

AUDIT CHALLENGES: DILEMMAS FOR THE AUDITOR IN A GLOBAL ECONOMY

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ABSTRACT

This paper is a market-informed analysis of the pressures that come to bear on the auditor of corporate accounts. It is argued that the integrity and independence of the auditor is a portion of the service quality which they bring to the exercise of providing an audit opinion. An economic model is then brought into play in order to illustrate how meeting public expectations, meeting the competitive environment, pleasing the client-company and fulfilling the appearance of independence with practice create pressures on the auditor to produce an 'opinion' that is less than independently-informed. The paper concludes with recommendations for action that may provide greater economic incentives for the auditor to conduct an ethical audit.

Keywords: audit, independence, competition, economics, public good, global

INTRODUCTION

What happens to the audit profession is economically and socially important. Where information assumptions under which free enterprise operates become threatened due to audit failure, the damage to markets and, more particularly to the individuals within them, can be devastating. If the opinion on which investors rely is not, itself, reliable then there is a cost to pay. Evidence of this comes in the form of the market retractions and increased regulation for auditors following on from public disclosures about management fraud. Such recent and sensational cases as Enron (US), HIH (Australia) and Parmalat (Italy) have brought this

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situation to light, but the phenomenon is certainly not a new one. It has to be asked, why are these audit failures so likely to occur?

Audit practice is often criticised because it is too 'competitive' an endeavour (e.g. see Mitchell, Sikka & Willmott, 1998; Zeff, 1992); yet the paradox for professions is that they are pressured into a competitive environment by the very forces which encourage them to serve the public good. While quite willing to 'regulate' them of late, no western-influenced government has offered to *fund* corporate audit despite audit's potential for contributing to a public and open market 'good'. This is probably understandable in political terms: It is difficult to envision the scenario in which an elected government offers millions or hundreds of millions of public tax dollars toward funding a professional practice, nor would it necessarily be a wise move. Private interest corporate and competitive agendas that currently influence auditors could be replaced by private interest political agendas, and at significant cost to the public purse. Firms have historically competed with other firms for audit and, more recently, for other types of assurance services. Private companies and lending institutions are the primary (and private) beneficiaries of this service; therefore, market-exposed audit practice is likely to continue.

Nonetheless, it is far from the theoretically-envisioned free market. The real challenge for auditors is to provide a private and contracted service which has also been translated by the courts as, effectively, a public good.¹ Courtroom judgements, in some cases, have tended to hold the auditor to a duty of care to a wide public (e.g. *Jeb Fasteners* 1981 in the U.S. and *Scott Group vs McFarlane* 1978 in New Zealand). How can the auditor serve both masters: public and private? And why do the occasional audit failures bring about such extreme market responses? It may be useful to consider how economic pressures come to bear on audit and why responses to them seem to be so extreme. The paper examines these points using an economic framework and closes with deducing as to the effect of audit market distortions and with recommendation as to how the problems that emerge may be usefully addressed.

AUDIT: AN ECONOMIC GOOD

Willekens, Steele and Miltz (1996) offer a tantalising argument for suggesting what could occur should economic incentives get in the way of the public interest. They use the practice of accounting standard-setting as their example,

¹ Seen to occur when, in case law such as *Esanda Finance vs Peat Marwick* 1997 in Australia, or *South Pacific Manufacturing vs NZ Security* 1992 in New Zealand, or *re Caparo PLC vs. Dickman* 1990 in the U.K. where third parties, if known to rely on the auditor's opinion, are owed a duty irrespective of their lack of contract with the auditor.

which until recently was almost exclusively within the realm of professional practice. They argue that producing standards that represent the lowest court-acceptable level of practice is not necessarily *ideal* in public interest terms. Nonetheless, and from the audit profession's perspective, keeping expectations down in the standards they set *is* economically rational. This is because setting higher accounting standards would, while potentially improving practice, obligate auditors to negligence lawsuits that are above and beyond current, and costly, expectations of their work.

Other audit practices can be assessed in a similar light. This is because the auditor is held to, and judged against, a similarly widely-publicised and yet internally conflicted range of expectations. They are expected to compete and contract for audit work while, at the same time, serve the public interest. So while aspects of audit and professional practice may appear to represent an un-professional approach to professional duties, an economics perspective sheds a different light on this pattern.

