2004). E&Y was again sued in April 2004 by a United Kingdom life assurance company, Equitable Life, because it claimed that E&Y “had failed to inform the then board of directors of the financial mess the mutual was in” (BBC News, 2005). The case was later dropped.

Further legal lawsuits relating to auditor independence and misconduct include KPMG with Xerox (BBC News, 2002), PwC and the truck rental group U-Haul International (BBC News, 2003) and Deloitte with regard to Adelphia, the US cable firm (BBC News, 2002). In the case of Parmalat, Deloitte (BBC News, 2005) was dismissed as joint auditor of Parmalat, while Grant Thornton partners, as was the case with Arthur Anderson LLP partners and Enron, were jailed.

The South African market however has not been left untouched by corporate scandals and some of the most prominent and public include Leisurenet and mining magnate, the late Brett Kebble. Both these cases refer to misconduct by management that eventually had a significant impact on the financial reports and status of the company.

However, the introduction of regulatory changes has had far-reaching effects on accounting firms - positively influencing their revenues and stretching their resources to deal with the increase in demand.

The impact of the internationalisation of financial reporting and accounting regulations on a large global player in the local market is therefore investigated in this study.

## **CHAPTER 2: LITERATURE REVIEW**

### **2.1 Introduction**

Much has been written about the influence of regulatory changes and legislation on business strategy focussing mainly on production facilities, environmental awareness, and labour legislation. The focus of regulatory changes and legislation has however now extended to financial reporting regulations largely due to the corporate scandals such as Enron and Worldcom.

Technology, globalisation and multinational organisations have abetted the move to the internationalisation of financial reporting standards in the hope to avert major corporate scandals in the future.

The literature review will examine the impact of global regulations on a national and organisational level.

### **2.2 The impact of regulatory changes on business product offering**

#### ***2.2.1 The influence of global business regulation on national regulation***

The impact of globalisation is easily detected through the increasing manifestation of global business regulation.



Beardsley and Farrell (2005) make the statement that economic regulation is good for competition.

They see regulation as a necessity for:

- a) the proper functioning of market economies;
- b) the mitigation of market failures, in the context of this study, Enron; and
- c) supporting competition and generally ensuring the welfare of consumers through the creation of environments of healthy competition.

Pattberg (2006) debates the influence of global business regulation on a national level. He is of the opinion that the impact of international regulatory changes is being aided by the existence of trans-national or multinational organisations and the knowledge sharing that exists between the various parts of these entities. He further argues that regulations are developed on three levels:

- a) Governments, treaties and intergovernmental organisations;
- b) Hybrid forms of regulation involving the parties above, but also non-governmental organisations; and
- c) Business regulation.

The influence of business regulation is seen as two-fold and a distinction is made between:

- a) Self-regulation (where a party determines its own rules for participation/codes of conduct); and
- b) Co-regulation (where at least one party is a non-profit organisation).

Self-regulation in this study would therefore refer to the measures implemented by accounting firms as part of their risk management strategies, e.g. codes of conduct (the Big Four accounting firm have all published their codes of conduct on their websites) and PSR reviews. Co-regulation would refer to the role of the Independent Regulatory Board of Auditors (hereafter referred to as the “IRBA”) and the South African Institute of Chartered Accountants (hereafter referred to as “SAICA”) in the South African accounting profession.

Pattberg’s theory therefore holds true within the context and current operating model of accounting firms; however, the level of self-regulation can only be understood through an integral knowledge of the firm. This knowledge is difficult to come by as it often holds competitive advantage for accounting firms as part of their risk mitigating strategies. Self-regulating could be seen in conjunction with the model of Bashab *et al* (2005) presented later in this Chapter where the internal and delivery risks of a professional firm are discussed. It is not yet clear how regulations have influenced the delivery risk of accounting firms nor is the impact of self-regulation on client service delivery clear.

Pattberg (2006) concludes by saying that the contribution of cognitive initiatives should not be ignored. In order to achieve multi-stakeholder buy-in, knowledge should be transferred through cognitive learning processes. The sustainability of the buy-in would however depend on integration of the process and knowledge across multiple levels.

It is therefore concluded that in order for regulation to be effected, there needs to be a level of understanding and agreement within society on the necessity of the regulation. However, the complexity of multi-level buy-in cannot be ignored. The gradual and relatively slow movement towards common reporting standards globally is evidence of this. According to the website, [www.iasplus.com](http://www.iasplus.com) (2006), Europe has not accepted IFRS in its entirety. Outside of the requirement for client buy-in of regulatory change is also the buy-in of the implementers of change, i.e. the accountants. It would be interesting to determine the level of intellectual buy-in by accounting profession into regulatory change.

Thompson and Strickland (1992) refer to a number of common driving forces that influences an industry. Regulatory changes and government policy changes are mentioned as one of the forces that can affect an industry because it is responsible for the onset of changes in an industry's operations and strategies. Thompson *et al* (1992) use the examples of deregulation in the automotive and airline industries and stricter regulations governing drinking age in the US and the resulting impact on the alcoholic beverage industry.

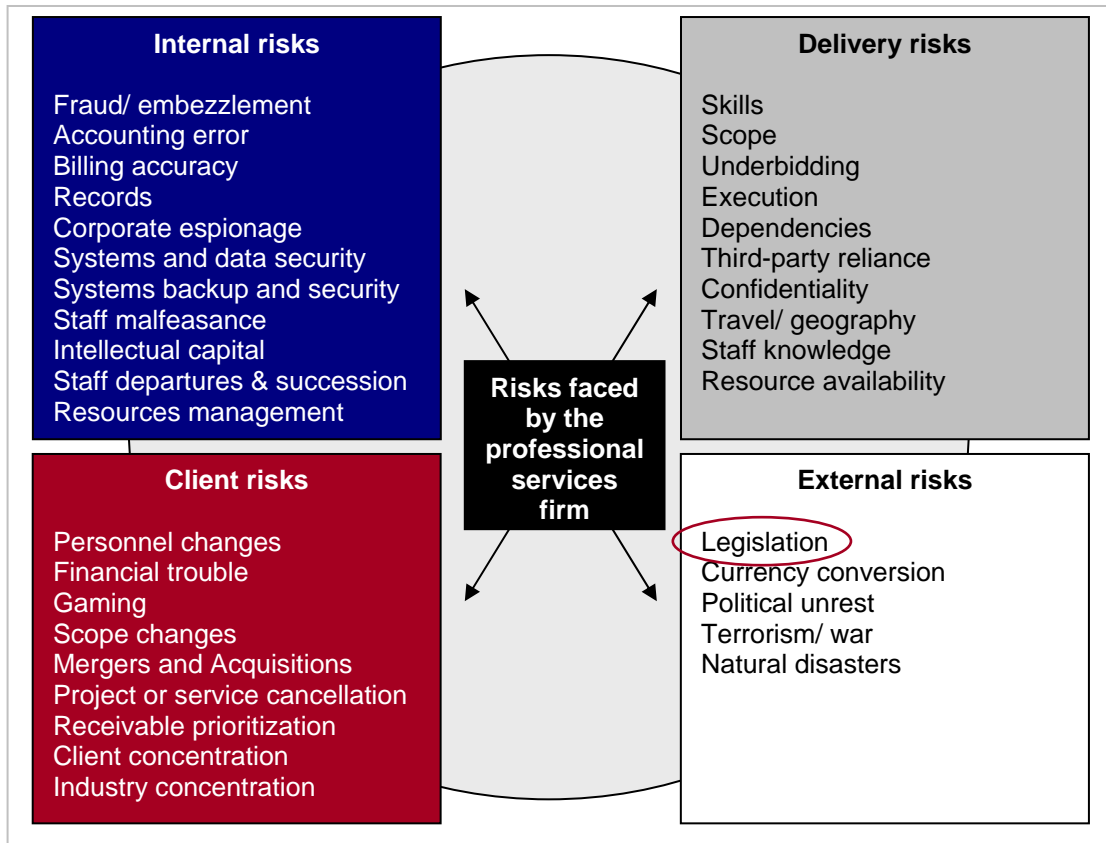
Although no in depth discussion is provided into the exact impact of regulations, the operational and strategic influence of industry regulations is acknowledged.

At the very least this theory is in line with other contemporary management theory that often refers to the impact of six environmental “forces” that influence business: political; economic; social; technological; legal and environmental factors.

Porter (1996) refers to government policy as a potential threat to entry for new players in the market especially in cases where an industry is highly regulated. The strict legislative requirements (as briefly described in Appendices A and B of this study), and the high demands on resources within accounting firms, substantiate that the entry level of new players in the accounting profession has been increased. PwC (2005) makes reference to the impact of regulatory changes on their own capacity. The 2006 global reviews of Deloitte, E&Y and PwC show that these firms total staff complement (support and client facing) have on average grown by 8% to cope with increased demands but there is still a shortage of skills. However, in the case of E&Y (2006), their client serving staff turnover increased to 16% while the revenue per employee increased by 11% (unfortunately none of the other Big Four accounting firms had published comparable data). More detail is provided on the global shortage of accountants later in this Chapter.

Baschab *et al* (2005) discuss the risks that can potentially influence the service delivery of a professional services firm.

**Figure 2: Risks influencing the professional services firm (Baschab and Piot, 2005)**



These risks provide an interesting insight into the impact of regulatory changes on the accounting industry as most of the factors listed as internal risks to an organisation can be countered by services offered by accounting firms. However, legislation, i.e. the European Union 8<sup>th</sup> Company Law Directive, (please see Appendix A) prohibits the delivery of certain services by an auditor to an audit client, where those services may actually enable a client to manage internal risk better. The financial reporting and corporate governance legislation that is therefore meant to protect a corporate, is making the auditor's task of

delivering an all encompassing business advisory service more difficult by requiring the auditor to be more independent and objective.

Turley (E&Y, 2004), the global CEO of E&Y, opposes the total prohibition of non-audit services by an auditor as he feels that the delivery of certain non-audit services by the auditor would aid the auditor in his understanding of a client and thereby increasing the quality of the audit delivered to the client.

External risks therefore have a fundamental impact on the delivery risks of an accounting firm due to independence concerns regarding the service offering delivered (delivery risks). This has a direct influence on the internal risks faced by a client. The client is then required to mitigate risk by acquiring the services of another professional services provider, effectively then mitigating the risk faced by the client when using a single service provider.

The importance of the legal and the political environment on industry and an individual organisation can therefore not be disputed.

It is obvious from the above that accounting firms are struggling to meet demand and that accountants do not agree with all regulatory stipulations. It would therefore be interesting to establish how the auditor-client relationship has been affecting where there auditor is trying to obtain buy-in into regulatory changes from audit committee members and C-class executives while dealing with independence requirements.

### ***2.2.2 Regulatory change is dynamic and happening at multiple levels between large numbers of players***

Mackenzie and Lucio (2005) argue that regulation can no longer be seen as the pure opposite of deregulation. Regulation has become far more complex due to the impact of multiple players. They state that “regulation does not exist in a vacuum, it operates in an economic and social context” (2005, 501).

Mackenzie *et al* (2005) emphasise the multi-dimensional nature of regulation by inferring that regulation influences across “sites, space and actors”. Regulation is the product of a number of processes and interventions that have influenced each other and that move between informal and formal situations where actors are linked to each other through a system of complex relationships. Baird, Post and Mahon (1990: 156) describe complex relationships as a degree of complexity and define it as “the number of forces or influences in the environment that affect or are affected by an organisation – forces that an organisation must keep track of or address”.

The advent of sustainability reporting for the mining industry is a clear example of the formalisation of environmental regulatory rehabilitation policies. These policies, for example, now not only require the participation of waste management companies, but also the financial reporting expertise of auditors amongst others.

The multi-dimensional aspect of regulation is evident in the multi-national business environment. The corporate failure of Enron has led to a number of informal measures to avoid similar occurrences, measures that have since been formalised across a number of countries. IFRS and SARBOX are examples of regulations that link actors through a complex system of relationships.

Brody *et al* (2005) highlight a number of factors that influence the development of national accounting principles.

The factors are (but not limited to):

- Culture of the country;
- Access to capital;
- Nature and source of finance (e. g. levels of Foreign Direct Investment – hereafter referred to as “FDI”);
- Business size, structure and complexity;
- Tax laws; and
- Other regulations.

Brody *et al* (2005) state that the higher the level of FDI in an economy, the more important the parallel alignment of national accounting standards with international standards becomes. Since its emergence from communism Poland has made huge strides in bringing its auditing profession in parallel alignment with international standards. Problems are however still being encountered due



the inability of practising auditors to apply internationally accepted accounting principles. Brody *et al* (2005) argue that this is probably due to the insufficient training of and continuous technical updates for auditors. The result of this lack of training has been quality deficiencies in the form and content of audit working papers, professional ethics and common practice norms. The problem of the discrepancy between Polish auditing standards and internationally applied standards is exacerbated by the fact that too few students are following auditing as a career, a problem that also exists in South Africa.

