The Factors determining the Degree of Severity of the Penalties imposed on Independent Auditors in Brazil

Determinantes do grau de penalização contra auditores independentes no Brasil

Determinantes del grado de penalización contra auditores independientes en Brasil

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Abstract
There has been a rise in the importance of auditing in capital markets through trust and credibility, as a result of business expansion. In light of this, the purpose of this research study is to discover the factors that determine the kind of penalties imposed on independent auditors, on the basis of the Punitive Administrative Proceedings filed by the Securities and Exchange Commission (SEC) in the period 2000-2017. This study makes a contribution to this scientific area by being the first to seek variables that can explain these penalties in quantitative terms. The sample of 76 proceedings was taken from the CVM and B3 sites. The regression models show that the penalties imposed on auditors are: (i) positive and related to a significant degree of breaches that occurred in the customer acceptance, execution of work and reports, repeated offenders and business clients that are listed in the Stock Exchange; (ii) negative and related in a significant way to the occurrence of breaches in audit planning, the existence of corporate governance in the audited clients, the big four firms and procedural timelines.
Keywords: Audit; Determinants of Penalties; Audit risk assessment

Resumo
A importância da auditoria no mercado de capitais, pela sua confiança e credibilidade, elevou-se com o desenvolvimento dos negócios. Destarte, esta pesquisa objetivou identificar os determinantes do grau de penalidades aplicadas aos auditores independentes, baseando-se nos Processos Administrativos Sancionadores autuados pela Comissão de Valores Mobiliários (CVM) no período de 2000 a 2017. O estudo contribui para a ciência sendo o primeiro a buscar variáveis que expliquem quantitativamente essas sanções. A amostra de 76 processos foi captada do sítio da CVM e da B3. Os modelos de regressão propostos mostram que as penalidades contra auditores são: (i) positiva e significantemente relacionadas às infrações ocorridas na aceitação do cliente, execução e comunicação dos trabalhos, aos acusados reincidentes e às empresas clientes listadas na bolsa; (ii) negativa e significantemente relacionada à ocorrência de infrações no planejamento da auditoria, à existência de governança corporativa nos clientes auditados, às firmas big four e aos tempos processuais.
Palavras-chave: Auditoria; Determinantes das Penalidades; Risco de Auditoria

Resumen
La importancia de la auditoría en el mercado de capitales ha aumentado con el desarrollo del negocio. Así, esta investigación tuvo como objetivo identificar los determinantes del grado de sanciones aplicadas a los auditores independientes, en base a los Procedimientos Administrativos Sancionadores presentados por la Comisión de Valores (CVM) de 2000 a 2017. El estudio contribuye al ser pionero en la investigación de las variables cuantitativamente de estas sanciones. La muestra de 76 casos fue tomada de los sitios CVM y B3. Los modelos de regresión propuestos muestran que las sanciones contra los auditores son: (i) relacionadas positiva y significativamente con las infracciones de la aceptación del cliente, la ejecución y la presentación de informes, los delincuentes reincidentes y las empresas clientes registradas; (ii) relacionada negativa y significativamente con la ocurrencia de infracciones de planificación, la existencia de gobierno corporativo en los clientes auditados, las cuatro grandes empresas y los tiempos de procedimiento.
Palabras clave: Auditoria; Determinantes de Sanciones; Riesgo de Auditoria

1 Introduction

The task of auditing is to assure *stakeholders,* in an independent way, that financial statements have been properly drawn up by a company (OJO, 2008), so that investors are suitably protected and the risk of information asymmetry reduced (NIYAMA; COSTA; DANTAS; BORGES, 2011). As a result, this leads to a financial market that is trustworthy and has greater credibility (ZAGONOV, 2011). However, despite expectations that auditors will act in an unbiased and independent way, a number of accounting scandals have come to light over the course of time which involved the manipulation of data and fraudulent activities in large national and international business enterprises – such as the cases of Enron, WorldCom and the Panamerican Bank. These have unsettled investors and made them cautious in their attitudes to auditors.

In light of this, studies on auditing standards – such as those carried out by Dantas and Medeiros (2015) and DeAngelo (1981) – are of great significance in the national and international literature on auditing. In a general way, there is an inherent difficulty for researchers when addressing this question, which is that they are faced with restricted access to the data and information that can allow them to assess the auditor´s work in an objective way. In contrast, the regulators have access to all the documentary records of the auditors when undertaking their responsibilities of monitoring, inspection and assessment of the standards and effectiveness of the work carried out by independent auditors.

Although in Brazil, this is the responsibility of different regulatory bodies and inspection agencies – such as the Federal Accounting Council (CFC) and Central Bank of Brazil (BCB) – the most important entity for undertaking this task is the Securities and Exchange Commission (CVM), the regulatory body of capital markets. This CVM seeks refuge in a prevailing view that the role of the auditor is essential to ensure the successful operations of the capital markets environment and that it can be characterized by trustworthiness and credibility, as pointed out by Bortolon, Sarlo and Santos (2013). Thus, there is a belief that auditing services are of great assistance in providing a higher degree of transparency and trustworthiness in the financial reporting of their clients and these two principles are the cornerstones of corporate governance.

In a general way, these regulatory bodies and inspection agencies act with a view to ensuring high standards are maintained by the independent auditors when carrying out their tasks. This is because the clients regard the auditors´ reports as a mechanism for ratifying the truth and reliability of financial information (SANTOS; GRATERON, 2003). Thus, essentially these activities conducted by the inspection agencies and sanctioned by official administrative procedures, operate as a means of assessing auditing standards. The results of the discovery of failings and irregularities on the part of the auditors, results in the imposition of penalties and the purpose of this is to discipline the way the profession operates and ensure it fulfils its responsibilities by not failing to uphold normative and ethical standards.