INDEPENDENCE AND INTEGRITY: AN ECONOMIC 'GOOD'

Most would accept that the auditor should exhibit the independence necessary to come to an objective decision as to whether financial statements (or other matter) is 'true and fair' and in accordance with accepted standards. The auditor should not be swayed by their own personal interests in determining what outcome will result, though such bias could potentially occur due to the economic relationships they enjoy with their own client-companies. These 'clients' are in a strong position to 'sway' the auditor's view simply because of their contractual relationship with them. If for example, the auditor is dependent upon the revenue provided by the client-company, they may be less inclined to come to an opinion that would render that company reluctant to enlist their services in the future. If their client-company has not paid the auditor's bill for services, if they have issued promissory notes in lieu, or if the audit services comprise a large portion of the auditor's revenue overall, then the auditor would have a natural inclination to avoid actions that threaten the losing the client-company relationship.

These competitive incentives place them in direct conflict with their obligations to the public however. The importance of applying integrity and independence into all they do is frequently argued for on the basis of a public good concept, where the audit 'opinion' is to be provided in the public interest:

A distinguishing mark of a profession is acceptance of its responsibility to the public....This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the

collective well-being of the community of people and institutions the professional accountant serves. A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. The standards of the accountancy profession are heavily determined by the public interest... (IFAC, 2000, May, para 9–10)

Yet, and in most nations where audit is a professionalized practice, auditors also have to bid and compete for their audit revenues against other similarly competitive firms. Competition is, of course, an important element in ensuring a 'free market' and efficient 'movement toward equilibrium' so expected in conventional economic circles (see for discussion Scott, Solomon & McGowan, 2001; Jayalakshmy, Seetharaman & Khong, 2005). In other words, and in economic terms alone, competition is a 'good thing'. This point is as illustrated in a standard supply-and-demand model in which the price of audit rises as further quality is incorporated into it (Figure 1, S1 being supply of audit quality, D1 being demand for it).

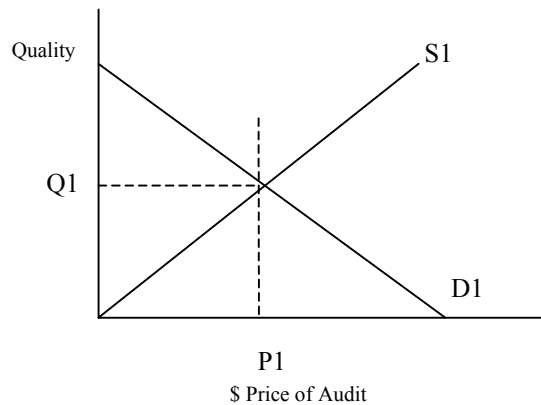


Figure 1. Supply-demand curve for audit quality

Competition will ultimately drive down the cost of audit to a point of equilibrium (P1, Figure 1) at which there is little money to be made and which satisfies the 'customer' (whoever that customer may be).

Audit price incorporates all elements of 'quality' including the cost of maintaining integrity and independence as well as the more tangible costs of staff training and overall management of the audit process. 'Integrity' and 'independence' are not cost-free however. There may be costs associated with sacrificing lucrative contracts due to the demands of independence, or of making unpopular decisions that ultimately have revenue implications when future services are not taken up. The equilibrium point (P1) comes into play therefore

where the supply of opinion 'quality' (including integrity and independence) (S1 in Figure 1) meets demand.

Competition, in theory, thus keeps quality up at a level needed to attract 'demand'; but there's a 'catch' here with respect to professional audit practice. The loss in 'quality' is not immediately apparent because it only exists if the auditor lets his or her related interest *affect* the quality of their work. Even then, it is only *apparent* in the event of company failure. Witness, for example, the timing of the criticism and outfall levied on New Zealand auditors when the excesses of an entire decade (the 1980s) were revealed: It took a major event (failure of 67 listed companies) and ten years to bring the costs of such negligence to their natural end. Then, finally, standards were added, court cases were raised or resolved. This lack of *apparent* audit quality failure lends a 'shadow' effect on the true costs of non-negligent audit. Furthermore, it is only likely to be revealed under certain traumatic and occasional episodes.