This study therefore strengthens the argument that industry-related changes cannot be seen in isolation from the national macro environment. The increasing effect of globalisation requires the harmonisation of financial reporting standards. Unfortunately, the implementation and application of a common set of standards is often hampered by the legacy of national environment and it can therefore be said that 100% consistent global accounting standards may be unrealistic over the medium to long term due to complex political agendas.

Financial reporting regulations can be divided into regulations governing the conduct of legal entities, such as corporates, and regulations primarily governing accounting firms.

The most notable accounting regulations and reporting standards introduced in the last five years are (please see Appendix A of this study):

- The Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act of 2002/SARBOX).
- The International Financial Reporting Standards (IFRS).
- The European Union 8<sup>th</sup> Company Law Directive.
- The South African Auditing Professions Act No.26 of 2006 (hereafter referred to as the “APA”).

In addition to accounting regulations and reporting standards introduced, guidelines (recommended, but not enforced by law in all cases) have also been introduced. The most notable guidelines include (please see Appendix B of this study):

- The International Standard on Quality Control for firms that perform audits (ISQC1).
- The King I and King II Reports on Corporate Governance for South Africa.

In addition to these guidelines, guidelines governing specific industries, e.g. pension funds, banks, etc. exist. These have not been covered in this study.

E&Y (2006) investigated the effectiveness of the implementation of IFRS in the European Union. Amongst others, they found that despite the fact that

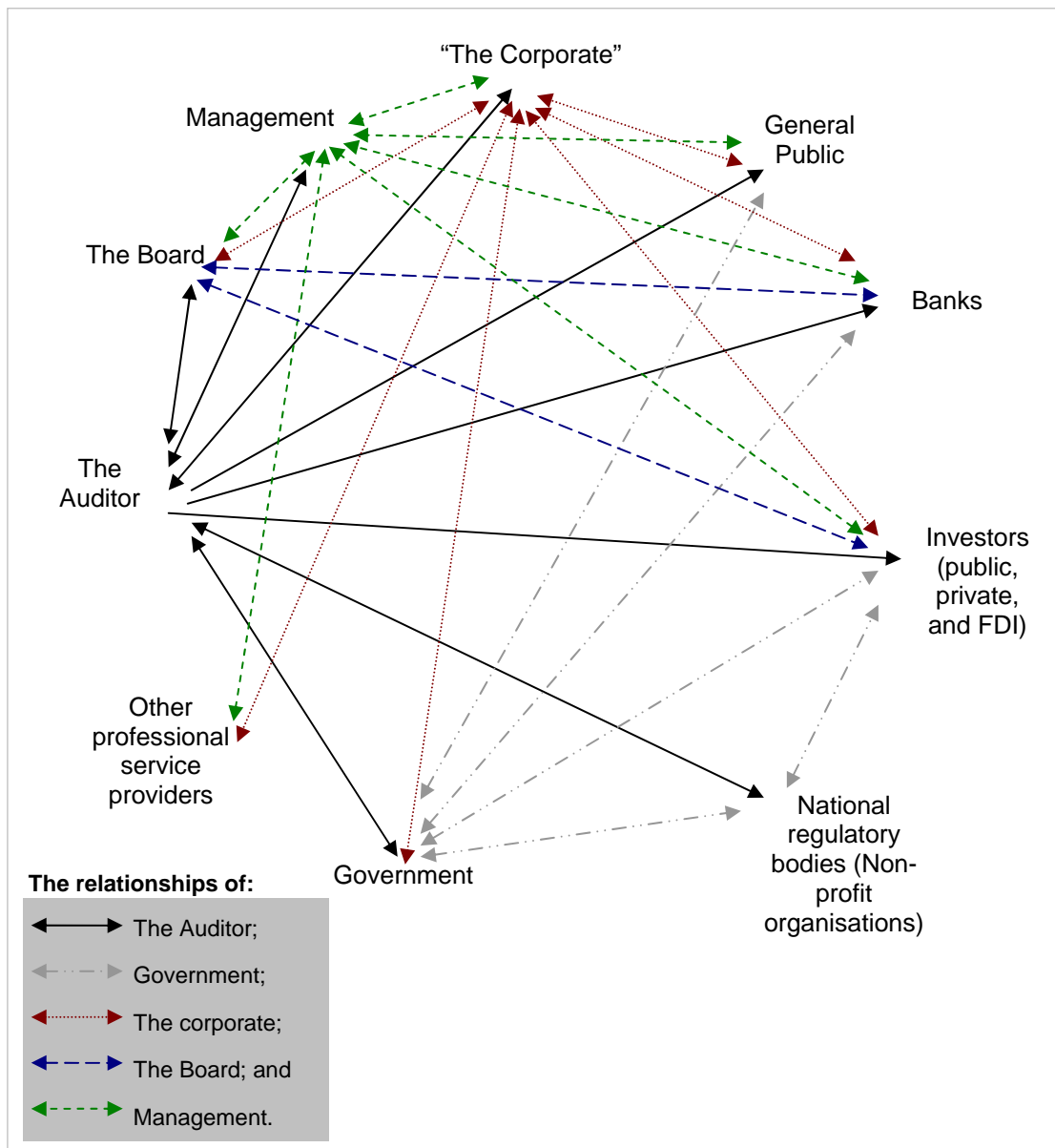
approximately 8 000 listed companies in Europe have implemented IFRS, the financial statements released still retained a strong national identity. This was mainly attributed to the fact that there is no IFRS standard dealing with the presentation of financial statements. They also concluded from their findings that companies aren't confident "that IFRS financial information is sufficient, or in some cases entirely appropriate for the purpose of communications their performance to markets" (E&Y: 4).

The new legislation has led to a fundamental change in the way auditors now serve and interact with their clients within a complex system.

A PwC study (2005) discusses some of the fundamental changes experienced by auditors and client audit committees. More detail on this study is provided in later in this Chapter.

An example of the complex relationship system existing between a corporate, its auditors, investors and the public is attempted in Figure 3.

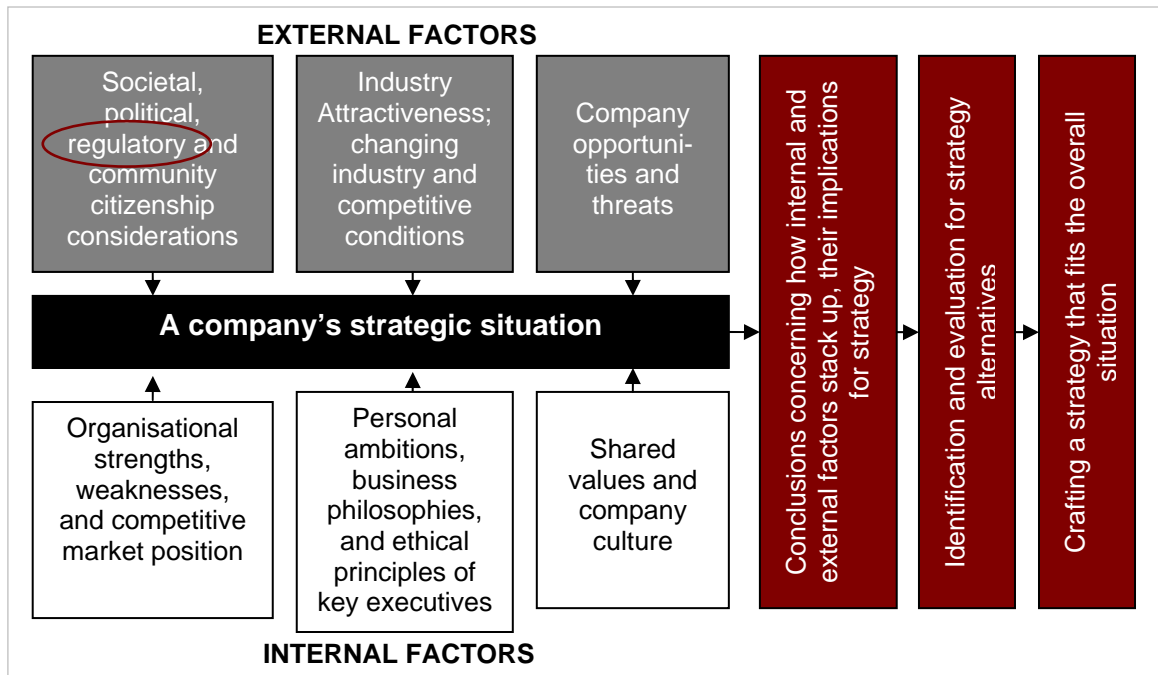
**Figure 3: An example of the complex relationships existing between an auditor, the client and the macro environment**



### **2.2.3 The influence of regulation on company strategy**

Thompson *et al* (1992) describe the factors/dimensions that have an influence on the choice of company strategy. Regulatory changes are featured as an external factor that contributes to/aids a company in being socially responsible.

**Figure 4: Factors shaping the choice of company strategy (Thompson and Strickland, 1992)**



Although this book was published 10 years before the Enron crisis, it already makes reference to what it deems to be a socially acceptable corporate strategy, i.e. one should therefore:

- a) Consider activities that are ethical and in the interest of the general public;
- b) Consider emerging pressures and priorities (and pre-empt them if there is any hope of remaining competitive);
- c) Take proactive action (and often legal corrective action) to avoid a regulatory confrontation;
- d) Achieve a balance between the interests of the shareholders and the stakeholders; and

- e) Aim for “good citizenship status” in the community.

This point is reinforced by Beardsley, *et al* (2005) who point out that regulation is indicative of a formal and explicit contract between business and society. In the absence of formal regulations, informal agreements will require companies to meet a set of minimum social responsibilities.

It can therefore be said that regulations have the task of maintaining order and enhancing social responsiveness across various levels within society. However, the above also implies that regulations should be dynamic and that in cases where wrongdoing is suspected, corrective action should be introduced as a matter of fact. The various codes of conduct published by the Big Four all require professionals to consider the impact of their actions on society. For example, the stipulation of the reporting of irregularities to the IRBA in South Africa, as required by the APA, therefore classifies it as a proactive action to avoid regulatory confrontation. However, the APA requires the auditor to first report an irregularity to the IRBA before communicating with the client.

The role industry attractiveness is also considered as part of the external factor in Diagram 3. When considering the role of regulations in the context of Porter’s Five-Forces model and Porter’s Diamond Model (Porter, 1996), it becomes clear that high levels of regulation increase the barriers to entry for new players into the market. This is discussed in more detail later in this chapter.

Businesses have to react to regulatory changes while considering their mission, strategic objectives, existing business model and competitive position. Many examples exist in practice of how companies react to change. The cigarette industry in South Africa is a clear example with the banning of cigarette advertising and the ingenious advertising methods used by Benson & Hedges for a short period afterwards. Accounting firms have managed to exist profitably and with good growth rates since regulatory changes have been introduced, however it is not clear what proactive behaviour accounting firms have engaged in the influence regulatory changes nor is it clear how service offerings have been affected outside of prohibited services.

McGahan (2004) identifies four trajectories of change: radical change; intermediating change; creative change and progressive change. The changes occurring in the accounting industry can be identified as intermediating change because although the core assets of accounting firms have not been the primary focus of change, the core activities have been. McGahan (2004) states that intermediating change primarily impacts the relationships of the organisation and it therefore proves very relevant to the scope of this research into how regulations have affected client relationships and client service strategies.

#### **2.2.4 The impact of regulatory changes on competition**

China's securitisation market is an example of a market where growth is currently inhibited due to weak legislation (Trombly and Yu, 2006). The problem is exacerbated by the various industry regulatory bodies that have different standards and procedures. This article emphasises the need to work towards a common goal as is the case with the accounting industry in its attempts for the internationalisation of accounting standards as discussed later in this Chapter.

Beardsley *et al* (2005) discuss a number of common regulatory traps that would have an impact on competition. These include the overregulation of competitive sectors (e.g. regulatory market entry) and products (design and functionality).

They identify measures to ensure maximum success in the implementation of regulations. Amongst others they believe that regulation needs to be based on current markets facts; be transparent in how it was designed; tailor-made for the national context; and considerate of the local infrastructure.

Beardsley *et al* (2005) discuss the benefits of regulation in the context of promoting competition and see it as an essential part of society where markets cannot function without rules that govern society. They see rules as a mitigation tool for market failures in industries where competition is considered rife and as vital in supporting/promoting competition and supporting/protecting the welfare of the customer. Disappointingly, they only discuss their views in network



industries such as telecommunications and electricity and do not mention any other industries, although the role of regulation in mitigation of market failures is perhaps the most relevant point to the research problem.

The regulatory changes introduced to the accounting industry since the Enron failure in 2001 consider all the factors above. The impact on factor markets in accounting firms has been strained but the big firms have still managed to show growth during this period. DiPiazza (PwC, 2005), global Chief Executive Officer of PwC, says that member firms have shown their strongest growth in five years due to increased work resulting from stricter accounting regulatory changes and a global economic upturn. This sentiment is echoed by Deloitte, E&Y and KPMG in their 2005 Global Annual Reports.