Hence, the purpose of this study is to identify the determinants – the characteristics of auditors, their clients and the work undertaken – as well as the types of penalties imposed by the CVM in the Punitive Administrative Proceedings (PAS) against independent auditors. This is based on the premise that establishing the determining factors with regard to the degree of severity with which penalties are imposed, can help to clarify the question of auditing standards and lead to an improvement in the measures taken for monitoring and supervision. To achieve this, there will be an examination of the decisions of the PAS based on the rulings of the CVM in the period 2000-2017 that were instituted against independent auditors (and which were taken directly from the site of the regulatory body).

This study assists in enabling future monitoring and supervisory activities to be carried out in a more sharply focused way, by making an assessment of the auditors, together with the key features of the companies being audited and the kind of work they undertake that can lead to the risk of auditors incurring penalties. As well as this, it seeks to make advances in discussions of this issue in the literature, where very little attention has been paid to the question of penalties imposed on auditors – Fusiger, Silva and Carraro (2015) and Veloso *et al.* (2015) seem to be the only exceptions. The users of accounting information can take note of the severity of the regulatory bodies through the work carried out by the auditors and this study can help them to make decisions within the auditing firm since breaches committed by auditors can cause the users of information to distrust the reliability of the financial statements. It can also assist the auditing firms themselves to mitigate

their risks by having a wider knowledge of the factors that can threaten their reputation and involve litigation. As a result, although this is not the focal point of this study, it can create a climate of improvement for the auditing standards that prevail in the capital markets of Brazil.

2 Theoretical Framework

2.1 The Role of Auditing

The Wall Street Crash in the United States, in 1929, led to feelings of uncertainty and distrust among investors and one of the consequences of this, was the determination that all the companies listed in the New York Stock Exchange should have an official auditing report at their disposal. Brazil witnessed an outbreak of a similar problem in the aftermath of the 2nd World War, with the arrival of multinationals in the country and as a result, there was a need to audit its accounting statements, as discussed by Hayes *et al.* (2005) and Niyama *et al.* (2011).

The auditing was concerned with communication, ensuring trust and credibility in the information circulating in the markets, providing a faithful representation of financial matters and giving protection to investors (NEWMAN; PATTERSON; BUFFALO, 2005; ZAGONOV, 2011; DANTAS; MEDEIROS, 2015). In this way, it sought to address the situation by establishing criteria and was thus able to analyze the prevailing standards and predetermined procedures, with a view to overcoming the problem of inefficiency and abusive practices, as made clear by Reis (2009). This statement is corroborated by Borges, Nardi and Silva (2017), when they state that auditing plays a key role by acting as an intermediary for disseminating information and hence finding and locating any discrepancies before it is made public.

The task of the auditor is to reduce the risk of information asymmetry and the the agency from experiencing problems, by providing information with a high standard of reliability in a way that allow its users to engage in decision-making, as argued by authors such as Braunbeck (2010), Evans Junior e Schwartz (2014) and Oliveira, Nakao and Nardi (2017). This definition is also ratified by the *International Standards on Auditing* (ISA), issued by the *International Auditing and Assurance Standards Board* (IAASB), where auditing is viewed as a service rendered to both an audited company – the internal users – and to third parties – the external users, which is evidence of their social purpose.

In view of their importance to the markets and users in a climate of growing globalization, it is essential for the auditors to comply with international standards. Thus, ISA 200 seeks to increase the degree of trust that users have in auditing, which is expressed through their opinions about accounting statements. However, the final product of the task of auditing is called the Auditors Report which describes the opinion of the auditors based on an analysis of the data.

2.2 Regulation of Auditing

The financial crisis of 1929 brought about significant changes in auditing, among which can be cited the promulgation in the U.S. of the *Securities Exchange Act* of 1934, which set up the *Securities and Exchange Commission* (SEC). This body was responsible for restoring the credibility of auditing to investors after the breakdown in trust following the collapse of the Stock Exchange in New York. Niyama *et al.* (2011) add that the regulations stemmed from corporate problems that had repercussions on society and that the regulators were under pressure to give a timely response to the users of accounting information by having recourse to stricter rules that increased the responsibilities of the auditors.

The first sign of regulatory procedures for auditing in Brazil was the enactment of Law No. 4.728, of 14th July 1965, which determined that the financial and capital markets must be subject to the rulings of the National Monetary Council (CMN); this was monitored by the Central Bank of Brazil (BCB), which also set up the Register of Independent Auditors. However, the concern with greater regulation only gathered strength in 2000, owing to a number of corporate scandals (NIYAMA *et al.*, 2011).

It became mandatory for companies involved in capital markets to be subject to independent auditing following the passing of Resolution CMN nº 88/68, which was subsequently strengthened by more modern laws on the subject: Law nº 6.404/76, art. 77, §3º and Law nº 11.041/09, art. 3º. The regulatory process culminated in the enactment of Law No. 6.385, of 7th December 1976, which instituted the Securities and Exchange Commission (CVM). This was given the responsibility of regulating and inspecting publicly held companies, a task that had to be carried out by auditors that were registered in this agency (NIYAMA *et al.*, 2011).

The economic crisis in Brazil in the period 1990-2000, when accounting scandals were discovered, such as that of the National Bank, led to a new wave of regulations and once again confirmed the theory of Niyama *et al.* (2011). The distrust among investors caused by the instability of the accounting profession, resulted in the issuing of Resolution CMN nº 2.267/96, which determined there should be a rotation of auditing firms in companies and that an investigation of internal controls should be mandatory. This was accompanied by the CVM Ruling nº 308/99, which represented how a number of significant changes should be implemented: the Technical Qualification Examination overseen by the CFC, continuous education, peer review, the rotation

of auditors, the identification of activities where there is a conflict of interest and the subjection of auditing to the standards established by the CVM, CFC and Institute of Independent Auditors in Brazil (Ibracon). It should also be noted that in Art. 35 of this ruling, there are a number of penalties for those who fail to comply with the requirements listed above. The list of possible penalties that can be imposed on auditors is strengthened by the CFC Resolutions nº 1.309/10 and 1.370/11 and Decree nº 9.295/46 which categorizes the penalties in accordance with the degree of severity of the offence: (i) a fine, (ii) a warning, (iii) a rebuke, (iv) suspension of professional activities and (v) cancellation of membership of the Reginal Accountant Register.