Where such *shadow* supply curve becomes more widely known, even should it exist in only one or two well-publicised examples, the effect upon the demand curve is likely to be swift and brutal. Witness, for example, the demise of Arthur Andersen, and earlier the failure of Laventhol and Horwath, when it was discovered that they were providing opinions that could not be justified. The court of public opinion was powerful in leading Andersen towards bankruptcy and, indeed, endangering the reputation of such other firms as to generate new legislation and rules in the form of the 2002 Sarbanes-Oxley Act (more on this is explained later). The demand for Andersen services became nil at any price. The following sections come to consider these circumstances and why they have such an effect.

PUBLIC EXPECTATIONS

'Quality' is in the eye of the beholder, and there are numerous beholders as to what is demanded from the audit service:

The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of professional accountants to maintain the orderly functioning of commerce. (IFAC, 2000, May, para 9)

Quality is demanded by a public, including all public securities markets, whether or not they are a direct party to the contract for assurance. That is, there is little point in having an 'audit' if, by paying less, you receive 'less than an

audit'. As is illustrated by the 'flat' D2 found in Figure 2, the public's demand curve may be unyielding to any price reductions. The public does not generally expect the 'price' of audit to affect the 'quality' of the audit opinion; they simply want a reliable opinion. (The public are not, of course, those who directly *pay* for audit, for if they were, price may be of greater interest.)

In addition to an unyielding demand curve, expectation gap studies indicate that, at least in some respects, the public may demand more 'quality' than the auditor can provide. That is, a public may have unrealistic expectations about what the auditor can do or find in their investigations (e.g. McEnroe & Martens, 2001). This would imply that D2 (Figure 2) is too simply high relative to what the auditor's capability which is represented by the solid portion of the S1 supply line.

There are a number of examples. Auditors may, for example, be expected to find *all* management fraud in the course of an audit. Senior management fraud is difficult to discover because, by its very nature, those who oversee the system and controls are also intentionally hiding some portion of it. The auditor cannot be expected to find all these instances and the courts have generally recognised this limitation even if the public has not always done so. As another example, it is probably unrealistic in today's global and complex organisations, to expect or be willing to pay for an audit that examines each and every transaction; nonetheless, this may be an expectation of some members of the public.

As a result, and due to an unyielding demand curve as well as some unrealistic expectations, the public's demand curve (at Q2 Figure 2) cannot always be met. T1 represents the degree to which such a public may be 'disappointed' even if the quality lies at efficient levels for contracting parties.

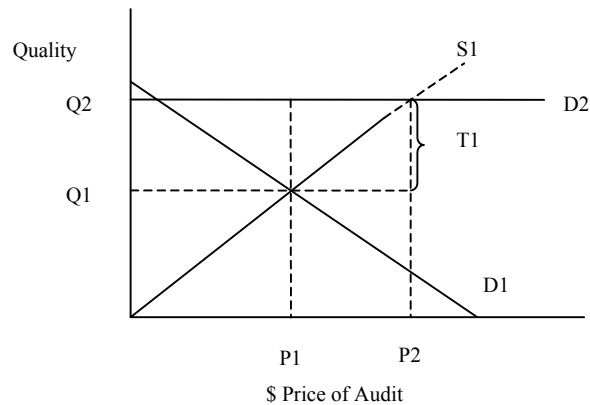


Figure 2. Public demand for audit

If a court upholds such a high and perhaps unrealistic position, and given the power of precedent, implications could be far-reaching. Potential and costly outfalls could include legislation that limits the audit profession's access to proprietary audit and the status benefits they enjoy from it (a move occurring now with PCAOB in the U.S. and elsewhere). There could occur an unlimited growth in the cost of audit fees to, increasingly, cover insurance costs for the inevitable lawsuits that would result from an assurance goal that can never be met.

Under the circumstances illustrated in Figure 2, and under such economic assumptions as are employed, money could be lost irrespective of whether audit 'negligence' (in the traditional sense) had occurred or not, simply on the basis of a difference in expectations between the user of audit opinion and its preparer. Evidence of this is often (controversially) touted by professions as a reason for limiting liability costs (e.g. Michaels & Parker, 2004) and some jurisdictions are starting to listen. For example, movements to limit the auditor's liability cap with sufficient insurance coverage, and certain limited partnership options are available to audit firms in the U.S. and in the U.K. (Reilly, 2004; Sidel, 2005). Whether this is a good move or not is yet to be seen and there will always be a cost: unlimited liability is that which ultimately holds the auditor to account and any weakening of that access to reparation may not only reduce unrealistic expectations, but they also may reduce recourse to legitimately-damaged consumers.