However, DiPiazza (PwC, 2005) makes reference to high demands being placed on their limited resources and the toll that has had on the business. He states that due to high demands of new regulations, staff's "work-life" flexibility has suffered and that mitigating workload measures have had to be employed. This trend makes sense in the context of basic micro-economics where high demand will affect supply, but where supply is limited or constrained, will affect unit price.

As stated earlier, increased regulations on an industry level have increased the barriers to entry for new participants due to the stricter requirements and the global shortage of auditors. It would therefore be interesting to establish the

effect of increased regulations on client service delivery within the context of limited/strained supply of resources.

**Conclusion:**

It is therefore clear that globalisation does have a significant impact on national regulations and that the influence of global events can be felt at an industry and organisational level influencing competition. Strong arguments also exist for the consideration of the national culture and economic when drafting legislation.

This offers an opportunity to investigate the impact of global standards on a national level and the impact on the client service delivering and product offering of an accounting firm.

***Proposition 1: The impact of regulatory changes of the product offering of accounting firms***

Regulatory changes have caused accounting firms to adjust their client service strategies based on internationally accepted standards leaving very little space for local interpretation and application to the unique features of the client's business.

## **2.3 The impact of financial reporting regulatory changes on client services and relationships**

### ***2.3.1 Post-implementation findings of regulatory changes in the accounting industry***

Ignatius Sehoole (2002), Executive President of the South African Institute of Chartered Accountants, cautioned business that business failures should not be confused with audit failures and that overreaction could lead to overregulation.

The effect of overregulation has been felt in the US as some firms and implementers have started to complain that the implementation of some regulatory requirements is impractical at a business level.

*The Economist* (April 2006) highlights the concerns of business and implementers alike with regard to the full extent of SARBOX (the first major regulatory reform act to be promulgated following the fall of Enron in late 2001). The most contentious section of SARBOX is Section 404 that deals with the internal controls of an entity (*The Economist*, April 2006).

The findings on the E&Y study (2006) focussed on the implementation of IFRS in Europe discussed earlier in this Chapter are also indicative of the levels of confusion that exists in the market due to gaps in the legislation.

Companies are however driven by a desire to be compliant due to the possibility of legal action for failure to do so.

A PwC (2005) study found that 88% of internal auditors (271 respondents in total) now report directly to the Audit Committee. A further 85% of all internal auditors attend all Audit Committee meetings, with 45% of respondents stating that they meet with their external auditors once a month or more. However, in stark contrast to these findings, respondents feel that the coordination between these external and internal auditors is minimal or lacking.

Although this study provides interesting insight into the increased levels of communication between clients and their external auditor, it also highlights the lack of a coordinated effort between some critical internal functions. A possible reason for this is increased requirements for independence that may cause a communication gap, especially in cases where the internal audit function is in-house, as advice can easily be construed as consulting. In cases where the internal audit function has been outsourced, professional respect between the internal and external service providers may be responsible for the communication, but it can not be said with certainty.

In a follow-up study to their 2005 study, PwC (2006) found that fewer businesses were dedicating resources to SARBOX compliance work, but that more and more businesses would rather spend more time on continuous internal auditing (PwC, 2006). Businesses have started to realise the

importance of continuous meticulous control versus annual checks and reactive responses. In another PwC study (2006), clients state that running a business based on internationally accepted controls provides an opportunity for the business to build a competitive edge above its competitors because of the greater focus on control. The impact of greater control on the auditor is debatable with fewer personnel focused on compliance, essentially freeing up more and more staff previously focused on compliance, to now focus on continuous control, it is likely that auditor revenue adjust accordingly.

Hahn (2004) describes how increased accounting regulatory changes are actually working positively in favour of some professional services firms. He discusses the economic benefits that firms specialising in valuation services are experiencing because accounting firms are prohibited from delivering these services to their clients due to the potential conflict of interest that may arise. Hahn (2004) however makes a sweeping generalisation that does not appear to necessarily ring true given the growth in global turnover by the Big Four as well as the statement by E&Y above. Hahn's (2004) statement however does open up a field for exploration into the spread of service providers used by large corporates now versus five years ago.

Since 2001 a number of regulatory and voluntary changes relating to the use of professional firm services providers have been introduced to corporates.

Comunale and Sexton (2005) investigated the impact of mandatory auditor rotation on audit firm market share of the Standards & Poor's 500 (hereafter referred to as the "S&P500"). They compared the impact of mandatory rotation (a scenario whereby a corporate would be required to rotate its auditor after a specified period) versus mandatory retention (refers to a scenario whereby a corporate would be required to retain the services of an auditor for a prescribed number of years) on auditor market share. Both of these scenarios would suggest that the auditor would deliver a higher level of service as their market share would be more secure for a prescribed period and they would therefore "have less incentive to seek future economic gain from a specific client and therefore would therefore be less likely to issue bias reports in favour of management" (Comunale *et al*, 2005: 235).

The report also refers to longstanding client-auditor relationships evidenced by the churn of auditors between the S&P500. However, no discussion is provided on the reasons for longstanding relationships.

Comunale *et al* (2005) conclude that should mandatory auditor rotation, as suggested in Section 207 of SARBOX, as a means to increase auditor independence and objectivity, be effected, it would have a tangible effect on the market share of the large accounting firms. However, more dominant players would lose some of their market share to some of the smaller players in the market and the market share distribution would become more evenly distributed. Auditor retention was determined to have a lesser impact on auditor

market share than rotation. The authors expand their conclusion by noting that audit firms are more likely to direct their efforts towards new client acquisition should retention become mandatory at the expense of their existing clients and therefore client service and quality.

It can therefore be said that the practice of mandatory audit firm rotation will be contradictory to the objectives of international accounting standards that seek to deliver a common set of high quality standards for the delivery of audits to all clients.

A contradictory view to that of Comunale *et al* (2005) is offered by Jeong, Jung and Lee (2005) who investigated the effect of mandatory audit assignment and the delivery of non-audit services on audit fees in Korean firms. The Korean Financial Supervisory Services body (hereafter referred to as the “FSS” and the Korean counterpart of the SEC) based on the Amended Act on External Auditors of 1989, introduced mandatory auditor-assignment for some firms in an effort to increase auditor independence while still maintaining an environment of competition between auditors. The period for mandatory auditor-assignment was set at three years and the FSS was responsible for assigning auditors to clients. Joeng *et al* (2005) found that mandatory auditor-assignment actually allowed auditors to charge their clients higher fees and that the delivery of additional non-audit services had no impact on auditor independence. The impact for the clients however was startling. Mandatory auditor-assignment in the case of Korean firms reduced the bargaining power of the clients, but

increased the fee revenue and bargaining power of the audit firms. In addition, Joeng *et al* (2005) found that the delivery of non-audit services may actually have a positive effect on audit quality because of knowledge spillover, but further research is still needed in this area.

What is interesting in this approach is that mandatory auditor-assignment not only affected the bargaining power of the players but also raised the entry barriers for new players in the market. Aspiring firms would therefore first need to establish themselves as credible, reputable and technically capable before being considered as a credible service supplier.

In criticism against Joeng *et al*, their research does not consider the levels of satisfaction that a corporate may have with its auditor or the reasons why a corporate would change auditors in the absence of guiding legislation, nor does it address the internal business models developed in the accounting firms for dealing with knowledge sharing, communication or areas of potential conflict.

Neither audit firm rotation nor audit firm retention is currently enacted in South Africa, although audit partner rotation is applied and has recently been reduced from seven years to five years. Audit partner rotation refers to the changing of audit partners every five years on an assignment while the client remains a client of the firm.



The Companies Amendment Bill of 2005, still to be enacted at the time of the submission of this study, suggested that the period for audit partner rotation be period be even less, proposing four years (the Southern African Chapter of the Institute of Directors, 2006). The Southern African Chapter of the Institute of Directors (hereafter referred to as the “IOD”) strongly opposed the implementation of this practice citing reasons such as limited accounting resources, deteriorating audit quality, increased audit costs, undermining the effectiveness of an audit and increasing audit risk. The IOD suggests that the audit partner rotation period be in line with international standards citing seven years. The SAICA also opposed the implementation of four years but suggested five years in line with the South African Banks Act, the Sarbanes-Oxley Act and the European Union 8<sup>th</sup> Company Law Directive.

It is clear from this that even though there are consensus between the various players in the profession/industry that audit partner rotation is beneficial, there is no consensus on whether to conform to international standards or apply rigid local standards opposed by industry bodies.

The introduction of legislative changes has forced companies to look elsewhere for service providers based on the prohibitions for additional services placed on incumbent auditors. Goldstein (2003) discusses how the increase in legislative requirements is indeed creating more revenue for auditors and consultants. However, he is quick to point out that these streams of revenue are not following their usual paths and that second tier smaller firms are benefiting by

securing assignments previously done by first tier firms but which they are now prohibited from doing by accounting regulations. The validity of this statement is questioned as the restriction of the auditor to deliver prohibited services does not exclude any of the other Big Four firms as service providers.

### **2.3.2 *The impact of regulatory changes on the auditor-client relationship***

#### **2.3.2.1 *The role of client relationships***

Boyd *et al* (1990) describe service as “critical to building a profitable long-term relationship with customers”.

Price and Arnould (1999) investigated the role of what they term commercial friendships. Commercial friendships are defined as the friendships that have an influence on the customer’s loyalty, service loyalty and positive word-of-mouth. The authors make a distinction between various levels of commercial friendships and the commercial benefits to the role players.

They conclude that that various types of interactions can be used to establish commercial friendships and that these relationships often form unintentionally. However, the success of these relationships is based on individual and situational characteristics. Price *et al* (1999) found that these commercial relationships do have a strong correlation with satisfaction, loyalty and positive word-of-mouth.

Unfortunately Price *et al* (1999) did not investigate the impact of commercial friendships on professional services organisations such as accounting or law firms. The scope of the research was confined to low cost services where it would be easy to change service provider and where regulatory requirements do not play a role. The research would therefore not be highly relevant outside of providing potential areas for research within the professional services industry. It would be interesting to establish the marketing impact of the strict regulatory requirements promoting auditor independence from the client on factors such as satisfaction, loyalty and positive word-of-mouth.

Coulter and Coulter (2002) investigated the relevance of trust in a client relationship and the importance of the length of the relationship on trust. They distinguish between “person-related” service offering characteristics (e.g. similarity, empathy and politeness) and “offer-related” characteristics (e.g. customization, competence, reliability and promptness) as characteristics influenced by the length of the relationship. They found that person-related characteristics were more important at the beginning of the relationship, but diminished in importance as offer-related characteristics became more important and a trust relationship had actually been developed.

This literature is useful in the sense that it boosts the argument against audit firm rotation and the establishment of a new relationship where trust has to be established. Given the complexity of some financial reporting regulations, offer-

related characteristics would in all likelihood be more important than, for instance, politeness.

Wang, Liang and Wu (2006) also investigated the factors that influence relationship bonding tactics and concluded that length of the relationship and relationship quality definitely has an impact on the customers' behavioural loyalty. Wang *et al* (2006) furthermore emphasises the role of service quality and the importance of effectively marketing to specific product to specific target groups.

However, financial reporting legislation is also aimed at removing the familiarity aspect of the auditor-client relationship in the interest of greater independence. The South African Amended Companies Act of 2005, still to be enacted, specifically mentions the perceived relationship build-up that occur between an auditor and client as detrimental to independence and proposes the rotation of auditors as a solution.

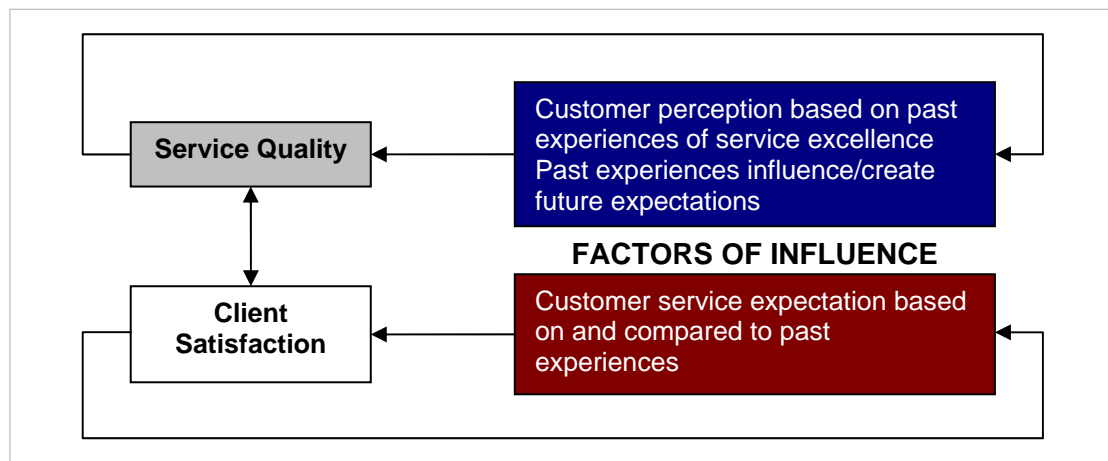
SARBOX, IFRS and the European Union 8<sup>th</sup> Company Law Directive also specifically focus their attentions to auditor independence.