The expansion of corporations over a period of time, together with the process of globalization, have shown the need to adopt standards that are shared with other countries with a view to strengthening the trust of international investors (HAYES *et al.*, 2005; PWC *et al.*, 2006). Since it was aware of the importance of standardization, in 2009 the CFC adopted 37 Technical Accounting Standards for Independent Auditing based on Traditional Information on Accounting in Brazil (NBC TA) and a Brazilian Standard of Professional Accounting for Independent Auditors (NBC PA), which represents a convergence with ISA, carried out under the auspices of IFAC and which has taken on responsibility for IAASB.

Having said this, auditing can be characterized as an activity designed to allow economic/financial control of any institution and ensure it is able to substantiate the truth of the information contained in financial statements and subsequently disseminated (ALMEIDA, 2004). Thus, the way independent auditors act, can be regarded as of crucial importance for operations in the financial and capital markets since they create an environment of trust and credibility (NIYAMA *et al.*, 2011).

2.3 Auditing Standards

A high standard of auditing is something that has been sought for a long time owing to the increasing importance of this activity in recent decades. In view of this, according to DeAngelo (1981), Watts and Zimmerman (1986) and Braunbeck (2010), there is a joint probability that a particular auditing session will detect and describe (on the basis of its report) any significant failing in the accounting system of the client. Paulo, Cavalcante and Paulo (2013) also point out that the standard of auditing is affected by the organizational and institutional circumstances of the client.

Nonetheless, there is an expectation *gap* between the aspirations of the market and what an auditor can really achieve in this area. Pob (1994), IFAC (2003), Ojo (2008) and Dantas and Medeiros (2015), argue that this expectation gap in auditing is one of the main sources of concern to the profession, as well as those who make use of financial statements and the regulators.

Braunbeck (2010), in turn, suggests that this *gap* can be narrowed through the coexistence of two variables which can ensure auditing of a good standard in this new market: technical competence and independence. The first variable is linked to the probability that the auditors will detect some fault in the client and that they will be assisted in their investigation by their degree of specialization, the training of their teams and the designing and application of auditing systems and methodologies (WATKINS *et al.*, 2001). The second variable is linked to the chance that misleading information might appear in the report.

Furthermore, the *Financial Reporting Council* (FRC) drew up the *The Audit Quality Framework* (FRC, 2008) which contains other guidelines for auditing standards such as: the internal culture of the firm, the tools and personal qualities of the members and *staff*, the effectiveness of the auditing process, trustworthiness and the use of reports; it also refers to external factors in the control of auditors as a key feature in the analysis. As pointed out by Ricchiute (2002), auditing involves mitigating the risk of material distortion in financial statements, since the materiality of this threat has a direct bearing on problems about the standard of the work (DANTAS; MEDEIROS, 2015).

Thus, it can be noted that effective auditing is closely linked to its standards although this feature is not easily verifiable by external agents at the time when it is undertaken (DANTAS; MEDEIROS, 2015). In view of this, it can be asked what exactly characterizes a good standard of auditing and its measuring system since, in the original way it was practiced, it could only be inferred that the quality of the work was bound up with the goals of the activity. Having said this, the real means of verifying the operational standards of auditing depends on being granted access to the governance of the firm and the written notes of the auditor, a privilege that is restricted to the regulatory bodies.

It is worth drawing attention to the importance of the corporate governance of the auditing clients to assess the standard of their work since there is a wide array of control mechanisms that protect and further the interests of the company's shareholders, as is made clear by Fama and Jensen, (1983). Hence a more closely monitored environment by the company, tends to represent a lower risk to auditing, as pointed out by Baker and Owsen (2002), Bedard and Johnstone (2004), Martinez and Moraes (2006), Bortolon, Sarlo and Santos (2013) and Dantas *et al.* (2016). In addition, Cohen and Hanno (2000) argue that auditors use the existence of corporate governance as a criterion for planning their work and calculating the auditing risks, which was less evident in this scenario and thus make it feasible to improve the standard of the project being undertaken.

Despite what has been described here, Manita (2009) believes that the complexity of auditing procedures and the standardization of the reports make it difficult for external users to determine what exactly

constitutes auditing of a good standard. Thus, one of the consequences of possible shortcomings by the auditor might be that they are more accountable for any litigation proceedings that arise from the monitoring by the regulatory bodies (BRAUNBECK, 2010; DANG, 2004; SEETHARAMAN; GUL; LYNN, 2002; PALMROSE, 1988). These kinds of proceedings can threaten the reputation of an auditing firm in the market and among the users, and this can also entail a loss of trust being conveyed to third parties. This underlines the importance of having auditing of a high standard in situations of uncertainty (THE TREASURY, 2010).

With regard to this, it should be made clear that there are still very few research studies in the academic world of Brazil, on the question of imposing penalties on questionable auditing activities. However, attention should be drawn to two studies in this area: Fusiger, Silva and Carraro (2015), and Veloso *et al.* (2015). In both these studies, the authors have sought to detect the main offences that have entailed punitive administrative proceedings with the aim of providing a clearer understanding of the failings, mistakes or failure to comply with standards, committed by auditors. The purpose of this inquiry was to allow future measures to be taken by means of educational activities, and enforcing stricter monitoring and inspection procedures, a fact that was corroborated by the increase of proceedings after the adoption of the system of international accounting standards in Brazil, through the enactment of Law nº 11.638/2007, which was designed to improve the reliability of accounting information.

3 Methodology

This study has adopted a descriptive and explanatory approach since its main objectives is to establish the factors (based on the characteristics of the auditors, the auditing clients and work carried out) that determine the degree of severity of the penalties imposed on auditors as a result of the rulings of the punitive administrative proceedings filed by the CVM. It can be regarded as an empirical-analytical study because it employs techniques that involve gathering, collating and analyzing predominantly quantitative data and having a significant concern with the causal relationship between the determinants, as defined by Martins (2002).