Arthur Andersen were only charged with having destroyed public evidence, not of the more serious negligence or fraud accusations to which they have been informally accused. Nonetheless, such dramatic response from the market indicates that the 'demand' for quality is not elastic and expectations of independence and integrity will not drop if the 'price' of audit is lowered; public demand is likely to be nonexistent in the face of any lowering in quality. If that public expectation of quality (Q2) exceeds market-efficient expectations of the corporate-buyer of audit services (Q1), the result may lend a sense of hopelessness on the part of the auditor perhaps as indicated by an exodus of firms taking on audit. This is certainly not how society or the market is likely to be best served.

AUDIT COST CUTTING CHOICES

It certainly cannot be suggested that either the public or the economy is served if the audit opinion becomes a 'rubber stamp' of approval. In terms of supply-and-demand, this is a *shadow* supply curve (S2, Figure 3), which represents the *real* service being provided by an auditor who is negligent in their duty in providing

an unbiased view. While the individual auditor may be able to gain short term rents from such an arrangement, and perhaps forever for that individual auditor, the quality of the service drops from Q1 to Q3 (Figure 3). This is not a good outcome in terms of the public (or stockholder's) good.

There is also money to be gained or lost due to the possibility that downward cost pressures will cause audit firms to respond by engaging in cutting corners to obtain audit or other types of more lucrative contracts. Evidence of 'lowballing'² suggests that this probably occurs now. As a result, auditors, while engaged in an audit, are in the tenuous position of being overly influenced by their dependence on *future* revenues from the client-company being audited *now*. Implications for pressures on the auditor to cut 'quality' are apparent and are represented by Q3 in Figure 3 should auditors cave in to such pressures. A new 'equilibrium' price forms (P3) and this then becomes the new 'standard' for audit pricing.

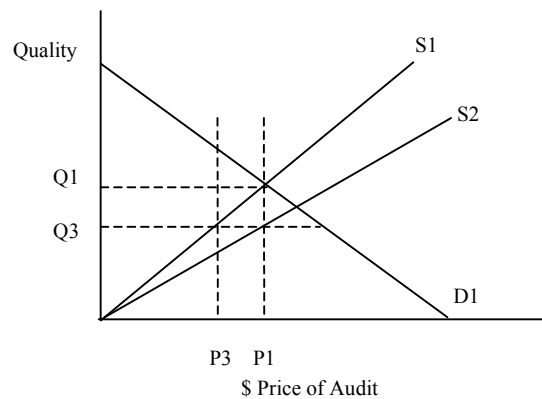


Figure 3. Effect of unethical audit pricing

This is a serious concern because even the most honest and upstanding audit firm partners will have a difficult time resisting pressures that call on them to drop down to the new (and negligent) equilibrium point. Unfortunately, unless a firm can make up the loss for conducting a quality audit in other ways, they will have to cut quality in order to meet this distortion in the competitive model.

PLEASING THE COMPANY

There will always be a problem if the party *paying* for the service is not also that party *demanding* the service. A company may not want, but are forced to pay,

² Bidding audits below cost in anticipation of future profits from other or future services.

for some elements of the auditor's quality service such as integrity and independence even if they do not want certain aspects of their governance revealed. A corrupt senior manager may not wish the auditor to reveal aspects of their stewardship to the corporate governing board. A 'quality' audit in the eyes of a (corrupt) corporate 'purchaser' of audit opinion may be a 'clean opinion' no matter what the circumstances may dictate. This creates a problem where the interests of the contracting party³ are in direct conflict with others to whom they also owe an obligation.

Many companies are forced to have an 'audit' under many requirements and regulations such as SEC regulations in the U.S. or statute in the U.K., Australia, New Zealand and elsewhere. Corporates and others simply have to *have* the audit in order to list on an exchange, to be seen credible and in order to obtain finance. As a result, they are perversely yet rationally motivated to exert pressure to *have* the audit but at the same time to encourage the auditor to reduce their *quality* for elements of the audit opinion with which they would rather dispense. That of value to the banker may not be of value to the CEO. We have then a shadow demand curve represented in Figure 4 by D3. This is the demand curve of the company for which 'integrity' and 'independence' is a liability and for which governing bodies and senior managers are almost certainly reluctant to pay.

