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**The Auditor's Dilemma:  
An Economic Perspective On An  
Old Problem**

by

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**THE AUDITOR'S DILEMMA:  
AN ECONOMIC PERSPECTIVE ON AN OLD PROBLEM**

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**Abstract**

This paper analyses the pressures that come to bear on the financial 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 that may provide greater incentives for the auditor to conduct an ethical audit.

## **THE AUDITOR'S DILEMMA: AN ECONOMIC PERSPECTIVE ON AN OLD PROBLEM**

### **1.0 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 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 (U.S.), HIH (Australia) and Parmalat (Italy) have brought this 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 and 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. This is not likely 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<sup>1</sup>. 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 v 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 responses in the market and, via regulation, via society? It may be useful therefore to examine 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.

## **2.0 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, 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 practise, 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 a broader 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.

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<sup>1</sup> Seen to occur when, in case law such as *Esanda Finance v Peat Marwick* 1997 in Australia, or *South Pacific Manufacturing v NZ Security* 1992 in New Zealand, or *re Caparo PLC v 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.

### **3.0 INDEPENDENCE AND INTEGRITY: AN ECONOMIC ‘GOOD’**

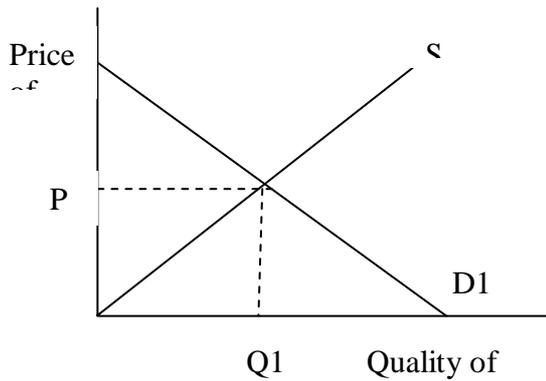
Most would accept that the auditor should exhibit the independence necessary to come to an objective decision as to whether financial statements (or other matter) is ‘true and fair’ and in accordance with accepted standards. The auditor should not be swayed by their own personal interests in determining 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 actions 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 Jayalakshmy, Seetharaman and Khong, 2005). In other words, and in economic terms alone, competition is a ‘good thing’. This basic point is as illustrated in standard supply - and-demand models in which the price (and cost) of audit rises as further quality is incorporated into it (Figure I).

**Figure I: Supply-Demand Curve for Audit Quality**



The impact of competition is that it will ultimately drive down the cost of audit to a point of equilibrium ( $P_1$ ) at a 'normal' profit (integrated into the equilibrium price at  $Q_1$ ) and which satisfies the 'customer' (whoever that customer is). 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. 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 ( $P_1$ ) comes into play therefore where the supply of opinion 'quality' (including integrity and independence) 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 80s) 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. The following sections come to consider these circumstances and why they have such an effect.

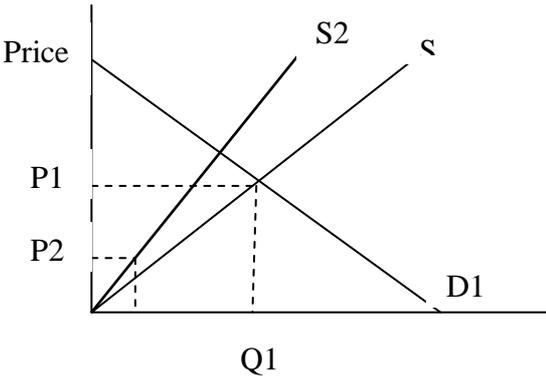
**4.0 PLEASING THE PUBLIC**

‘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).

As recent court cases have painfully demonstrated, 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. 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 II), which represents the *real* service being provided by an auditor who is neglect 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 Q2. This is not a good outcome in terms of the public (or stockholder!) good.

