Audit Failure and the Crisis of Auditing

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Abstract

Legislators have been using audit and financial crises as excuses to introduce additional regulation into an industry that is already over-regulated. This practice is questioned here because of the ability of the free market to punish audit failures, the dynamism shown by participants in relation to the voluntary adoption of new self-regulatory policies and the high costs and dubious effectiveness of the new regulations adopted. A more prudent approach that would give the market time to discover the efficient mix of services, quality safeguards and firm structures is advised. Current regulatory tendencies, the main element of which is mandatory auditing, risk condemning financial auditing to triviality and increasingly ineffective regulation.

Keywords: auditing, regulation, non-audit services, auditor rotation, crisis.

I. Audit failure and regulation

Auditing has changed greatly in recent decades, and these changes aggravate the difficulties usually faced by legislators in weighing the costs and benefits of regulation. More than ever, legislators should therefore give the market time to develop more efficient guarantees and find out by trial and error which systems and products are the most valuable. Instead of showing patience, however, legislators are keen to use audit and financial crises as excuses to introduce additional regulation into an industry that is already over-regulated.

The ability of the market to punish audit failures and the dynamism shown by the market in the Andersen case confirm this. Soon after the Enron bankruptcy, not only did Andersen's partners and employees suffer heavy losses, but new policies were also adopted voluntarily by all kinds of players. Many companies replaced their auditors, and some disallowed the purchase of non-audit services from them. Some institutional investors also promoted more active involvement of shareholders' meetings in controlling external auditors. Audit firms themselves were soon busy separating activities and, perhaps more importantly, they changed their incentives in order to reinforce mutual control among partners and avoid negative externalities between their different offices and divisions. Many firms also improved their internal controls, for instance by speeding up the rotation of audit partners.

This voluntary adoption of measures by audit firms throws light on the natural process of searching for and adopting better solutions in a changing environment. Thanks to the crisis, participants in the industry know more about possible solutions and where to apply them. Both the punishment some of them received for wrongdoing and the changes being applied indicate that the market is actively regulating itself.

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As markets are based on freedom, it is inevitable that there will be bankruptcies and even fraud. But the fact that such crises exist should not be a cause for concern. Rather, we should look at the link between causes and consequences, making sure only that the penalties inflicted on those responsible are proportionate to their behaviour.

If governments want the market to perform well, they should resist the temptations of populism that emerge in most crises. They should, instead, appreciate better how crises can punish mistakes, how they expose the real costs and benefits of new business policies, and how they promote the adoption of new strategies and quality safeguards. Far from being a problem, most crises make it *unnecessary* to intervene in the market. When this is forgotten, the field lies open for private interests to use the crises to their own benefit.

Nevertheless, recent financial fiascos have triggered a profusion of interventions in what seems to be the weakest link – the auditing industry – even though other sectors of financial markets may have had the same or more responsibility.[1] The most sweeping reform to date was introduced in the United States. The Sarbanes-Oxley Act of 2002, enacted by the US Congress on 30 July 2002, reformed US accounting rules and put in place a new regulatory body, the Public Company Accounting Oversight Board (PCAOB), which is independent of audit firms.

The total compliance cost of the Sarbanes-Oxley Act has been estimated at $7 billion a year for listed companies only. The cost of complying with one of its provisions, Section 404, which requires managers to organise and assess internal control systems and auditors to assess their effectiveness, has been estimated at 1 per cent of firms' earnings. As a consequence of assisting clients in complying with the Act, fees reported by the audit firms grew by 25 to 33 per cent and were expected to rise by an additional 35 per cent by mid-2004, when the requirement for firms' assessment of their own internal control became effective.[2]

II. The proposed European regulation

On 16 March 2004, following in the hasty footsteps of the United States, the European Commission proposed a tougher, revised Directive on statutory audit in the European Union to combat corporate fraud and auditors' malpractice and to prevent further scandals such as those at Enron, Ahold and Parmalat.