The requirement of auditor independence is therefore seen as counter intuitive to relationship building and the establishment of trust between a client and his auditor.

### 2.3.2.2 Measuring audit services

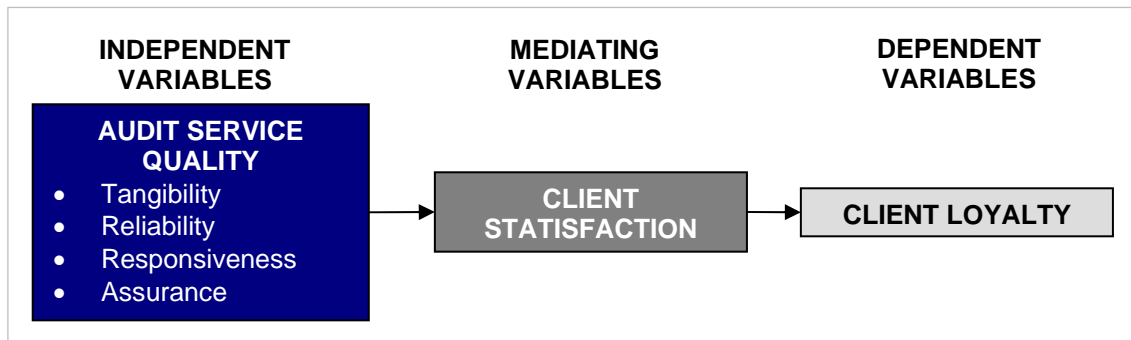
Ismail *et al* (2006) investigated the perceptions of Malaysian listed companies towards audit firm service quality, client satisfaction and loyalty. They describe the customers' past experiences as being paramount influences in valuing current services delivery. Their findings is summarised in Figure 5.

**Figure 5: The interdependence between Service Quality and Client Satisfaction (Adapted from Ismail *et al*, 2006)**



Ismail *et al* (2006) describe audit quality as the likeliness that an auditor is able to discover and report an irregularity in the accounting systems of a client, a skill influenced by the auditor's technical abilities and independence. However, they also make the point that increasing competitive pressure between accounting firms, forces firms to a) lower audit quality and b) audit price concurrently in an effort to retain the client or win a new client.

**Figure 6: Conceptual structure of the research model (Ismail *et al*, 2006)**



Ismail *et al* (2006) used an adaptation of the SERVQUAL model designed by Parasuraman to design their questionnaire.

The five dimensions of the model are as follows:

**Table 2: Service quality dimensions measured in SERVQUAL (Ismail *et al*, 2006)**

SERVQUAL Dimension	Definition
1. Tangibility	The physical appearance of the audit firm, inclusive of available facilities
2. Reliability	The ability of the employees of the audit firm staff to perform the promised service timely and accurately
3. Responsiveness	The willingness of the employees of the audit firm staff to assist clients and provide a prompt service
4. Assurance	The ability to convey trust and confidence
5. Empathy	The caring individualised attention that the employees of an audit firm provide to clients

Ismail *et al* (2006) concluded that reliability and assurance are the most important aspects for fulfilling client expectation; tangibility was ranked as the least important factor. The overall results revealed that client expectations were not met by the auditors and that the largest gap was in the area of empathy where clients felt they needed more individual attention with more focus on responsiveness, reliability and assurance. The study also revealed that client

expectation is primarily influenced by reliability and assurance. However, clients were willing to continue their relationships despite the identified gap in expectations.

The low ranking of tangibility is not surprising. The result can be ascribed to the operating model of accounting firms where financial audits and audit committee meetings are primarily held at the client's premises. However, physical footprint is important as is evident in the global footprint of the Big 4 accounting firms. These firms have a global country presence ranging from 136 to 149 countries respectively (as highlighted in Chapter 1).

The high scores for reliability and assurance are also not surprising given the requirements of stock exchanges regarding the publishing of financial results. This reinforces the research done by Fargher, Taylor and Simon (2001) discussed later in this Chapter.

Various criticisms have however been launched against the SERVQUAL model.

Sureshchandar, Rajendran, and Anantharaman (2002) criticised the use of only the SERVQUAL model in the context of for instance the banking industry. They suggested an additional three factors be considered when evaluating service quality. These factors are: a) service content; b) service delivery and c) social image.

Van Dyke, Prybutok, and Kappelman (1999) cautioned against the use of the SERVQUAL model in measuring the quality of information systems services. They found that the model presented problems with regard to the reliability and validity of the measure and caution should therefore be exercised in the application of the model.

These facts contribute to a healthy discussion of the measures that should ideally be used in the measurement of service quality and it is clear that measuring service quality is difficult. However, this study will focus on the effect of regulatory changes on client service strategies and therefore quality; but the views obtained on service delivery are those of delivery partners and therefore subjective in nature. The five dimensions of the SERVQUAL model however prove useful.

Richard (2006) investigated the relationship between the finance director and the auditor and in a bid to understand the impact of the relationship on the audit process and the quality. She concludes that the role of the auditor needs to be carefully defined by the client, the auditor needs to have a key understanding of the business of the client and that the onus rests on the auditor to act independently. She suggests that auditors should receive training in the field of independence behavior and understand how to be independent and impartial while understanding the business of the client and showing empathy.



## **Conclusion:**

It is therefore clear from the research and the press that the implementation of financial reporting regulations has presented new challenges not only to the delivering of services by professional firms but has also impacted the dynamics of relationship building due to independence restrictions.

### ***Proposition 2: The impact of regulatory changes and independence requirements on the auditor-client relationship***

The call for more independent conduct by auditors through regulations has impacted the relationship between the client and the auditor and in some cases leading to frustration for both.

## **2.4 The impact of regulatory changes on accounting firms**

Despite the economic benefits many professional services firms have derived from the new legislation, other “negative” impacts have also been detected. These relate to smaller firms which do not have the capacity or the expertise to deal with some of the demands placed by large corporates for service delivery and the resulting negative effect of poor service delivery and client dissatisfaction.

Van der Linde (2006) describes the plight of small accounting firms and the significant impact the new accounting regulations have had on their businesses. In the past, small audit firms in South Africa were able to charge small businesses R1 000 for an audit, but now their costs have increased to as much as R6 000 due to the stricter requirements.

*Accountancy Ireland* (2005) stated that more auditors are needed to cope with the requirements of new accounting regulations and that “sources” of auditors beyond Europe are required. This argument is reinforced by Bruce (2005) and PwC (2005).

*The Pretoria News* (2006) reported that the United Kingdom office of Deloitte Touche Tohmatsu went to Zimbabwe on a recruitment drive in an attempt to counter their staffing crisis at the end of 2005. Apparently these recruitment drives by foreign firms have become quite common in countries like South Africa and Australia. Unfortunately the shortage of accountants is a world-wide phenomenon and these countries are also struggling to meet the increased demand.

Although accounting firms have experienced dramatic growth an audit and other related services, revenues from advisory and consulting services have tapered off due to restrictions imposed by regulations. However, E&Y (2005) states that the contribution of audit services to total turnover has decreased from 80% a number of years ago to 60% in 2005. Services relating to compliance have

however dramatically increased. This is in line with the PwC 2006 study into the State of Internal Audit where they found they clients have opted to a system on continuous control and auditing as opposed to interval auditing. There is thus a greater move toward prevention in the market.

As stated earlier, the global shortage of accountants will also have an affect on the client service delivery of an organisation putting more strain on existing resources as well as possibly the client's perception of quality service delivery. Fargher *et al* (2001) tried to determine the influence of auditor reputation on audit services across 20 countries. They found that the higher the domestic requirements for legislative financial reporting, disclosure and litigation, the higher the demand for high reputation service providers, i.e. Tier 1 accounting firms. Audit fees are positively correlated to the size and complexity of the client. Interestingly, fees were found to be lower for utilities, mining and financial firms. Fargher *et al's* (2001) research is strengthened by the findings of Ismail *et al* (2006) where reliability and assurance achieved high scores due to the requirements of stock exchanges regarding the publishing of financial results. High reputation auditing firms would therefore benefit financially in high regulatory environments. This finding is in line with the turnover figures presented for the Big Four accounting firms in Chapter 1, thus confirming the importance of experience and expertise when purchasing high cost services. Unfortunately this research was published in 2001 and the impact of corporate scandals such as Enron and the resulting implementation of higher reporting requirements have not been considered. The internationalisation of reporting

standards, e.g. IFRS, would also have a significant impact on the results of the study should it be repeated now.

Additional aspects that could be considered should this study be presented in present day include the evaluation of the relevance of subject reputation (i.e. reputation built around a particular subject/ product or service), e.g. expertise in implementing SARBOX compliance measures, and also the number of organisations that have changed auditors/ service providers and their reasons for doing so. This research therefore, although slightly relevant, appears to offer many windows of opportunity for further research.

A clear shortcoming of Fargher *et al's* research report is the fact that the research was conducted in Malaysia and no mention was made of the types of companies included in the sample, i.e. multiple listed companies, and the extent to which the audit supplier had been prescribed by the holding company elsewhere. Limited reliance can therefore be placed on the reasons stated for changes, but the research report does make a valuable contribution to the understanding of a model to evaluate service quality.

A number of factors influence the productivity and profitability of accounting firms. Productivity of accountants is treated as an input factor directly influencing operations and productivity. The importance of employee morale as a factor contributing to the growth and learning ability of an accounting organisation cannot be ignored. The demands of increased accounting standards and the global shortage of accountants have turned the focus to the

retention strategies. In a study conducted by the American Institute of Certified Public Accountants and discussed in an article by Baldiga (2005), factors influencing the work/life balance opinion held by accountants, levels of motivation and opportunities for promotion.

*Finweek* (May 2006), reported Allen Swiegers, Chief Operating Officer Elect of Deloitte South Africa, as saying that the average training of professional staff has increased from three to four days per annum a number of years ago, to 16 to 17 days per annum currently. Training is used as a risk mitigating measure to ensure that middle and top management are completely informed of the latest trends, developments and accounting standards issued.

A high reputation needs to be built, maintained and progressively adapted over time to suit current market conditions and demands. A high prevalence of regulatory compliance requires a high reputation firm to continually build and distribute knowledge, thus enhancing client service delivery through interpretation and application. Reputation and knowledge can therefore be seen as key variables affecting the delivery of high quality service.

### **Conclusion:**

It is clear that the requirement for increased control and higher demands of compliance has had an impact on the capacity of accounting firms. The global

shortage of accountants and demand for knowledge sharing and training are not helping matters in dealing with a capacity shortage.

***Proposition 3: The impact of regulatory changes on the internal processes and efficiency of accounting firms***

The high demand for better internal controls and compliance introduced through tougher regulatory changes has forced accounting firms to become more efficient in their use of resources.

## CHAPTER 3: RESEARCH METHODOLOGY

### 3.1 Introduction

In order to gather information relating to the research propositions qualitative research was conducted. The single case study methodology was implemented using purposive, non-probability sampling and a semi-structured questionnaire as research tool in face-to-face interviews.

Detail around each aspect is described below.

### 3.2 Research design

Qualitative research was selected for research design due to the focus on a large accounting firm and to establish the impact of regulatory changes on the firm's client service strategy. Hussey and Hussey (1997: 12) define qualitative research as "more subjective in nature and it involves the examining and reflection on perceptions in order to gain an understanding of social and human activities". They use the term phenomenological paradigm for qualitative paradigms and list the following characteristics (Hussey *et al*, 1997: 54):

- Tends to produce qualitative data;
- Uses small samples;
- Concerned with generating theories;

- Data is rich and subjective;
- The location is natural;
- Reliability is low;
- Validity is high; and
- Generalises from one setting to another.

The single case study method was selected as the research approach. Landman (1988: 53) describes a case study as a “detailed description of a person, event, institution or community designed to create nomothetic knowledge”. Henning, Van Rensburg and Smit (2004: 41) see a case study as a “format for design that is characterised by the focus on a phenomenon that has identifiable boundaries. Data that are not applicable to the case, are not utilised unless they indirectly affect the nature of the case”. Landman (1988: 72) goes on to define nomothetic knowledge as “a study that permits generalisation beyond the specific person, event, institution, or community studied”.

Some of the weaknesses of cases studies are described by Hussey *et al* (1997) include: a) obtaining access to the desired organisation can often be difficult; b) the process can be very time-consuming; c) boundaries are easily blurred; and the unit of analysis is a living organism and therefore has a memory and future expectation that may be difficult to understand without an understanding of the impact of events on the individual.



Hussey *et al* (1997) describes the following characteristics of case study research:

- The objective of the research is to understand the presence of particular phenomena within its context;
- The research is not embarked on with a set of preconceived questions in mind; and
- The research will use a number of methods for the collection of both qualitative and quantitative data.