3.1   Defining the Limits of the Object of the Study

The scope of the research covers the Punitive Administrative Proceedings filed by the CVM against auditors in the period 2000-2017. This information was collected from the site of the CVM, with the aid of the "auditor" and "auditing " filters and those were selected that had an auditor as a defendant, making a total of 76 criminal proceedings in the period under investigation.

Thus the trials in question can include more than one defendant and/or auditing report, in view of the fact that more than one person might be responsible for the work carried out and that in most cases, the breaches committed by auditors are repeated on consecutive occasions. The general observations concern the individual circumstances of each penalty that is imposed, since these are closely related to a report and a person accused. The number of these was obtained through a combinatorial analysis of events within each PAS. This involved making a permutation of the appropriate characteristics and obtaining the pattern of the $Proceedings_n/Report_z/Accused_w$, observation where n is the trial under scrutiny, z is the number of reports investigated during the proceedings (n) and w is the number of defendants within the proceedings (n).

In this way, Table 1 displays the number of trials, reports, defendants and notes made by inspectors during the period 2000-2017.

Table 1: Number of proceedings, reports, and defendants tried in the period 2000-2017

	Total amount
Number of Proceedings	76
Number of Reports	211
Number of Defendants	132
Number of Observations Trial/Report/Defendant	355

3.2   Designing the Variables for the Model

The regression model (1) was developed with the aim of identifying the factors that determined the degree of severity of the penalties imposed on independent auditors. This was based on three interrelated categories that are essential to this study: the accused independent auditors; the auditing reports; and the Punitive Administrative Proceedings.

3.2.1 Features of the Accused Independent Auditors

The large auditing firms, also known as the *big four*, are major players in this market which can be explained by the great capacity they have for monitoring, their considerable financial resources, their trained

professionals and the fact that their reputation is ensured by their brands (PALMROSE, 1986; WATTS; ZIMMERMAN, 1986; CHAN et al, 1993).

This oligopolistic situation might be a positive factor for the profession because as Kallapur *et al.* (2010) state, these firms represent a *proxy* of auditing standards. On the other hand, Jubb (2016) believes that no regulator wishes to bring down one of these large auditing firms because they are anxious not to drive up even more competition in the sector. This is reflected in the fact that there is less chance of these firms being subject to punishment or monitoring by the regulatory bodies owing to the ¨too big to fail¨ principle, which has an adverse effect on this part of the market. The power of the large auditing firms is also underlined by Mello and Baptista (2011), when they state that they tend to come to an agreement with the CVM before embarking on punitive proceedings. With regard to this, it is deemed necessary to analyze the seriousness of the breach committed by one of the *big four* (*B4* organizations) and by only physical persons (*PF*), which would make a contrast with the current analyses of the large corporations and their resources.

The CVM plays the role of an inspection agency and regulator of capital markets which entails adopting a pedagogical and harsh approach when imposing penalties on first-time offenders, as explained by Machado (2018), and is the rapporteur of several Punitive Administrative Proceedings. In addition, Renteria (2018) states that the occurrence of violations on the part of auditors shows that the professionals are not properly prepared for their work, while the removal of offenders from the market by means of suspension or cancelling their registration, makes the profession efficient. In these circumstances it was deemed necessary to analyze the behavior of the regulatory body before the first or repeated offenders, by means of a variable *AM2*, which detects the cases where the accused are cited in more than one trial.

3.2.2 Characteristics of the Reports

Corporate governance practices tend to reduce the problems in institutions by making the work of the auditors easier and by collaborating with them. This interpretation is corroborated by the so-called effect of corporate governance on risk management which has been examined by Bedard and Johnstone (2004), Martinez and Moraes (2006), Bortolon, Sarlo and Santos (2013) and Dantas *et al.* (2016). These authors mention that a good system of governance results in good internal controls and hence, lower risks to independent auditing. Furthermore, as corporate governance is regarded as poor in entities where there are cases of fraud, as shown in the study by Farber (2005), there was clearly a need to assess the relationship between these practices and the cases of violations in auditing, thus creating the *GC* variable in the regression model.

Information asymmetry can be reduced by the role played by the auditors which is to certify the publication of reliable information of a good standard. This is mainly important for the decision-making of users in listed companies because these entities form the basis of the capital markets. As a result, the failings of the auditing forms of the Stock Exchange can have serious implications on financial statement disclosures and lead to *stakeholders* making wrong decisions. Thus, the need for the CVM to ensure the credibility of the capital markets means that a *List* variables should be included in the study. This would show that if the audited company is listed in B3, it would be possible to analyze how the agency takes action when confronted with breaches that are within its regulatory sphere.

In view of this, the auditors must fulfil their responsibility of instilling trust in the market by not creating a climate of uncertainty with regard to their integrity when issuing the end product of their activities – the auditing report (HOLLINGSWORTH; LI, 2012). And in the conclusion of their study, Hayes et al. (2005) outline four essential stages: 1st Phase – Client Acceptance, 2nd Phase – Planning, 3rd Phase – Execution of tasks and 4th Phase – Assessment and Communication. Thus, it is clear that the professionals must master the art of undertaking all the phases of the project, with a view to obtaining results that are satisfactory and have no failings. For this reason, it was deemed necessary to incorporate the *F1*, *F2*, *F3* and *F4*, variables in the research study (which represent breaches committed in the respective four phases of the auditing), to check if any error made in these stages has a direct bearing on the degree of severity of the penalties imposed by the CVM.

Also, with regard to auditing reports, Chen, Srinidhi and Su (2014) state that they must provide the reader with the necessary means of understanding the entity being audited and not make a distinction between different kinds of opinion. Thus, there is a need to assess whether the CVM behaves in a different way with regard to the types of reports being inspected, or in other words, if the body handles the key issues emerging from the information contained in the annual and quarterly reports in an equitable way. In light of this, the *RelA* variable which indicates the presence of the annual report, has been added to the model.