This proposed Directive contains new rules on how Member States regulate auditors and how they should allow auditors to conduct their business. It mandates each Member State to create an independent body to oversee the audit profession, which would be governed mainly by non-practitioners, and establish an effective system of investigations and sanctions. The proposed Directive also rules that audit firms be regulated by authorities in the Member State where they are established – 'home country control' – and sets procedures for the exchange of information among oversight bodies in the different Member States. In addition, auditors would be banned from being involved in management decisions taken by client companies, and all companies listed on the stock market would have to establish independent audit committees which would recommend an auditor for shareholder approval. Finally, Member

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1 See Demski (2003).

2 For a detailed analysis of these and other consequences of the Act, see Koehn and Vecchio (2004). In its report on competition in the accounting profession, the US General Accounting Office (2003) concluded that the largest firms had the potential to exercise market power but found no direct correlation between recent consolidation and such things as client choice, audit fees, audit quality and auditor independence.

States would have to introduce a rule for the rotation of audit firms every seven years or, alternatively, the rotation of audit partners every five years.

III. Three pillars of auditing

In previous works (Arruñada 1999a, 2000), I have argued that audit regulation should consider three basic characteristics of auditing: professional judgment, the specific nature of audit quality and the existence and effectiveness of private quality-assurance techniques.

Professional judgment means that auditors use information that is unverifiable or costly for third parties to verify when deciding on an audit report. As a consequence, verification capabilities determine which approach regulators should follow. If they think that the market is able to verify and sanction a broader set of performance variables than regulators or judges, then regulation should be market-friendly, meaning that it should aim to facilitate market sanctions in the case of auditor failure, instead of substituting such market sanctions with regulatory or judicial sanctions. Otherwise, regulation risks inducing so-called 'defensive auditing', with auditors using only *hard* – i.e. easily verifiable – evidence to support their opinions, with the end result that audits become trivial.

The second important consideration for regulating audit quality is that clients are mainly harmed not when their own audit is of low quality but when some other client of the same auditing firm unexpectedly fails, without proper warning from its auditor. Therefore, clients have very strong incentives to monitor, evaluate and invest in their audit firms' quality. Meaningful regulation should therefore focus on helping this monitoring process by providing useful information. This could make it advisable to impose mandatory disclosure duties on audit firms if private incentives in this regard are insufficient because of problems of collective action between or within audit firms.

The third element to consider is that audit firms use diverse mechanisms to safeguard quality, such as reputation and 'specific' assets, which are valuable only in relation to a given use. These mechanisms involve different implementation costs and will be adapted to different situations and clients. Regulation should therefore take into account how these mechanisms work in order not to hinder the use of low-cost safeguards such as quasi-rents or 'brand-stretching' related, for example, to non-audit services. Moreover, regulation should allow some discretion in order for firms and clients to choose an efficient mix of safeguards.

I am afraid that the proposed revision of the Audit Directive performs poorly according to these criteria. It certainly does not fall into the trap of naïve interventionism of the sort that would condemn auditing to a costly state of triviality, but it goes several steps in that direction. Let us consider some specific comments on non-audit services, auditor rotation and mandatory auditing.

IV. Non-audit services

The proposed Directive stops short of separating auditors from consultancy work, despite protests that their linkage compromises auditor independence. However, the *Wouters* ruling of the European Court of Justice,[3] by which national law can forbid lawyers from working with auditors, in order to protect the proper practices of the legal profession, has been followed by a different proposal for a Directive on professional services in the internal market (COM (2004) 2).

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[3] ECJ, Case C-309/99 *Wouters* [2002] *ECR* 1-1577.

Since the early days of their profession, financial auditors, either alone or together with other professionals working for the same firm or within the same network of separate firms, have provided a whole array of non-audit services to their audit clients. These services include bookkeeping, development of accounting systems, tax consulting, executive recruitment, management and financial advisory services, legal help and corporate recovery, etc.