Miles and Huberman (1984) describe the case study sampling as a method to enable deductive reasoning.

A case study therefore creates knowledge within pre-defined boundaries that can be generalised to a broader environment, in this case knowledge gained about a large global accounting firm operating within the borders of South Africa could be applied to the South Africa accounting profession or possibly even wider if the environmental factors are the same.

In-depth interviews were conducted with key individuals at strategic decision-making level within a large multinational accounting firm based in South Africa. A semi-structured questionnaire was used for data collection.

Landman (1988: 67) aptly defines the objective of interviews as “a direct attempt by the research to obtain reliable and valid measures in the form of a verbal response from one or more respondents”.

The purpose of these interviews was to develop an understanding of the impact of regulatory changes on client service strategy of a large accounting firm and the actions of strategic decision makers in order to prove or disprove the propositions developed.

Strategy policymakers and client service partners were targeted for interviews as a means of confirming the impact of regulations on strategy, establishing the extent of the impact of regulatory changes and to determine the practicality of the policies and measures implemented to ensure compliance.

Content analysis was used to analyse the data received.

Triangulation was used to prove the validity of the findings. Miles and Huberman (1984: 234) define triangulation as follows: “triangulation is supposed to support a finding by sharing the independent measures that agree with it or at the very least that don’t contradict it”. Validity is important and is described as “the best approximation to the truth of a given proposition, inference or conclusion” (www.socialresearchmethods.net, 2006) or as “the extent to which the test satisfies the purpose for which it was constructed” (Landman 1988: 96).

Hussey *et al* (1997: 57) define it as “the extent to which the research findings accurately represent what is really happening in a situation”.

Perry (2001: 319) state that triangulation improves construct validity and that the success of case research depends on the “multiple perceptions of reality”. These perceptions are influenced by the “triangulation of several data sources”, i. e. several sources substantiating a phenomena.

The objective of establishing internal validity is to determine to the extent to which a relationship exists between an independent variable and a dependent variable with no influence from any other external factors (Landman, 1988).

Landman (1988: 97) define external validity is “the extent to which experimental findings can be generalised to another person, condition or setting”, i.e. the usefulness of the data.

As part of the preparation for the interviews and to develop an understanding of impact of financial reporting regulations on the South African accounting industry, a Professional Manager from the IRBA was interviewed.

### **3.3 The population of relevance**

The population of relevance is a large multinational accounting firm that currently operates within the borders of South Africa. The organisation offers a wide variety of professional and financial related services. However, within the

context of this study, the focus is on the delivery of audit services as industry-related regulatory changes specifically refer to the role of auditors and issues around financial and statutory reporting.

### **3.4 The sample**

Non-probability purposive sampling was chosen as a sampling method in order to select a research sample consisting of strategy policymakers and senior client service partners who would be best able to comment on the auditing pre- and post 2002.

Welman and Kruger (2001) describe purposive sampling as beneficial where units of analysis are purposefully chosen to represent a section of the relevant population.

More specifically, expert sampling was used. The sample consisted of top management responsible for the development of the formal client service strategy of the firm as well as client service delivery. The purpose of the interviews was to establish the “house view” on strategic responses to new legislation as well as to obtain firsthand points of view of how regulations have affected client service delivery and to prove or disprove the propositions stated.

The sample of six was made up as follows:

- An Executive Committee member and partner responsible for firm-wide client service delivery;
- The National Marketing Director;
- The National Head of Audit;
- Two senior client service delivery partners; and
- A Regional Head of Audit.

A total of six interviews were conducted.

### **3.5 The research instrument used**

The research instrument used was a semi-structured questionnaire with open-ended questions. The questionnaire is attached as Appendix C to this study.

The questionnaire was structured into three sections based on the three propositions outlined in Chapter 2. Please see Appendix D of this study for detail on how the questions were developed.

### **3.6 The process of data analysis**

Content analysis was used to analyse the data gathered in the interviews in order to identify common threads and points of differentiation/inconsistency.

Data displays were used to describe key points captured during the interviews. The concept of data displays was developed by Miles *et al* (1984) and described by Hussey *et al* (1997). Data displays is "a visual format that presents information systematically, so that the user can draw valid conclusions and take needed actions" (Hussey *et al*, 1997: 261).

### **3.7 Limitations of the research**

The following limitations were identified:

- The research only investigated the response of a single multinational accounting firm to regulatory changes and presents an opportunity for further research in South Africa.
- The population of relevance was a Tier 1 accounting firm. Regulatory changes however affected the industry as a whole and smaller firms and empowerment firms that do not have the same "deep pockets" as Tier 1 accounting firms may therefore have responded differently.
- No other environmental influences other than regulatory changes were considered in the research.

## **CHAPTER 4: DISCUSSION OF RESEARCH RESULTS**

### **4.1 Introduction**

The objective of this chapter is to discuss the results of the data gathered in order to reach a conclusion on whether the research objectives have been met.

Data was collected through the use of a semi-structured questionnaire and in-depth interviews with five top partners and a director within a large accounting firm based in South Africa.

### **4.2 Data received**

As discussed in chapter 2, three propositions were developed to determine the impact of regulatory changes on the client service strategies of a large accounting firm in South Africa. Qualitative research was conducted to establish the validity of these propositions.

The results will be discussed as they relate to the propositions set out in Chapter 2 while identifying links to the literature reviewed. This presents the opportunity to compare current findings with research done in the past, and in some cases research findings from before the Enron corporate scandal, the event credited as the turning point for strict regulatory changes and the move towards global harmonisation of accounting regulations.

#### ***4.2.1 The impact of regulatory changes of the product offering of accounting firms***

Proposition 1 was developed to establish the degree to which the internationalisation of accounting standards have impacted the product offering of accounting firms and the extent to which auditors now consider the unique features of a client during an audit.

Standardisation as a concept would imply that little option is left for customisation for the sake of achieving an internationally accepted standard.

##### *Proposition 1:*

Regulatory changes have caused accounting firms to adjust their client service strategies based on internationally accepted standards leaving very little space for local interpretation and application to the unique features of the client's business.

Five questions were asked in order to establish whether this proposition is true or false.



#### 4.2.1.1 *Difference between global and local financial reporting standards*

Question 1 probed the differences that still exist between financial reporting legislation on a global level and on a national level.

All the respondents agreed that IFRS has been a strong driving force for financial reporting, but that a strong presence of local legislation can still be found that will have a substantial impact on national accounting standards, e.g. the APA, the PFMA, and US GAAP. IFRS is widely regarded as an example of the global move towards the internationalisation of accounting standards. The role of national culture is mentioned by Brody *et al* (2005) and is supported by evidence that certain countries have opted for stricter or more loosely defined versions of IFRS. France and Canada have stated that they will only consider the implementation of IFRS by 2010. However, France has taken a stronger stance to auditor independence than required by IFRS. In the US, US GAAP is also more narrowly defined than IFRS.

The respondents also confirmed that legislation is an environmental factor influenced by government and globalisation and is therefore regarded by accounting firms and clients as an external factor.

A respondent stated that differences exist on a legislative basis and not on a standards level: "There are some differences but it has to do with regulations not with standards, the APA is very unique and focused on South Africa as is

the Companies Act”. This points to the significant role of government in establishing rules in the interest of society as discussed by Brody *et al* (2005). The role of government was also reinforced by the respondent, and while he acknowledges the role of government in adding a local perspective on global regulation, he cautions against hidden political agendas: “the ideology of global regulations should remain and localisation should not be politically driven.”

The role of government and other legislative bodies in the development of industry regulations were confirmed and a number of respondents were of the opinion that stakeholders should play a more active role in legislative drafting.

This finding is in line with Pattberg’s (2006) findings where he investigated the influence of global business regulation on a national level. A number of respondents referred to the SEC restrictions applicable to certain clients. As was stated in Appendix A, SEC restrictions only apply to organisations listed on the New York Stock Exchange. SEC restrictions are therefore a legislative requirement. This further supports Pattberg’s theory that the existence of trans-national or multinational organisations and the knowledge sharing that exists between the various parts of these entities will aid globalisation. A respondent referred specifically to the confusion created among clients in cases where there has not yet been a harmonisation of accounting regulations.

Four respondents made reference to stricter or more loosely defined legislative measures being applied in certain geographies, e.g. France and the US. Based

on the work done by Brody *et al* (2005), who investigated the factors that influence the development of national accounting principles, e.g. FDI, it would be interesting to establish the connection between countries that have implemented IFRS and those that have not and the complexity of their national accounting legislation in comparison to IFRS compliant countries.

It appears from this that there is no major difference between local and global financial reporting legislation, all respondents are in favour of the changes that have been implemented. However, national legislation has a strong influence as was noted by some of the respondents that made reference to jurisdictions where regulations are stricter and more loosely defined. A clear distinction is made between IFRS and SEC regulations and some reference is also made to regulations specific to South African such as the APA and the PFMA. Interestingly only respondent referred to the high cost of compliance.

#### 4.2.1.2 *Focusing on the client's business*

Question 2 set out to determine the various factors that would be considered during a financial audit. The following factors were identified in order of prevalence:

**Table 3: Factors that would typically influence the financial audit of a business**

Issues influencing audit	Supported by number of respondents
1. Business risks and issues/complexity	5
2. Industry regulation	3
3. Industry expertise – understanding of industry issues	3
4. Participation of management	3
5. Business type	2
6. Subjectivity	2
7. Public sector vs. private sector	1
8. Audit committee involvement	1
9. Quality of internal controls	1
10. Future strategy of the business	1
11. Funding structures	1
12. Stance towards compliance	1

It appears that the unique features of a client’s business still have a fundamental impact on the financial audit.

A respondent confirmed this by stating that “the auditor [therefore] has to focus on the business risks faced by the client”.

Another respondent alluded to the changes brought about by new regulations, “new regulations have forced us to understand the client’s risk better”. Problems due to strict regulations are however also mentioned, “There has been a lot of frustration from the client’s side due to independence issues, but we certainly consider the unique risks of the client”.

The internationalisation of accounting standards has forced accounting firms to become better acquainted with the unique business risks faced by their clients.

All respondents alluded to the uniqueness of the client's business and the fact that the unique risks faced by a client play a role in the financial audit. Another common theme was that of industry expertise as an aid to understanding the client's business.

The responses for Question 5 strengthen the heightened focus on the business risks faced by the client. It is anticipated by all respondents that industry specialisation will feature more strongly in the future as a tool to better aid auditors in understanding the business risks of a client. Interestingly only one respondent responsible for the conducting of audits referred to the marketing relevance on industry expertise. It can therefore be said that industry specialisation, although not stated as such, can be seen as a risk mitigation instrument in the future.

One of the respondents however speculated about the relative size of the market and would have an impact on industry specialisation: "I think that industry specialisation should be a function of the size of the market. There are only four big banks in South Africa so how do you become an industry expert if you only audit one bank, it doesn't make sense".

The responses therefore substantiate the theories and findings of Baschab *et al* (2005) and Thompson *et al* (1992) on the importance of industry and the unique internal risks of a client.

#### 4.2.1.3 *Impact of regulatory changes on client service*

All but one respondent believed that regulatory changes have impacted the client service strategy of the firm.

The general feedback was that regulatory changes have forced accounting firms to adjust their client service strategies due to independence restrictions, thus impacting the client relationship. This supports the theory of Thompson *et al* (1992) that regulatory changes will impact on the strategy of an organisation.

Most of the respondents described the softer side of the impact on client service. A respondent said that the “relationship has become more adversarial” while another respondent described it as “distant and confrontational”. Respondents also made reference to the fact that the new regulations have made accounting firms more risk averse. One respondent specifically referred to the tendency of partners now to rather say no to a new opportunity because they would rather be safe than sorry.

One respondent however focused more on the practical implication of the new regulations. He described the increased focus on procedures with “more time [being] spent on the pre-planning phase of [the] audit” and the stricter internal controls and procedures that auditors now have to follow when engaging a client. Two respondents however felt that many of the changes that have been brought about are the results of overreaction by accounting firms and regulatory

bodies. This however supports the theory of Baschab *et al* (2005) in their statements on the delivery risks faced by a professional services firm.

Most of the respondents also saw the impact of the regulatory changes in the context of a wider service offering and the accompanying independence restrictions as a negative influence on both the firm and the client. Most of the procedures that accountants have to adhere to are however self-imposed.

Sehoole (2002) cautioned the market against overreacting and overregulation. The self-imposed strict procedures can however be described as the strict strategies of self-regulation as described by Pattberg (2006).

There is consensus between the respondents that regulatory changes have impacted on the internal and external processes of the firm. Reference is made to specific strategies implemented by the firm to manage risk as well as the relationships held with clients. Respondents also refer to the impact of restrictions on delivering value added services to a client. Two respondents comment on the reaction of the firm to regulatory changes, but at opposing poles, reactive versus proactive strategies.