3.2.3 Characteristics of the Punitive Administrative Proceedings

The CVM Ruling nº 308/99, art. 25, stipulates a) a minimum period of five years for the preservation and safe keeping of all the audit documentation and b) longer periods for determining cases expressed by virtue of Administrative Enquiries. Furthermore, Law nº 6.838/80, art.1º, stipulates a five-year time-frame for the punishment of self-employed professionals subject to disciplinary proceedings that have arisen from what

has been recorded by the relevant bodies, including a confirmation of the date when the respective breach occurred. On the basis of what has been outlined above about the characteristics of PAS, it was deemed necessary to check the Opening Time (**TA**) and the Time of Judgement (**TJ**) of the reports being analyzed.

3.3   The Regression Model

For reasons outlined in Section 3.2, the regression model (1) was developed to determine the possible relationships between the determinants and the degree of severity of the penalties imposed, while taking account of the three key aspects of the research study. The 355 observations stemming from the combination of Proceedings$_n$/Report$_z$/Accused$_w$ were included for the analysis .

$$PEN_{(FP)z} = \beta_o + \beta_1 PF_z + \beta_2 B4_z + \beta_3 AM2_z + \beta_4 List_z + \beta_5 GC + \beta_6 F1_i + \beta_7 F2_i + \beta_8 F3_i + \beta_9 F4 + \\ \beta_{10} RelA_i + \beta_{11} TA_i + \beta_{12} TJ_i + \mathcal{E}i \qquad (1)$$

Where:
$PEN_{(FP)i}$: Weighted measure of the penalties imposed for breaches committed in the number of observations/ proceedings/report/accused *z*, measured in accordance with the criteria outlined in Table 2, assuming FP equals 0.25 or 0.50 alternately;
PF_i: Indicates if the defendant in the number of observations/proceedings/report/accused *z* is an individual person – *dummy* variable taking 1 if it is an individual person and 0 if it is a legal entity;
$B4_i$: Indicates if the client referred to the number of observations/proceedings/report/accused *z* was audited by one of the four main auditing firms called the *big four* – *dummy* variable taking 1 for the statements audited by PwC, KPMG, E&Y or Deloitte and 0 for the others;
$AM2_i$: Indicates if the defendant in the number of observations/ proceedings/report/accused *z* was cited in more than one trial – *dummy* variable taking 1 for the accused cited more than once and 0 for the other cases;
$List_i$: Indicates if the audited company referring to the audited company and the number of observations/ proceedings/report /accused *z* is an open capital entity, or in other words, if it is a company listed in B3 – *dummy* variable taking 1 for listed companies and 0 for the others;
GC_i: Indicates the service requirements of corporate governance in the audited company with reference to the number of observations/ proceedings/report/accused *z* – *dummy* variable taking 1 for the companies listed in the levels of corporate governance of B3 and 0 for the others;
$F1_i$: Indicates the presence of breaches in the number of observations/proceedings/report/accused *z* committed in the 1st phase of the auditing – Client Acceptance, according to the separation of functions shown by Hayes *et al.* (2005) – *dummy* variable taking 1 for the breaches of Phase 1 and 0 for the others;
$F2_i$: Indicates the presence of breaches in the number of observations/ proceedings/report/accused *z* committed in the 2nd Phase of the auditing – Planning, according to the separation of functions shown by Hayes *et al.* (2005) – *dummy* variable, taking 1 for the breaches of Phase 2 and 0 for the others ;
$F3_i$: Indicates the presence of breaches in the number of observations/proceedings/report/accused *z* committed in the 3rd Phase of the auditing – Execution of tasks, according to the separation of functions shown by Hayes *et al.* (2005) – *dummy* variable taking 1 for the breaches of Phase 3 and 0 for the others;
$F4_i$: Indicates the presence of breaches in the number of observations/proceedings/report/accused *z* committed in the 4th Phase of the auditing – Assessment and Communication, according to the separation of functions shown by Hayes *et al.* (2005) – *dummy* variable taking 1 for the breaches of Phase 4 e 0 for the others;
$RelA_i$: Indicates if the work undertaken by the auditor in the number of observations/ proceedings/report /accused *z* is an Annual Report – *dummy* variable taking 1 if it is an Annual Report and 0 for the other cases;
TA_i: Opening Time of the trial refers to the number of observations/proceedings/report/accused *z*, which is obtained from the difference between the date when the inquiry begins and the date when the audit reports are issued, in years;
TJ_i: Time of Judgement refers to the number of observations/ proceedings/report/accused *z*, which is obtained by the difference between the date when the ruling of the inquiry is made and the date when the proceedings begin, in years ;
$\varepsilon_{i,t}$: Regression error term ~ N(0, σ^2).

The weighted measures of the penalties were based on established parameters (as shown in Table 2), a greater weight being attributed to stricter penalties (cancellation or suspension from the Reginal Accountant Register) and discharging the cases of acquittal. Two kinds of measurements were employed for cases of fines which gave rise to alternative values to the dependent variable of the model ($PEN_{(FP)}$). The weighting factors used were established as the basis for the judgements of the research and to reflect issues of sensitivity. This was because it was thought that it would be useful to analyze and compare the wide range of results that could be obtained from: (i) 0.25 as the minimum weight for fines - with a view to setting the same threshold for the smallest fines as well as ¨warnings¨ and (ii) 0.50 as the minimum weight for fines when setting a higher threshold for all the fines with regard to ¨warnings¨.

Table 2: **The weighting of the Penalties**

Categories of Penalties (Section 4.1.4)	Weights attributed
01 and 02. Cancellation and/or suspension from the Register	1.00
03. Fine*	Formula: $\left[\left(\frac{VM_i}{(VM_{mx} - VM_{mn})}\right) \times (1 - FP)\right] + FP$
04. Warning	0.25
05. Acquittal	0.00

Where: VMi is the value of the fine in the analytical report; **VMmx** is the maximum amount of the fine among 355 observations and **VMmn** is the minimum; **FP** is the weighting factor, taking 0.25 and 0.50, as alternate figures
*Updated IPCA values, accumulated until December 2017.