**Figure II: ‘Shadow’ Supply Curve if Independence/ Integrity Reduced**



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 toward bankruptcy and, indeed, endangering the reputation of such other firms as to generate new

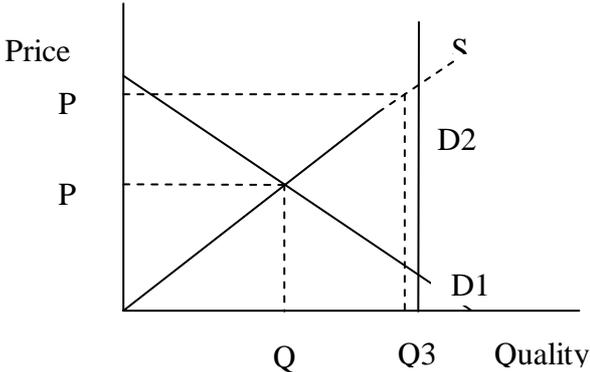
legislation and rules in the form of the 2002 Sarbanes-Oxley Act (more on this later!). The demand for Andersen services became nil at any price.

**5.0 PUBLIC EXPECTATIONS**

Quality is demanded by a public, including all public securities markets, even though they are not direct party to the contract. As is illustrated by Figure III (D2) however, the public’s demand ‘curve’ may be unyielding and high at any cost. Expectation gap studies indicate that, at least in some respects, they may also be unrealistic (e.g. McEnroe and Martens, 2001). For example, auditors may 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 what they are there to protect. 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, the public’s demand curve may not only be high (D2), but it simply may be above what the auditor can reasonably do (represented by the dotted line on S1). Cost-inconsiderate and potentially unrealistic expectations can be pictured as in Figure III.

**Figure III: Public Demand for Audit**



Thus, such a public may be ‘disappointed’ even if the quality lies at efficient levels for contracting parties. 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 exceptional 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 III, 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 maker. Evidence of this is often (controversially) touted by professions as a reason for limiting liability costs (e.g. Michaels and 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 elastic. Expectations of independence and integrity are critical. Public demand is likely to be nonexistent in the face of any lowering in quality. If that public expectation of quality (Q3) 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.

## **6.0 MEETING THE COMPETITIVE ENVIRONMENT**

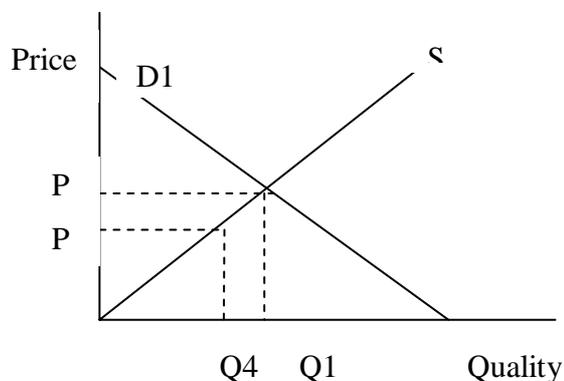
There is also money to be gained or lost due to the possibility that downward cost pressures will cause audit firms to respond by engaging in cutting corners to obtain audit or other types of more lucrative contracts. Evidence of ‘lowballing’<sup>2</sup> suggests that this probably occurs now. As a result, 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

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<sup>2</sup> Bidding audits below cost in anticipation of future profits from other or future services.

now. Implications for pressures on ‘quality’ are represented in Figure IV should auditors cave in to such influence. A new ‘equilibrium’ price forms (P4) and this then becomes the new ‘standard’ for audit pricing.