Independence emerged as the major influencer of changes in the client services strategy followed by the internal risk management measures of the accounting firm. It also appears that most of the issues that have emerged have been to subject of confusion and limited buy in into the new regulations that still exist in

the market. As one respondent stated: “Clients still see us as their business partners. In some cases rules such as SEC restrictions and PCAOB regulations apply and the result is a lot of frustration on the client’s side because we are not allowed to assist them with certain issues even though we had done so in the past.”

#### 4.2.1.4 *The reaction of the client*

There is evidence from the interviews that multi-level buy-in into the necessity and benefit of the new regulations has not yet been achieved. It also raises the point of auditors having to believe in the legislation themselves before they can implement it at their clients, otherwise the exercise is futile.

One of the respondents also referred to the magnitude of other regulations outside of financial reporting regulations. This is reinforced by the argument of Mackenzie *et al* (2005) that regulation requires the participation of a number of players, across complex relationships. The resistance to buy-in is illustrated by an analogy used by one of the respondents to describe his client’s reaction to the changes: “Clients don’t appreciate it, they think it is unnecessary” and “it’s like hitting a small nail with a large hammer”.

The responses in general substantiates that the accounting industry is finding itself on the intermediating trajectory on industry change as described by McGahan (2004).



***Conclusion:***

Based on the feedback received it is concluded that this proposition is false.

The internationalisation of financial reporting standards does not mean that the new accounting rules do not allow for a level of customisation, the new regulations has actually forced accountants to become better acquainted with their client's business risks in order to deliver a better risk-based audit. The internationalisation of financial reporting standards therefore allows for the implementation and application of common standards and statements within the unique context of a client's business.

Accounting standards have also given guidance to national legislation. However, multi-level buy-in into the regulatory changes has not yet been achieved. The researcher would infer that there are two reasons for this:

- a) The complex nature of the regulations; and
- b) The risk adverse position taken by accounting firms.

Therefore it can be said that regulatory changes have caused accounting firms to adjust their client service strategies based on internationally accepted standards allowing for more focus on business risks and industry influence. The client relationship has however been challenged by:

- a) The complexity of the regulations;
- b) The level of national regulation that supersedes any global standards; and
- c) The degree of multi-level buy-in achieved.

The general consensus appears to be that whereas clients have implemented change, they do not necessarily agree with the reach of the regulations: they do not understand them, and they do not know who to blame so they tend to take their frustrations out on the auditor. One respondent referred to the regulations outside of financial reporting that clients also have to comply with. This is indicative of the complex nature of regulatory requirements that business has to comply with and presents a valid argument to easily understandable legislation that will encourage as much compliance as possible.

#### ***4.2.2 The impact of regulatory changes and independence requirements on the auditor-client relationship***

Proposition 2 was developed to establish the impact of regulatory changes on the client relationship.

##### ***Proposition 2:***

The call for more independent conduct by auditors through regulations has impacted the relationship between the client and the auditor and in some cases has lead to frustration for both parties.

Five questions were asked in order to establish whether this statement is true or false.

#### 4.2.2.1 *Independence and the client relationship*

All respondents were in agreement that regulations have impacted the client relationship to a greater or lesser extent. Some respondents however did not see this as a stumbling block and believe that the reaction is only temporary and manageable. Independence featured strongly as the main factor of influence for statements: “[it has] strained the relationship especially where we have had to be very strict to ensure independence.

All the respondents but one felt that regulatory changes have impacted the client relationship negatively and in some cases made this statement in conjunction with terms such as “negatively” and “strained”. The regulatory changes that have been implemented were focused on strengthening the independence of the auditor. Two respondents however felt that the new regulatory changes should not have brought about a major change as independence has always been a requirement, but that the requirements have now been formalised and promulgated. It is clear from the responses that the prevalence of deep personal relationships is the target of these regulations and that the relationship should be “professional and productive”.

Price and Arnould's (1999) commercial friendships can therefore not be that easily applied in the context of auditor client relationships. A respondent felt that the new regulations "made the building of deep relationships difficult" Some of the respondents felt that regulations have driven a wedge between the client and the auditor. This strongly supports the findings of Richard (2006) that commented in the difficulties that will arise from enforcing independence. She also stated that the responsibility rests with the auditor to ensure that independence is maintained.

It was clear from the feedback that the respondents feel that the regulations that have been implemented are too complex and onerous and that less complexity would not only benefit the client, but also work to the advantage of the auditor-client relationship.

Although respondents mentioned independence as the major influencer of relationships, no-one thinks that it will lead to permanent damage. This could be due to the fact the independence regulations are required on an industry-wide basis and all accountants therefore have to adhere to these requirements. One of the respondents aptly stated: "I merely see it as a challenge because it has set new parameters". It is merely a case of a situation of flux.

#### 4.2.2.2 *“Tools” for managing auditor independence*

There was strong opinion against audit firm rotation and the many disadvantages were highlighted by all respondents, e.g. increased risk in the first year of audit, potential lowering of audit quality towards the end of the appointment period.

The opinion is overwhelmingly against the implementation of mandatory firm rotation and the reasons given relate to the risks faced by both the client and the auditor.

Five respondents favoured audit partner rotation as a viable alternative to firm rotation as a level of continuity and industry expertise would remain in the firm. This ties in well with the role of industry expertise in understanding the business risks of a client better and quicker. Respondents felt that the recently introduced five-year rotation plan was however too short to build a good understanding of a complex client. The reasons given were strikingly similar to those given by the IOD (2006) in their comments on the Amended Companies Act.

It is clear from these responses that clients struggle with the application of independence positions taken by auditors and that it strains the relationship. “Clients find audit partner rotation difficult as it is. They don’t have any sympathy with the new partner that has to learn about their business, they expect the

partner to learn from his predecessor and hit the ground running. Clients will have even more difficulty adjusting to this [audit firm rotation] than audit partner rotation and it will cause a lot of frustration.

Most respondents offer an internal and external view; however, only one respondent focused on the internal consequences of independence regulations on the personal impact of auditors. This provides an interesting perspective in that an accounting firm also has internal challenges when applying independence regulations. Another respondent however has a positive view on dealing with the communication of independence issues to the client.

#### 4.2.2.3 *Managing frustration due to independence regulations*

All respondents noted examples of top multinational clients that have experienced frustration due to independence rules not allowing auditors to deliver prohibited services. This supports the points raised by E&Y (2004) in their comments on the prohibition on non-audit service in the European Union 8<sup>th</sup> Company Law Directive.

The restrictions placed on relationship building outside of the scope of a professional relationship would have an impact on the nature of the relationship as described by Coulter *et al* (2002). It can therefore be concluded that given the increased focus on the client's unique business risks as described earlier in this chapter, the relationship is likely to develop based on "offer-related"

characteristics. The progress as suggested by Coulter *et al* (2002) from a “personal-related” relationship to an “offer-related” relationship may actually have been reversed in the accounting profession in the interest of independence. A relationship based on personal characteristics would then develop over time. In addition, the requirement for a strictly professional relationship would in all likelihood extend the period of transition from an “offer-related” relationship to a “personal-related” relationship.

Long-standing auditor client relationships, where an audit partner has served a specific client for a number of years, have also been targeted by independence regulations. A number of tactics such as mandatory audit firm rotation, mandatory audit firm retention and mandatory audit partner rotation are available.

A number of alternative solutions to alleviate the current frustration were suggested:

- a) Abandon complex regulations in favour of easily understandable, practical regulations (the after the fact unhappiness with the internal controls demanded by SARBOX is an example of this);
- b) Develop a more sensible application of IFRS to smaller companies; and
- c) Lighten the requirements for audit partner rotation from five years to the internationally applied seven years.

***Conclusion:***

Based on the data gathered, it is concluded that the proposition is valid and that the call for more independent conduct by auditors through regulations has impacted the relationship between the client and the auditor, in some cases leading to frustration for both parties.

The lack of consistency between the measures implemented by different jurisdictions is confusing and therefore strengthens the argument for a closer alignment of national regulations with global standards if the move towards the internationalisation of accounting standards is to be successful.

***4.2.3 The impact of regulatory changes on the internal processes and efficiency of accounting firms***

Proposition 3 was developed based on the assumptions made for Proposition 1 assuming that a global “convergence” of accounting standards should eliminate any unnecessary processes/procedures in the interest of greater efficiency.

***Proposition 3:***

The high demand for better internal controls and compliance introduced through tougher regulatory changes has forced accounting firms to become more efficient in their use of resources.



#### 4.2.3.1 *Efficiency in accounting firms*

All the respondents are in agreement that the internal business processes of the firm have been affected through more control and internal checks and balances and that regulations have definitely not lead to greater efficiency.

There is no clear agreement on whether the changes implemented have benefited the firm's ability to manage compliance or the quality of the audit and the firm's own risk. It is however clear that regulations have had a tremendous impact on resources; further resources are required "to ensure that the firm does not cross the regulatory boundaries that were set" in order to ensure compliance, manage risk and increase the quality of the audit.

All the respondents but one felt that although the regulations probably had greater efficiency as their objective, the contrary has actually been achieved.

Accounting firms have become more risk averse and in an effort to manage their risk, have implemented a number of risk controls and quality review processes. These processes are performed and controlled by highly qualified professionals in many cases in addition to their existing duties. A respondent commented that "the process has therefore become more inefficient, but the quality of the audits is consistently higher". The higher quality of audits was also confirmed by other respondents.

The more “meticulous” risk management processes and controls have put more strain on existing resources and have influenced the firm’s capacity. This point was strongly emphasised in Chapter 2 where reference was made to statements by PwC (2005), *Accountancy Ireland* (2005) and Bruce (2005).

#### 4.2.3.2 *Dealing with the global shortage of accountants*

All respondents felt that the firm was not coping well with the global shortage of accountants and that more should be done to promote the profession and the firm, as one respondent stated: “we are only trying to survive”.

Reasons identified for the shortage of accountants globally are:

- a) New regulations that require a higher level of involvement in audits, i.e. a larger number of accountants involved on an audit to ensure compliance;
- b) Risk mitigating procedures implemented by accounting firms;
- c) The high level of personal risk that an auditor is now subjected to in terms of prosecution that involves substantial fines issued to the individual and possible jail sentences;
- d) The perception that exists with young people that accounting is boring and no fun; and
- e) The exodus of a large number of accountants from the profession to the private sector;

No definitive solutions for the long term were offered, but short-term tactics have been implemented to ensure that demands are met. One respondent made reference to some of the unconventional tactics used in Hong Kong to promote the profession.

A number of respondents felt that it was important to be first in line for talent and be “the employer of choice”.

This may have a significant impact on the existence of smaller accounting firms in the long run if they are not able to secure enough talent to maintain their capacity requirements. The impact of larger accounting firms’ deep pockets on securing capacity may increase the risk of the prevalence of challenges currently faced by accountants in Poland.

All the respondents acknowledged that the industry and the firm are currently facing capacity issues and that government and the Department of Education both have a role to play. Two respondents made direct reference to the attractiveness of the profession to young people and all respondents referred to the role of industry bodies to promote the profession.

The efforts of overseas accounting firms were seen as negative if “we can attract them back into the local profession. I also think that we need some sort of a talent exchange programme with our overseas counterparts to build global knowledge.”

#### 4.2.2.3 *Remaining competitive as an accounting firm*

Question 13 investigated the internal processes of accounting firms most affected by regulatory changes.

This feedback should be seen in close comparison with the feedback received relating to the efficiency of the firm.

Time and capacity constraints again featured strongly due to factors such as increased levels of training, quality reviews and compliance work. Technology is however mentioned in a positive enabling light.

The respondents identified 10 areas affected by new regulations:

- a) Training;
- b) More onerous control and review processes (this includes PSR, the documentation of internal processes and “transactions”, quality control processes and firm-wide monitoring reviews by industry bodies such as the IRBA and the PCAOB);
- c) Capacity planning;
- d) Recruitment processes;
- e) The cost structure of accounting firms due to higher insurance premiums and overhead costs;
- f) The audit methodology;

- g) The use of state of the art technology;
- h) Winning new business;
- i) Partner decision-making and technical consultation; and
- j) Time.

It is obvious from this that the regulatory changes have had an enormous impact on the ability of accounting firms to successfully serve their clients efficiently while at the same time mitigating risk.

In order to prioritise the most crucial areas impacted by the regulations, respondents were asked to identify the factors they believe accounting firms should possess in order to compete effectively.

The responses can be summarised as follows:

**Table 4: Requirements for competing effectively as an accounting firm identified by respondents**

Requirements for competing effectively	Supported by no. of respondents
People	6
Interesting and rewarding working environment	2
Brand/reputation	2
Commitment to quality/Quality control processes	2
Recruitment processes	1
Strong HR processes	1
Strong information technology framework	1
Understanding of the market	1
Products	1
Justifiable fees	1
Transformation	1
Values	1
Price	1
Training	1
Existing relationships (familiarity with the organisation and the people)	1

People are therefore regarded as the strongest contributor to competing effectively. The researcher anticipates that people would remain the number one contributor for competitive advantage given the global shortage of accountants.