4 Analysis of the Results

On the basis of the 355 observations/ Proceedings$_n$/Report$_z$/Accused$_w$ and with the aim of determining the degree of severity of the penalties imposed on the auditors in the PAS, filed by CVM, the examination and assessment of the empirical results follow stages related to: (i) an analysis of descriptive statistics; and (ii) an analysis of regression. In the PAS that were analyzed, 16 types of breaches committed by external auditors were found, which are set out in Appendix A.

4.1 Descriptive Statistics for Variables

The first stage of the empirical tests involved measuring the variables – the descriptive statistics for these are outlined in Table 3.

Table 3: Descriptive statistics for the variables of the model (1)

	Average	Median	Standard Deviation
PEN(25)	0.4898	0.3192	0.3494
PEN(50)	0.6052	0.5462	0.3101
PF	0.5577	1.0000	0.4967
B4	0.1493	0.0000	0.3564
AM2	0.1887	0.0000	0.3913
List	0.1915	0.0000	0.3935
GC	0.0789	0.0000	0.2695
F1	0.4507	0.0000	0.4976
F2	0.4141	0.0000	0.4926
F3	0.8620	1.0000	0.3449
F4	0.7746	1.0000	0.4178
RelA	0.8282	1.0000	0.3772
TA	2.9696	2.9389	1.7725
TJ	2.7553	2.0694	2.8960

Where: **PEN(25)** is the degree of severity of penalties imposed following the committing of breaches with FP equal to 0.25; **PEN(50)** is the degree of severity of penalties imposed for breaches committed, with FP equal to 0.50; **PF** is the indicator of the individual ; **B4** is the indicator of the *big four* auditing companies; **AM2** is the indicator of the accused who are cited in different trials on more than one occasion; **List** is the indicator of the companies listed in B3; **GC** is the indicator of companies listed in the levels of corporate governance of B3; **F1** is the indicator of breaches that occurred in the 1st Phase of the auditing – Client Acceptance; **F2** is the indicator of breaches that occurred in the 2nd Phase of Auditing – Planning; **F3** is the indicator of breaches that occurred in the 3rd Phase of auditing – Execution of Tasks; **F4** is the indicator of breaches that occurred in the 4th Phase of Auditing – Assessment and Communication; **RelA** is the indicator of the auditing of the Annual Report; **TA** is the Opening Time of the proceedings in years; **TJ** is the time of judgment in years .

On the basis of the data shown in Table 3, it can be seen that on a scale of 0 to 1, most of the penalties have a degree of severity higher than 0.3 and 0.5, when account is taken of the fact that both the medians of **PEN(25)** and **PEN(50)**, respectively, were above this value. Having said this, it can be concluded that most of the punishments were fines and/or suspension and cancellation of the register, because the respective weighting factors were greater than the median shown. It should be underlined that the biggest fine imposed in the period under analysis was imposed on KPMG, because there was a lack of the necessary diversity of opinions in the audit report of *Lojas Arapuã.*

With regard to explanatory variables, the following was determined: most of the PAS rulings are against actual individual auditors (55%); the *big four* represented about 15% of the cases; about 19% of the observations refer to repeat offenders; the companies listed in the Stock Exchange represent less than 20% of the cases analyzed; only 8% of the hearings refer to companies that meet the requirements of the corporate governance of B3; the problems that arose from the testing phases and audit evidence (**F3**) and communication of results (**F4**) were predominant with regard to the procurement phases (**F1**) and planning (**F2**); a significant proportion (83%) of the proceedings referred to cases of annual reports; the opening session of PAS was 2.9 years; while on average, the ruling lasted, on average, 2 years 8 months.

4.2 Regression Analysis

Preliminary tests were conducted for an estimate of the model and to determine the risk of multicollinearity, by means of establishing the correlation between the independent variables. Like all the correlations that were ascertained, they were well below the threshold of 0.8, recommended by Gujarati (2006), and thus the risk of multicollinearity among the independent variables was excluded.

The key stage of the empirical tests for determining the degree of severity of the penalties imposed by the CVM in the PAS on independent auditors takes place through an estimate of the model (1), and combining two ways of measuring the dependent variable ($PEN_{(FP)}$), as was highlighted in Section 3.3. Given the autocorrelation indices and heteroscedasticity in the residuals, the estimate took place with the aid of the SUR PCSE method, which leads to a robust parameter design, even in the presence of autocorrelation and heteroscedasticity in the residuals. The results are displayed in Table 4.

Table 4: Estimate of the model (1), with the dependent variables $PEN_{(25)}$ and $PEN_{(50)}$

Independent Variables	Dependent Variables	
	$PEN_{(25)}$	$PEN_{(50)}$
ß	0.1123 (0.1482)	0.3351 *** (0.0000)
PF	0.0045 (0.8851)	-0.0119 (0.6569)
B4	-0.1427 *** (0.0044)	-0.1903 *** (0.0000)
AM2	0.1848 *** (0.0000)	0.1569 *** (0.0001)
List	0.1274 *** (0.0040)	0.1025 *** (0.0074)
GC	-0.3302 *** (0.0000)	-0.2831 *** (0.0000)
F1	0.2718 *** (0.0000)	0.2208 *** (0.0000)
F2	-0.0979 *** (0.0072)	-0.0560 * (0.0743)
F3	0.2700 *** (0.0000)	0.1206 ** (0.0230)
F4	0.1584 *** (0.0007)	0.2248 *** (0.0000)
RelA	0.0734 (0.1165)	0.0479 (0.2363)
TA	-0.0366 *** (0.0001)	-0.0277 *** (0.0005)
TJ	-0.0121 ** (0.0385)	-0.0190 *** (0.0002)
Nº Observations:	343	343
Period	2000/2017	2000/2017
R^2	0.4039	0.4398
R^2 Adjusted	0.3822	0.4194
Statistic F	18.6329	21.5898
F (p-value)	0.0000	0.0000