**Figure IV: 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.

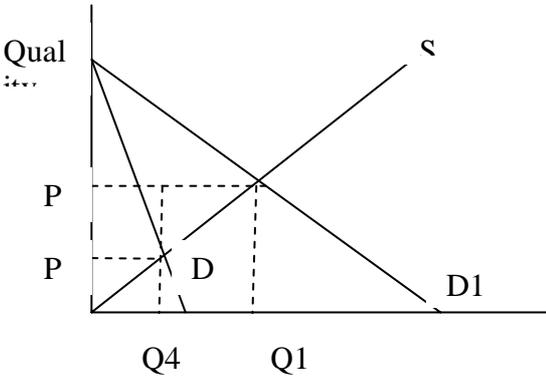
## 7.0 PLEASING THE BOARD

There will always be a problem if the party *paying* for the service is not also that party *demanding* the service. Taken from the client-company’s perspective, they may not want, but are forced to pay, for some elements of the auditor’s quality service such as integrity and independence. From the senior manager’s point of view, they may not wish the auditor to reveal aspects of their management actions which may not appeal to the corporate governing board. Alternatively, the governing boards may not wish the auditor to enforce a compliance with accounting standards, such as a revaluation down of assets, that would discourage future investors. In either case, a problem exists where the interests of the contracting party<sup>3</sup> are in direct conflict with others to whom they also owe an obligation.

<sup>3</sup> 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 and Minnier, 2003)

Nonetheless, these 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 V by D3. This is the demand curve of the company for which ‘integrity’ and ‘independence’ is a liability and for which they are almost certainly reluctant to pay.

**Figure V: 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 engagements (at P5, 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 some consultancy services to clients that they later audit.

**8.0 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 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,

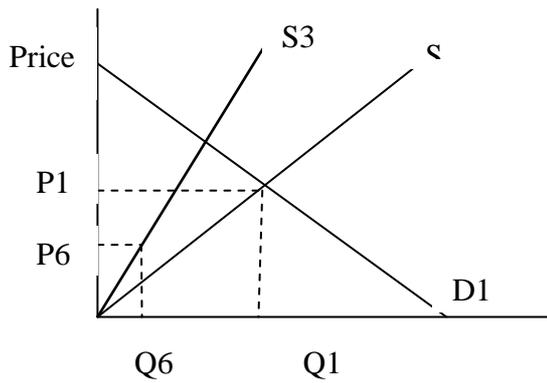
integrity, objectivity or professional scepticism had been compromised.  
(IFAC, 2000 May, p. 12).

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 toward 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. 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 VI) 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* of quality which is 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.

Either distortion can create market effects therefore, 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 (P6), and that they should apply, to their work. If audit quality is overvalued in the market (and S3 represents *actual* quality) then audits are overpriced and a public discovery of the difference would lead to market reactions at the poor quality (Q6) provided. 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.

**Figure VI: Shadow Supply: Independence Appearance ≠ Actual**

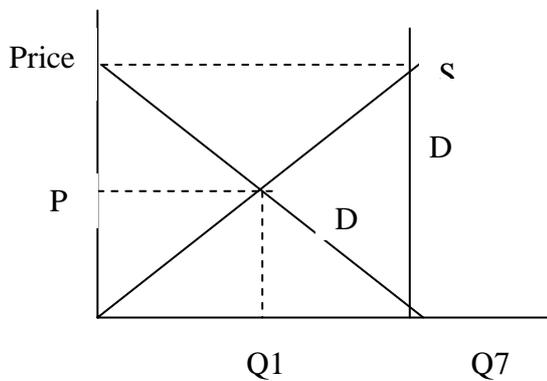


The market does not know of this shadow curve, of course, unless it is dramatically revealed to exist in such headline-grabbing discoveries such as a massive company failure and management fraud which was not anticipated an audit firm which was ‘too close’ to its clients.

**9.0 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 (indicated by where the demand curve D4 crosses S1 in Figure VII) if there’s any demand (for that particular audit provider) at all.

**Figure VII: An Effect of Disappointed Markets**



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 in 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.

## **10.0 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 toward 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 toward 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 this about 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 toward 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* (4 August 2005, p. 11) 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 \$13000 total for three cases in 2004 and \$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. I suspect other professions may not be far behind.

It would seem that the ethical professional 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, that there will continue to be a heavy price to pay for failing to provide the right environment for ethical audit.

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