The brand/reputation is also regarded as important and reinforced the work done by Fargher *et al* (2001). It would however be interesting to establish the point of view of smaller accounting firms on the importance of brand and reputation.

One respondent saw factors such as quality, independence, compliance and the ability to conduct a high quality audit as hygiene strategic factors to be able to compete effectively, not to differentiate yourself from your competitor.

***Conclusion:***

It is concluded that the proposition that regulatory changes have led to higher efficiency in accounting firms is false. All respondents referred to the onerous quality control processes implemented internally, the increased overheads to manage the firm's risk and the global shortage of accountants.

The internal control processes implemented by accounting firms to mitigate risk, have placed higher demands on a profession that is already short of resources over the short to medium term. The respondents of the firm interviewed do not

believe that enough is being done at a professional level to effectively address the shortage of accountants globally and it is therefore no wonder that the most important competitive advantage for accounting firms has been identified as people.

### **4.3 Conclusion**

It is clear from the responses received that regulations have had a massive impact on the strategies of accounting firms. It appears from the above that the introduction of regulatory changes has had more negative consequences than positive.

Clients have been positively impacted by the greater focus of auditors on the client's business risks and unique issues proving proposition 1 false.

The auditor-client relationship has been negatively influenced by the call for higher independence by the auditor and the confusion that exists in the market around the implications of complex regulations, proving proposition 2 true.

Despite cautionary warnings against overreaction, accounting firms have implemented onerous risk mitigating and quality control procedures in order to manage their own external and delivery risk. Unfortunately these measures have made to firm more inefficient proving proposition 3 false.

It can therefore be said that internal validity has been established for the influence of regulatory changes as an independent variable on the client service strategies of accounting firms as a dependent variable.

Accounting firms have redesigned their internal systems relating to business processes, operating efficiency and margins, client service, training and staff retention, and internal quality processes. The operational impact of these regulations is noted in aspects such as more meticulous audit planning, the identification of subject matter experts to be consulted during an audit, and extended training at all levels in the accounting firm.

The confirmation of internal validity also extends to external validity, thereby confirming that regulatory changes have impacted the accounting profession as a whole. Evidence received from the respondents that validates external validity includes: profession-wide independence regulations and regulatory bodies; the global shortage of accountants; the struggle for talent and higher insurance premiums.

However many the frustrations experienced around the new regulations, none of the respondents were negative about the future of the accounting industry. As one respondent noted “I think things will return to normal. Regulation will not become less, but will become more practical. I think independence, audit intensity and audit proliferation are here to stay, but I do believe it will become more practical if they become less rigorous and remove accounting



requirements on small audits.” Another stated “It is purely an issue of dealing with change. People just need to get used to it and in five years from now everything will be a norm again and people will have fun and enjoy being in the profession.”

## **CHAPTER 5: CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

High-profile global corporate scandals in recent years have resulted in the design and implementation of regulations covering issues such as corporate governance, risk management and more recently, the activities and conduct of accounting firms.

The purpose of this study was to explore the impact of regulatory changes on the client service delivery strategies of a multinational accounting firm based in South Africa.

### **5.2 The research and key findings**

Three propositions were developed to test the impact of regulatory changes on client service strategies.

Proposition 1 tested the degree to which regulatory changes have caused accounting firms to adjust their client service strategies based on internationally accepted standards leaving very little space for local interpretation and application to the unique features of the client's business.

The research found this proposition to be false. Global accounting standards and regulations have forced accountants to become better acquainted with the business risks of a client in order to deliver a higher quality audit. Global business regulations have had a massive impact on business. The role of national government was confirmed with the presence of local regulations that differ from global standards. It was also found that clients struggle to accept the changes brought about by new regulations. This is likely to continue until multi-level buy-in from all the players in the relationship has occurred.

Proposition 2 investigated the impact of more independent conduct by auditors on the relationship between the client and the auditor. The research concluded that the call for more independent conduct by auditors through regulations has indeed impacted the relationship between the client and the auditor, in some cases leading to frustration for both parties proving the proposition to be true. The lack of consistency between the measures implemented by different jurisdictions, e.g. mandatory audit firm rotation, was confusing and therefore strengthened the argument for a closer alignment of national regulations with global standards if the move towards the internationalisation of accounting standards is to be successful.

Proposition 3 sought to determine whether the high demand for better internal controls and compliance for corporates introduced through tougher regulatory changes has forced accounting firms to become more efficient in their use of resources. The research found this proposition to be false due to the high risk

mitigating policies and procedures implemented by accounting firms and the high demands placed on already stretched resources. Regulations demanded better internal controls and compliance by corporates which then, by implication, meant more work for auditors, but with existing resources and a diminishing pipeline for talent.

The impact of regulatory changes on client services strategies for both accounting firms and the profession was confirmed, thus proving internal and external validity.

Based on the research the following touch points of regulatory changes in accounting firms have been identified:

**Figure 7: Areas influenced by financial reporting regulations changes**



### **5.3 Key shortcomings of the research and areas for further research**

The research only investigated the response of a single multinational accounting firm to regulatory changes and presents an opportunity for further research to investigate and compare the responses of all the Big Four accounting firms in South Africa.

The sample size was small and mainly consisted of audit partners. Interviewing partners from other service lines in order to better understand the impact of prohibited services on their revenue stream may offer interesting insights into the client services delivery tactics of a multi-disciplinary professional services organisation in the light of audit-related regulatory demands.

External validity for the profession/industry was established; however, it would be useful to determine the impact of regulatory changes on smaller accounting and empowerment firms that do not have the same “deep pockets” as Tier 1 accounting firms.

No other environmental influences other than regulatory changes were considered in the research.

## 5.4 Understanding the implications and recommendations

The implications of the research are fivefold:

- a) Clients can expect higher quality audits from their auditors in the future based on the fact that new standards and regulations force auditors to become better acquainted with the clients' business risks. Industry expertise will become a risk-mitigating tool to provide higher levels of assurance due to a better understanding of clients' business risks. Clients will however have to understand and "buy-in" into the primary objectives of regulations to ensure higher quality audits through a more meticulous auditing process. Accounting firms are able to influence the understanding and buy-in of clients through better and more timeous communication that is not associated with fee discussions and reporting of issues to regulatory bodies. As audits have become more tailor-made to the clients' business risks, so should the communication of new standards also be tailor-made to ensure buy-in.
- b) Clients need to understand that the high independence requirements developed are in their own interest. Auditors would therefore have to be more forthright in guiding clients through the state of flux, taking time to proactively explain and agree services. The researcher agrees with the comments offered by one of the respondents that auditors can still maintain independence whilst assisting clients in the selection of service providers to

deliver prohibited services and working closely with those service providers within the scope of their audits.

- c) Confusion around financial reporting regulations will persist in the market as long as standards remain complicated and onerous. Clients and accounting firms alike have a responsibility to communicate challenges and misunderstandings and misinterpretation in a colloquial fashion to government and other regulatory bodies. Complex national financial reporting regulations will deter FDI and may affect the national economy in the long term.
- d) There is agreement with some of the respondents that the application of complex accounting standards and regulations to small companies is unrealistic and that a less cumbersome version should be considered for smaller entities. An IFRS “Light” version could possibly also offer a survival tactic for smaller accounting firms that do not possess the same resource capacity as Tier 1 and 2 accounting firms. This recommendation by implication means that the client market and accounting profession is stratified in terms of interpretation and service providers. The implication for the larger firms would be that this would free up capacity currently spent on smaller audits, and allow for greater audit process efficiency and hopefully lower cost to the client. The Amended Companies Act of 2005, still to be enacted, is taking the first step in the right direction with the exclusion of limited liability companies from IFRS compliance. The viability of this suggestion would however have to be investigated.

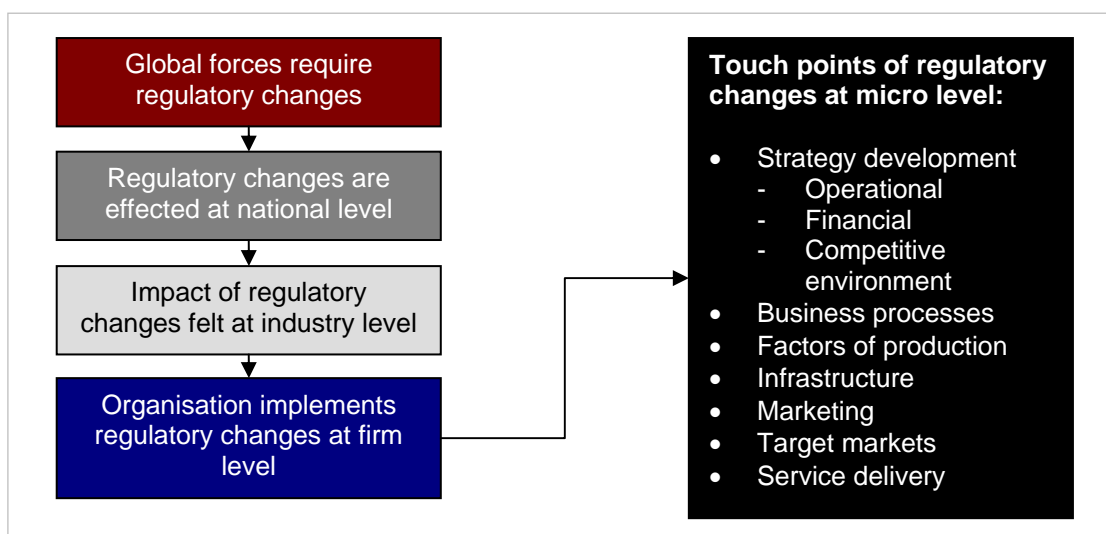
e) Accounting firms have implemented laborious internal risk management and quality control processes to mitigate their risk exposure. It is recommended that accounting firms re-evaluate these measures and define minimum industry/profession wide processes that will simplify monitoring and auditing of compliance by profession regulatory bodies.

## 5.5 Closing remarks

The impact of globalisation is becoming more apparent in business and is aided through the massive growth in technology. In order to compete internationally, a minimum set of standards needs to be met indicating stability and cause for investment.

Regulatory changes and challenges are one factor that will influence the strategy a company will follow to establish itself as a competitive player.

**Figure 8: The impact of regulatory changes on a firm**

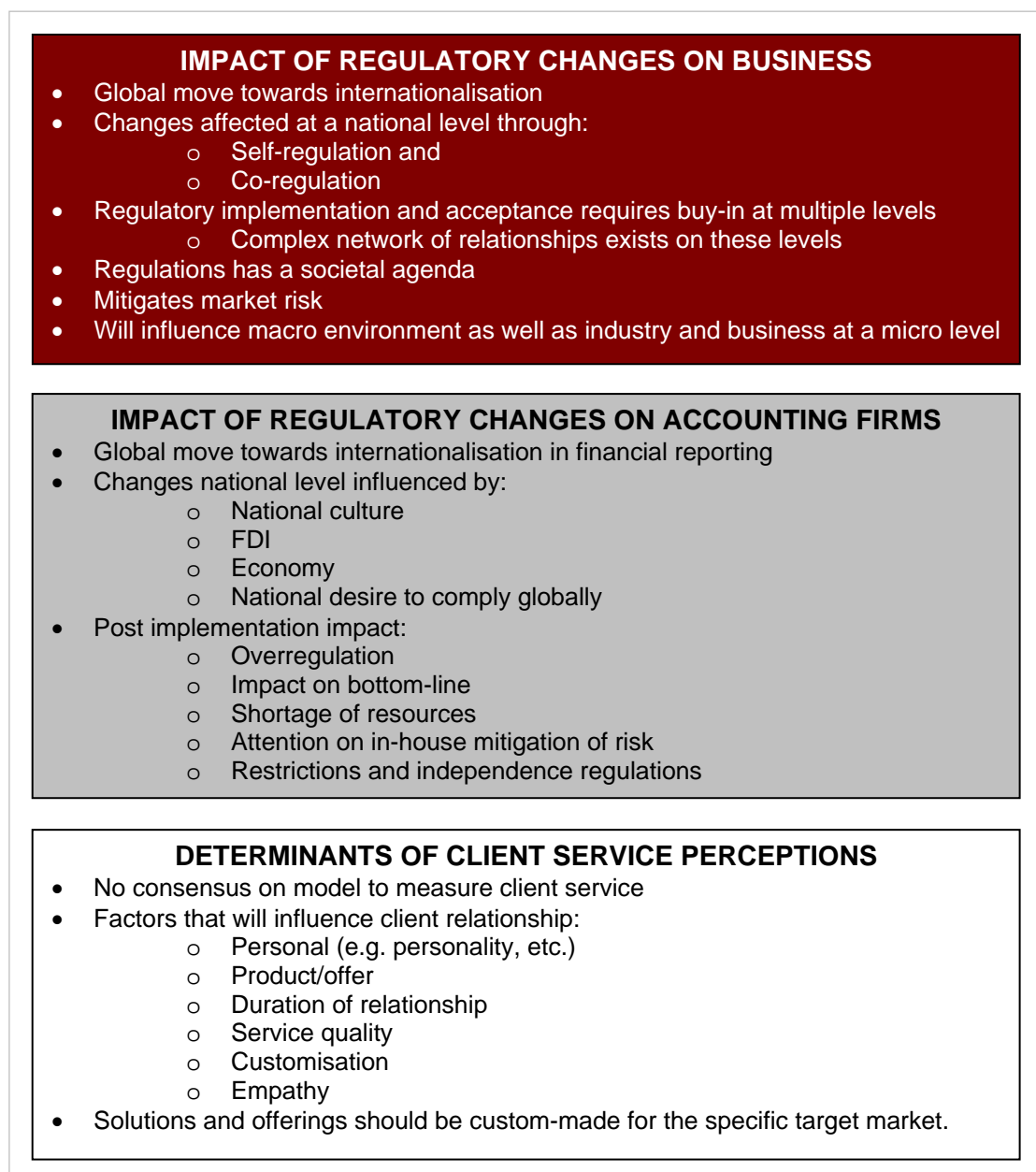




The researcher undertook this study in order to understand the impact of an environmental factor such as regulatory changes on a business and its go-to-market and client service strategies.