Where: **$PEN_{(25)}$** is the degree of severity of penalties imposed for breaches committed, with FP equal to 0.25; **$PEN_{(50)}$** and the degree of severity of the penalties imposed for breaches committed, with FP equal to 0.50; **PF** is the indicator of the individual auditor; **B4** is the indicator of the *big four* companies in the auditing; **AM2** is the indicator of the accused cited more than once in different proceedings; **List** is the indicator of the companies listed in B3; **GC** is the indicator of companies listed in the levels of corporate governance of B3; **F1** is the indicator of breaches that occurred in the 1st Phase of auditing – Client Acceptance; **F2** is the indicator of breaches that occurred in the 2nd Phase of auditing – Planning; **F3** is the indicator of breaches that occurred in the 3rd phase of auditing – Execution of Tasks; **F4** is the indicator of breaches that occurred in the 4th phase of auditing – Assessment and Communication; **RelA** is the indicator of the auditing of the Annual Report; **TA** is the opening time of the proceedings in years; **TJ** is the time of judgement in years. Level of significance: *** 1%; ** 5%; * 10%. P-values between brackets.

With regard to the variables that represent the characteristics of the auditors, the results of the tests show that regardless of the dependent metric variable, in $PEN_{(25)}$ and $PEN_{(50)}$, there is no significant statistical relationship between the degree of severity of the penalty and the PF variable, which shows there is no difference between the penalty imposed by the CVM on individual auditors or legal entities.

In the case of the $B4$ variable, there was a negative relationship that was statistically significant with the dependent variables ($PEN_{(25)}$ or $PEN_{(50)}$), which showed that the degree of severity of the penalty imposed on the *big four* is less than on the other auditing firms and the individual auditors. This negative relationship can be attributed to these companies potentially have a comparable standard, which would reduce the likelihood of serious errors – subject to stiffer punishments. Moreover, this result corroborates the study by Kallapur *et al.* (2010), who state that the work carried out by the *big four* acts as a *benchmark* for auditing standards, or rather, tends to have fewer failings. In addition, it is worth mentioning the views of Mello and Baptista (2011), when they draw attention to the tendency of large companies to come to an agreement with the CVM before embarking on proceedings, and of Jubb (2016), who believes that no inspector wants to bring down one of the large auditing firms, while being anxious to point to mitigating factors to ensure these entities are given lower penalties. Finally, it is worth mentioning that during the period under analysis, no maximum penalty (such as suspension or cancellation of registration) was imposed on any of the *big four*, although one of the large auditing firms (KPMG), had to pay a heavy fine.

Another point regarding the characteristics of the auditors is that the tests showed a positive relationship between the dependent variables and repeat offenders ($AM2$), or in other words, when the auditors were charged with a second offence, the punishments tended to be harsher. This suggests that the decisions made by the punitive body are influenced by the number of accusations that have been made against an auditor. Moreover, this might suggest there is resilience in the rulings of the CVM, in proceedings where the defendant is being accused of a breach for the first time and confirm that the body adopts a disciplinary behavior, in the opinion of Machado (2018). Having said this, it is clear that the CVM attempts to punish with the utmost rigor, professionals who are not suited to belonging to this ¨market¨, that is professionals who are repeat offenders.

The second area of analysis is concerned with audited reports in cases where the PAS takes action against auditors. The tests reveal a positive link between the degree of severity of the punishments imposed on auditors and the fact that the audited client is a company listed in the B3, which is evidence that the punishments imposed on auditors for faults made in the auditing of companies with ties to capital markets, are stricter than those meted out to other companies. This pattern of behavior supports the belief that the information about these entities is naturally of crucial importance for the decision-making of investors, owing to the information asymmetry involved. Thus, the imposition of stricter penalties for the faults committed in this area, might be designed to have a disciplinary effect on the market.

Another factor that emerged when testing clients to determine the strictness of the penalties imposed on the auditors, was the degree of corporate governance of these entities. The results show a negative relationship between the variables, which is evidence that there are fewer penalties for auditors who carry out work in entities that have a level of governance. This corroborates the findings of Farber (2005), who states that fraudulent entities have a weak corporate governance or none at all. Thus the empirical evidence found is intuitive since the governance allows a greater degree of efficiency in the company (BEDARD; JHONSTONE, 2004; MARTINEZ; MORAES, 2006; BORTOLON; SARLO; SANTOS, 2013; DANTAS *et al.*, 2016), by reducing auditing risks. As a result, the possible breaches by auditors in a corporate governance environment tend to be milder and have fewer repercussions and hence incur lower penalties.

The third area of analysis concerns Punitive Administrative Proceedings, such as the professional work undertaken by the auditors. The tests revealed that the measurements for estimating the penalties for the auditors have a positive relationship with the $F1$, $F3$ e $F4$ variables and negative with $F2$. This provides evidence that the judgments of the conduct of the independent auditors in the inquiries, is linked to the phases of Client Acceptance ($F1$), Execution of tasks *($F3$)* and Assessment and Communication ($F4$) and that this leads to stricter penalties being imposed on the auditors by the CVM. On the other hand, the rulings linked to offences committed by the auditors in the Planning phase ($F2$) result in milder punishments. These results are in line with the statements made by Hollingsworth and Li (2012), in so far as it is necessary for auditors to avoid casting any doubt on their integrity or their capacity, when issuing auditing reports and thus be able to fulfil their responsibilities in each stage of the project with skill and dexterity. This means that breaches with regard to the independence of professionals, failings in the procedures and tests, and errors in the reports that are issued, (and which are related to the $F1$, $F3$ and $F4$ variables), are of greater importance to the users of the information, since they are subject to more severe penalties by the CVM. In contrast, failings in the planning stage may not necessarily entail problems in the outcome of the auditing, because they can be remedied in the subsequent phases; this explains their negative relationship with the dependent variable that was analyzed.