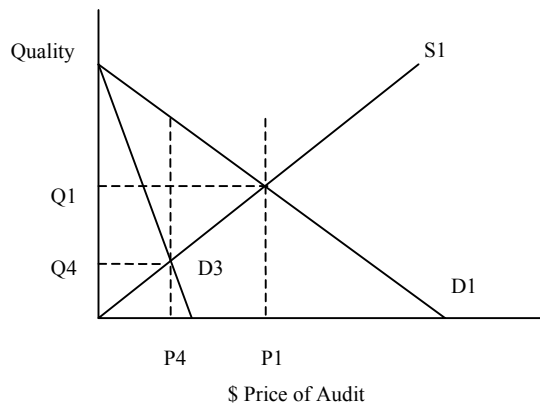


Figure 4. Private interest company demand curve

Given that the audit cost for an auditor who succumbs to such pressure gives them a lower equilibrium price at least over time and over a series of

³ Sometimes managers are effectively the 'contracting party' to the auditor where they hold strong influence over governance decisions, or where they have a weak board or where they have strong positions on the board itself. This is a common situation and is much critiqued in the management and governance literatures (e.g. see Rezaee, Olibe & Minnier, 2003)

engagements (at P4), then the auditor has no less than two sources of pressure by which they should reduce quality: pressure from their client and cost savings. The breakeven price may be reduced by making unethical but revenue-increasing decisions such as those involved in providing certain close consultancy services to clients that they later audit.

QUALITY: IS IT REAL?

At the same time, it is not only up to the professional to *be* independent and to enjoy integrity; but also to have the *appearance* of that independence.

Independence in appearance [is] the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised. (IFAC, 2000, May, para 12)

The fact that the *appearance* is distinguished from *actual* independence is important in economic terms because there are, in effect, two services which are being provided in rendering an audit opinion. The first, the *existence* of independence, is the best assurance against an inappropriate opinion being rendered. The second is an *impression* which may be important towards retaining calm in the markets. Ideally, the two situations – *actual* and *appearance* – overlap because the public would act upon a level of quality which conforms with that which it represents.

If there is incomplete overlap however, market distortions are likely to occur. Assumptions that the auditor *is* independent, if refuted by facts that indicate otherwise, are likely to be traumatically received (represented by T2 in Figure 5). The New York Stock Exchange dropped within a few days after information about Enron emerged. Similar retractions occurred on Australian Stock Exchange upon disclosure of the HIH insurance problems. This indicates the presence of yet another shadow supply curve (S3 in Figure 5) representing an *actual* level of independence which lies below its *appearance*. This could occur if the auditor(s) are negligent or if the standards and oversight are simply not up to the task of maintaining that level of quality. The reverse could be true as well; S3 could represent an *appearance* below the *actual*. In this case the value of the auditor's opinion will be undervalued and it may be that auditors will be hard-pressed to charge for the true value of that provided.

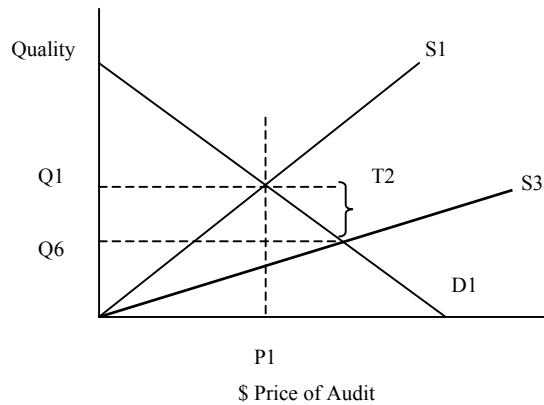


Figure 5. Independence supply: appearance not equal to actual

Therefore, either distortion can create market effects, albeit quite different ones. The danger of undervaluation is that auditors may succumb to pressures to adjust their audit 'price' to a lower level of quality than they are applying, and that they should apply, to their work. If it is overvalued then audits are overpriced and a public discovery of the difference would lead to market reactions. A consistent undervaluation or overvaluation of the auditor's integrity and independence is a type of market distortion that is difficult, but important, to avoid.

The market does not know of this shadow curve, of course, unless it is dramatically revealed to exist in such headline-grabbing discoveries such as a massive company failure and management fraud which was not anticipated by an audit firm which was 'too close' to its clients.