Based on the findings of the research the following model was developed.

**Figure 9: The impact of regulatory changes on different spheres of business**



It has also emerged from the research that the full implications of regulatory changes can only be fully comprehended and mapped after the fact.

The findings of this research have led the researcher to conclude that strategy in itself is complex and requires a consideration of the impact of globalisation and internationalisation in order to make viable strategic decisions. Strategic decisions will continue to become more complicated due to the consideration that needs to be given to the environment and the multiple players in the complex relationship network.

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## APPENDIX A: Notable accounting regulations and reporting standards

The most notable accounting regulations and reporting standards (SEC, 2002; SAICA, 2006; IRBA, 2006; PwC, 2006) introduced in the last five years are:

Accounting profession regulation	Region implemented and focus group	Key aspects and objectives
<p>The Public Company Accounting Reform and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley Act of 2002, hereafter referred to as "SARBOX").</p>	<p>United States of America.</p> <p>Applies to all entities listed on the New York Stock Exchange, their subsidiaries and associates. Implementation is controlled by the United States Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB"). The SEC is tasked with the protection of investors and integrity of security markets. The PCAOB is responsible for the implementation and monitoring of auditors providing services to SEC-listed entities. The PCAOB was created by the SEC to monitor the conduct of auditors.</p>	<p>Protect investors by requiring management to continually improve and monitor the accuracy and reliability of corporate reporting.</p> <p>Section 404 of this act is of particular interest due the significant impact it has on the internal control systems of corporates. These controls relate the documentation, evaluation, continuous testing and monitoring of internal controls relating to financial reporting.</p>
<p>The International Financial Reporting Standards (hereafter referred to as "IFRS")</p>	<p>Global but implementation is at the discretion of the National Governments and local auditing and accounting regulatory bodies. The European Union now requires most listed entities to report in line with IFRS.</p> <p>Companies listed on the JSE in South Africa are also required to apply IFRS in their financial reporting.</p>	<p>These standards were introduced to facilitate the common interpretation and comparability of financial information between different geographies.</p> <p>It has as a secondary objective to reduce costs, inefficiencies, and risks caused by different financial reporting standards.</p> <p>The objective with IFRS is to establish a common standard of financial reporting in order to eliminate misinterpretation and can therefore be described as the internationalisation of financial reporting standards.</p>

Accounting profession regulation	Region implemented and focus group	Key aspects and objectives
<p>The 8th Company Law Directive adopted by the Council of the European Union adopted in April 2006</p>	<p>The directive was adopted by the Council of the European Union (hereafter referred to as the "EU") and is applicable to the 25 member countries of the EU.</p>	<p>The amendments to the directive of 1984 are aimed at enhancing investor confidence in audit quality by specifying the duties of statutory auditors. The directive is specifically focused on auditor independence and ethics.</p> <p>PwC (2006) list the following significant changes:</p> <ul style="list-style-type: none"> <li>• "The creation of public oversight bodies for the audit profession in each EU member state, and the creation of the European Grouping of Auditor Oversight Bodies to encourage cross border regulatory cooperation;</li> <li>• A requirement for all auditors to be subject to a system of quality assurance in accordance with international audit standards and subject to public oversight;</li> <li>• The establishment of the principle of audit independence;</li> <li>• The requirement for all auditors to be registered;</li> <li>• The adoption of International Standards on Auditing across the EU; and</li> <li>• A requirement for public interest entities to establish an audit committee or ensure that the collective board assumes similar responsibilities".</li> </ul>



Accounting profession regulation	Region implemented	Key aspects and objectives
<p>The Auditing Professions Act No.26 of 2006 (hereafter referred to as the “APA”)</p>	<p>South Africa</p>	<p>Governs the conduct of auditors to stakeholders but also the organisational structure of accounting firms and reporting responsibilities. Governs the conduct of auditors and accountants with regard to the reporting of reportable irregularities to management and stakeholders. The Act does not only impact on the regulatory bodies governing auditing, but also the responsibilities of auditors to act in the interest of stakeholders and shareholders. The reporting of Reportable Irregularities is a differentiating factor. The legislation also has far-reaching implications for small and medium enterprises and smaller accounting firms in terms of current business models, employee skills and capacity demands.</p> <p>The Act has increased the awareness of audit committee members to the potential organisational risk because of internal and computer controls.</p>

Unfortunately the full extent of these regulations, as with any other regulations, has only been fully comprehended after the fact.

The Amended Companies Act of 2005 has been purposefully left out from this table as it was not yet enacted at the time of the submission of this study.

## APPENDIX B: Notable financial reporting guidelines

In addition to accounting regulations and reporting standards (IRBA, 2006; IOD, 2006) introduced and briefly outlined in Appendix A of this study, guidelines (recommended but not enforced by law in all cases) have also been introduced.

The most notable guidelines include:

Accounting profession guideline/ standard	Region implemented	Key aspects and objectives
1. International Standard on Quality control for firms that perform audits (ISQC1)	Global  All accounting firms, regardless of size, are subject to practice reviews.	The ISQC1 came into effect on 1 June 2005.  Addresses the operational effectiveness of auditors and accountants.  Requires auditors and accountants to monitor and improve their own internal control measures.
2. The King I and King II Reports on Corporate Governance for South Africa	South Africa  Applicable to all entities listed on the JSE Securities Exchange and all other large and medium size businesses at their own discretion.  Compliance by JSE listed entities with King II requirements in itself requires compliance with the requirements set out in the Global Reporting Initiative ("GRI"). The GRI has as its primary objective the establishment of common reporting standards on economic, environmental, and social performance, i.e. sustainability reporting.	<b>The King I Report - 1994</b>  The King Committee on Corporate Governance was established by the Institute of Directors in July 1993. The King I Report on Corporate Governance was published on 29 November 1994 and provided guidelines to companies on measures for effective corporate governance.  The King I Report received international recognition as the most comprehensive publication on corporate governance.  <b>The King II Report - 2002</b>  The King Committee on Corporate Governance launched the King Report on Corporate Governance for South Africa – 2002 (King II Report) on 26 March 2002.

In addition to these guidelines, guidelines governing specific industries, e.g. pension funds, banks, etc. exist. These guidelines have not been covered in this study.

## APPENDIX C: The Questionnaire

### THE IMPACT OF REGULATORY CHANGES ON THE CLIENT SERVICE DELIVERY STRATEGIES OF A LARGE ACCOUNTING FIRM IN SOUTH AFRICA

PLEASE NOTE: All information provided will be treated as highly confidential and no information whatsoever will be disclosed to a third party under any circumstances.

#### Section A: Uniqueness of the client

1. What are the major points of difference between international and local financial reporting requirements?

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2. What unique features/characteristics of a client's business will typically have an impact on the outcome of the audit?

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3. How have regulatory changes impacted of the client service strategy of the firm?

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4. What is your client's perception of regulatory changes (in general)?

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5. How do you foresee the role of industry knowledge in a financial audit in the light of regulatory changes in the future?

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**Section B: Auditor independence**

6. What do you believe is the impact of regulatory changes on the client relationship?

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7. Do you see the call for auditor independence as a threat to your relationship with the client?

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8. Do you believe that mandatory audit firm rotation in the interest of independence is valid?

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9. Have there been any incidences of frustration due to independence restrictions with clients over the past 24 months?

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10. What changes would you like to see in the current set of regulations/restrictions?

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**Section C: Becoming more efficient**

11. Do you believe that regulatory changes have forced accounting firms to become more efficient?

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12. How are you dealing with the global shortage of accountants?

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13. Internally speaking, which areas have been impacted the most by regulatory changes?

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14. What factors enable an accounting firm to compete effectively?

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*Thank you for taking the time to participate in this interview*

## APPENDIX D: Development of propositions based on literature review

The questions for the semi-structured questionnaire were developed based on the literature covered and research propositions stated in Chapter 2.

### *Proposition 1:*

Regulatory changes have caused accounting firms to adjust their client service strategies based on internationally accepted standards leaving very little space for local interpretation and application to the unique features of the client's business.

Question	Questions were developed based on literature from:
1. What are the major points of difference between international and local financial reporting requirements?	<ul style="list-style-type: none"> <li>• Pattberg (2006)</li> <li>• Brody, Moscovice and Wnek (2005)</li> </ul>
2. What unique features/characteristics of a client's business that will typically have an impact on the audit?	<ul style="list-style-type: none"> <li>• Baschab and Piot (2005)</li> <li>• Thompson and Strickland (1992)</li> </ul>
3. How have regulatory changes impacted on the client service strategy of the firm?	<ul style="list-style-type: none"> <li>• PwC (2006)</li> <li>• E&amp;Y (2004)</li> <li>• E&amp;Y (2006)</li> <li>• Baschab and Piot (2005)</li> <li>• Thompson and Strickland (1992)</li> </ul>
4. What is your client's perception of regulatory changes (in general)?	<ul style="list-style-type: none"> <li>• PwC (2006)</li> <li>• E&amp;Y (2006)</li> </ul>
5. How do you foresee the role of industry knowledge in a financial audit in the light of regulatory changes in the future?	<ul style="list-style-type: none"> <li>• McGahan (2004)</li> <li>• Porter (1996)</li> </ul>

*Proposition 2:*

The call for more independent conduct by auditors through regulations has impacted the relationship between the client and the auditor and in some cases has lead to frustration for both parties.

Question	Questions were developed based on literature from:
6. What do you believe is the impact of regulatory changes on the client relationship?	<ul style="list-style-type: none"> <li>• The Economist (2006)</li> <li>• Richard (2006)</li> <li>• E&amp;Y (2004)</li> </ul>
7. Do you see the call for auditor independence as a threat to your relationship with the client?	<ul style="list-style-type: none"> <li>• Wang, Liang and Wu (2006)</li> <li>• Richard (2006)</li> <li>• SAICA (2005)</li> <li>• IOD (2006)</li> <li>• McGahan (2004)</li> </ul>
8. Do you believe that mandatory audit firm rotation in the interest of independence is valid?	<ul style="list-style-type: none"> <li>• Goldstein (2003)</li> <li>• Price and Arnould (1999)</li> <li>• Coulter and Coulter (2002)</li> <li>• SAICA (2005)</li> <li>• IOD (2006)</li> </ul>
9. Have there been any incidences of frustration due to independence restrictions with clients over the past 24 months?	<ul style="list-style-type: none"> <li>• Richard (2006)</li> <li>• Comunale and Sexton (2005)</li> <li>• Jeong, Jung and Lee (2005)</li> </ul>
10. What changes would you like to see in the current set of regulations/restrictions?	<ul style="list-style-type: none"> <li>• SAICA (2005)</li> <li>• IOD (2006)</li> </ul>

*Proposition 3:*

The high demand for better internal controls and compliance introduced through tougher regulatory changes has forced accounting firms to become more efficient in their use of resources.

Question	Questions were developed based on literature from:
11. Do you believe that regulatory changes have forced accounting firms to become more efficient?	<ul style="list-style-type: none"> <li>• PwC (2005)</li> <li>• Pattberg (2006)</li> </ul>
12. How are you dealing with the global shortage of accountants?	<ul style="list-style-type: none"> <li>• Pretoria News (2006)</li> <li>• Accountancy Ireland (2005)</li> </ul>
13. Internally speaking, which areas have been impacted the most by regulatory changes?	<ul style="list-style-type: none"> <li>• Baldiga (2006)</li> <li>• Finweek (2006)</li> <li>• PwC (2005)</li> <li>• Pattberg (2006)</li> </ul>
14. What factors enable an accounting firm to compete effectively?	<ul style="list-style-type: none"> <li>• Fargher, Taylor and Simon (2001)</li> <li>• Ismail, Haron, Imbrahim (2006)</li> <li>• Pattberg (2006)</li> </ul>