A further point regarding the characteristics of the work, is that a test was conducted to determine whether or not the cases in which the final outcome is an annual report ($RelA$), proved to have a statistical significance for the severity of the penalties that were imposed. This evidence confirms the view of Chen, Srinidhi and Su (2014) that the auditing report should provide the reader with a full account of the entity being audited and thus enable decision-making to be carried out. The reason for this is that there are clear signs that

there no attempts are made by the CVM to differentiate between the types of reports issued by auditors. The results show the importance of information in itself, whatever type of work has been undertaken.

Finally, with regard to the control variables – representing the opening and judgment of the proceedings - there were negative and statistically significant relationships for the severity of the penalties imposed, or in other words, the longer the period of time allotted for the opening of the proceedings and the judgment, the less severe were the punishments. One possible explanation for these results is that minor and less serious infractions tend not to be treated in a timely way and are given a lower priority in the order of proceedings, because they have less effect on society. This accounts for the link between long opening and judgment times and less severe penalties, which stem from the degree of seriousness of the audit failures. Moreover, it should be stressed that the question of the resources of the accused during the proceedings was not determined and how this is linked to the degree of severity of the penalties, which might indicate that a longer period of time for the judgment led to more lenient punishments.

5 Conclusion

The purpose of this study was to establish the determinants – the characteristics of the auditor, audit client and work undertaken – for the degree of severity of the penalties imposed by the CVM in the 76 PAS rulings in the period 2000-2017. The empirical tests covered the examination of descriptive statistics, the correlation matrix and the estimates of the regression model.

On the basis of the descriptive statistics, it was found that most of the penalties involved the imposition of fines and/or suspension and cancellation of the register; the accused are individual auditors or legal entities (but not the *big four)* and are not repeat offenders, in proceedings instigated by the CVM; the audited clients involved in the proceedings are not listed companies and are not incorporated in the levels of corporate governance of the Stock Exchange; the breaches take place in the phases of execution (tests and giving evidence) and communication (reports) of the auditing; and the outcomes of the work which led to the proceedings are annual reports. It was also established that the opening time and judgment time of the PAS lasted for periods of 2 years 8 months and 2 years 10 months respectively.

With regard to the empirical tests carried out on the basis of estimates of the regression model (and aimed at determining the degree of severity of the penalties imposed by the CVM, the results showed the following: a) a positive relation when the accused auditor was a repeat offender (*AM2*); b) the auditing client in the judged case was a listed company in the B3 (*List*); c) the breach committed - the object of a regulatory examination occurred during the Client Acceptance phase (*F1*), the Execution of Work (*F3*) or Assessment and Communication (*F4*). On the other hand, negative relationships were found between the severity of the penalties imposed when: a) the auditing firm was one of the *big four* (*B4*); b) the audited company was involved in sectors of corporate governance (*CG*) of the Stock Exchange; c) the breach which was the case before the Proceedings had occurred in the Planning Phase (*F2*); the opening time (*TA*) and the judgment time (*TJ*) of the proceedings. The results also provide evidence that the auditor was either an individual auditor (*PF*) or a legal entity and the outcome of the work was an annual report (*RelA*) or something else that does not affect the kind of penalties imposed in the rulings of the proceedings.

The study is based on the importance of auditing in capital markets, since the failings of auditing threaten the trust and credibility of the work carried out by these professionals and have a direct impact on the operations of the markets. We believe the evidence obtained can make a research contribution to the literature in this field by highlighting the characteristics of the auditors, clients and work undertaken. It can also assist the economic agents, regulators and auditors themselves to take measures to improve the operations of independent auditors. The examination of the PAS can make it easier to understand all the key factors that are involved when ensuring a commitment of auditing to high standards.

With regard to the main limitation of this study, it must be emphasized that the PAS were examined from a subjective standpoint, including the characterization of the breaches that were cited and that this might involve a degree of bias in the researchers´ analysis.

In view of this, in future research there could be a cross-referencing of the results obtained in Brazil with those of other countries, with a view to noting the changes in the political and economic sphere and the extent to which the professional conduct of auditors affects the degree of severity of the penalties imposed on these professionals in the case of failings and breaches. In addition, it would be useful to establish a framework for understanding the behavioral aspects of auditors and audited companies which might be linked to the penalties imposed by the CVM.

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APPENDIX A

In the table A-1 are verification as infractions found in the sanctioned administrative processes initiated against auditors and auditing companies by CVM.

Table A-1: Infractions committed by auditors and audit firms **(2000 to 2017)**

Infractions Categories	Total	
	Qty.	%
Audit Phase 1: Customer Acceptance		
01 *Non-compliance with the rules regarding audit fees*	68	7,71%
02 *Irregular performance as an independent auditor and/or a specialist in the stock market*	20	2,27%
03 *Failure to comply with the audit rotation rule*	16	1,81%
04 *Violation of the rules on the principle of audit independence*	9	1,01%
Subtotal Phase 1	**113**	**12,81%**

Audit Phase 2: Planning			
05 *Insufficient and/or inadequate planning, work program and audit follow-up*		78	8,84%
	Subtotal Phase 2	**78**	**8,84%**
Audit Phase 3: Tests and Evidence - Execution			
06 *Audit performed in disagreement with the standards*		160	18,14%
07 *Insufficient and / or inadequate audit procedures and documentation*		140	15,87%
08 *Performing inept or fraudulent auditing*		60	6,80%
09 *Absence and/or inadequacy of the Management's Responsibility Letter and/or the Service Delivery Agreement*		48	5,44%
10 *Absence of technical and professional competence*		35	3,97%
	Subtotal Phase 3	**443**	**50,23%**
Audit Phase 4: Assessment and Communication			
11 *Insufficient and/or inadequate Report and/or Audit Report Issuance*		122	13,83%
12 *Absence of correct modification of opinion in the audit opinion*		94	10,66%
13 *Failure to keep audit documents for a period of 5 years*		17	1,93%
14 *Non-communication to CVM on the practice of events by Management that are at odds with the rules*		14	1,59%
15 *Non-issuance of the Audit Report*		1	0,12%
	Subtotal Phase 4	**258**	**28,12%**
Total		**882**	**100**

NOTES