EFFECTS OF AN UNHAPPY MARKET

At the point at which any of the major players – shareholders, potential shareholders, bankers, company employees and other stakeholders, third party financiers, managers, company directors and board members – become surprised and subsequently dissatisfied with the quality of the audit, and for any of the reasons suggested by the previous analysis, there may be a significant 'price' to pay. That is, where expectations of the audit opinion do not, for one reason or another, match practice, then the demand for audit, or at least the type of audit or the professional body offering that audit, is likely to fall quickly and dramatically.

This may be occurring now. Professional bodies are threatened by moves to reduce their authority over audit and their own practice. The Sarbanes-Oxley Act 2002 in the U.S. is the most well-known of these; and among its painful prescriptions is the tacit removal of standard-setting rights from the profession to a government committee (Public Company Accounting Oversight Board or PCAOB). With its newly-constituted regulatory authority, the U.S. accounting profession has far less room to claim its pre-eminent professional position. In Australia, the government-commissioned Ramsay Report 2001 was the one of the first responses to scandals involving insurance company failure HIH. Its recommendations were ultimately incorporated into the Audit Reform and Disclosure Act 2004 which reconstituted its standard setting body more independent of the profession. Canada's Institute (CICA) has had to respond to events in the U.S. and elsewhere and has now a standard setting body dominated by non-professional members. The U.K. profession, the Institute of Chartered Accountants in England and Wales (ICAEW), is moving in this direction under pressure from government's Department of Trade and Industry (DTI). New Zealand's attorney general, Margaret Wilson, has proposed separating standard setting from the profession in 2005. Overall, these are strong messages delivered reasonably consistently over a variety of global regulatory and economic environments.

These events are not random and, at least in terms of a bureaucratic pace, they have occurred within a short time frame. The impact on the auditor's 'trading' value as an independent agent has been scorched by this small number, but dramatically significant, instances of audit failure. The impact is of course on those who make financial decisions based on the credibility of the audited reports, and on the professions and the people they employ. 'Audit' is not about to disappear, there is a need for it in any open and accountable society; what can 'disappear' however is the potential by which a particular 'profession' may be seen to represent it.

CONCLUSION

Audit may thus be subject to a far more dramatic market swings than their conservative image might suggest. Equally, the expectation of the public and the public's view of the auditor may vary greatly within a relatively short period of time from complete reliance to total distrust. This paper has suggested that there is a *market* explanation for these extremes. While market rationales do not excuse instances of auditor negligence, they may go some way towards explaining why the industry is so susceptible to such events.

In the absence of radical moves to publicly-fund corporate audit, what can be done? Improved audit committee strength would go some way towards ensuring that internal conflicts (between managers and the board) are reduced. Around the globe a focus on governance and independent boards may be helping to bring about this change now. Active public scrutiny by shareholders or their representatives (e.g. insurance companies, fund managers), might help by participating in annual meetings and proxies. Courts and an informed judiciary are also important in the complex business and professional context; though this may be difficult to achieve in the smaller jurisdictions where judges are called upon to have a wide breadth, but not necessarily depth, of knowledge (e.g. see Pickens, 2003).

Real and serious audit oversight of professionals *by* professionals would also go some way towards ensuring that the competitive pressures on the auditor are, at least, balanced by professional pressures on the auditor to conform to ethical practices. There may be significant room for improvement in this matter. For example, *The Australian* (Anonymous, 2005) recently criticised the Institute of Chartered Accountants of Australia (ICAA) for their failure to come down hard on poor member behaviour. They report that the ICAA's Professional Conduct Tribunal rarely imposes its greatest sanction (membership ban for life) and in 2004 there was only one such sanction, and one in 2003; there were six (temporary) suspensions in 2004 and nine in 2003. Fines were low at only A\$13000 total for three cases in 2004 and A\$17,500 for 11 cases in 2003. These are not strong messages to an industry that earns millions annually and on which the reliability of market figures depend. It is suspected that other professions may not be far behind.

It would seem that the ethical professionals can be caught by their positioning in the middle of conflicts, and a market volatility, that are difficult to address on an individual or even individual firm level. It would seem that unless there are reliable structures in place to ensure that the interests of the public are as well represented as the interests of the market, there will continue to be a heavy price to pay for failing to provide the right environment for ethical audit.

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