In previous works that examine these effects in detail (Arruñada 1999a and 199b), I concluded that the provision of such non-audit services reduces total costs, increases technical competence and motivates more intense competition. Furthermore, it does not necessarily damage auditor independence nor the quality of non-audit services. Prohibitions are therefore misguided.

Cost savings arise from knowledge spillovers: the fact that audit and service provision share information both as a product and as a process. Similarly, economies of scope of a *contractual* nature are reached when the same private safeguards can be used to guarantee the quality of both audit and non-audit services.

A second effect relates to competition in the audit market. Applying standard industrial organisation analysis shows that the provision of non-audit services is unlikely to harm competition in the audit market. There is, however, a risk of confusing observations, mainly because cost savings will cause price reductions in both markets and at each stage (initial or subsequent engagements), depending on specific competitive conditions. Also, in this industry, regulators and practitioners continue to see the pricing of initial engagements below cost – what is usually called 'introductory pricing' or 'low-balling' – as a bad practice instead of seeing it as a mere symptom of healthy competition. However, prohibiting low-balling would be equivalent, and of equally anti-consumer nature, to preventing cellular phone companies from giving away telephones to their new subscribers.

The third effect is on competition in the markets for non-audit services. This is probably the most clearly beneficial effect. Quality arguments do not hold here because clients are well informed about the eventual prejudicial effects of joint production. It is, therefore, an issue for the market to decide. It is also an area where private interests have been very active in using audit independence as an excuse for avoiding competition from audit firms.

On the basis of this analysis of the consequences of non-audit services, auditors should be allowed to provide all kinds of services and/or to self-regulate this provision. Regulation, if any, should focus on *client diversification* and help the market to act as the main disciplinary agent. Furthermore, given that the variability of non-audit service fees is higher than that of audit fees, regulators might try to facilitate the role of the market when evaluating the incentives of audit firms. For this purpose, mandatory disclosure of fee income diversification is sufficient. Disclosure of the maximum concentration reached with the best client would provide similar benefits without the more substantial costs involved in full disclosure of fees.

V. Auditor rotation

The proposed Directive will compel Member States to introduce the mandatory rotation of audit firms every seven years or, alternatively, the less costly rotation of audit partners every five years.

Mandatory audit firm rotation increases costs and substantially reduces quality.[4] It makes audits more costly because it increases production costs and reduces competition in the marketplace. The increase in costs derives from the fact that a substantial amount of specific

4 For a detailed analysis of auditor rotation, see Arruñada and Paz-Ares (1997).

assets – connected most visibly, but neither exclusively nor fundamentally, to initial audits – is destroyed and must to a large extent be rebuilt with each rotation. Additionally, firm rotation also drastically alters the pattern of competition in the auditing industry. It directly creates a system of turns and, in short, an artificial division of the market, which may favour collusion among auditing firms. More importantly, it also reduces the incentive to invest and compete because firms that manage to excel find themselves obliged to relinquish their achievements periodically.

Furthermore, audit firm rotation probably damages the two main determinants of quality. The auditor's *technical competence* – i.e. its ability to detect irregularities in the financial statements – is hampered by the greater number of initial audits and the lesser degree of specialisation. Mandatory rotation might also harm the auditor's *independence* – its willingness to disclose in its report any irregularities its might have detected. Even if the rule reduces the cost to the auditor of reporting and thus of being independent, it also probably reduces the expected cost of not reporting and becoming dependent. This is because the rule does not substantially modify the transaction costs of collusion and probably reduces both the probability of detecting non-reporting auditors and the amount of sanctions associated with such detected non-reporting.

VI. The real crisis of auditing: is mandatory auditing necessary?

Rather than setting out on new regulatory adventures that would just place yet more restrictions on auditing work, governments should review some of the existing regulations which, in my opinion, are the real culprits of the current situation. The most harmful of these regulations is perhaps the one that obliges large firms or listed companies to audit their accounts, as mandated by several Directives.[5] Let us see why.

Voluntary demand for external auditing is directly related to the fact that it is the directors or management that prepare the accounting information. This leading role of the agent or 'party to be monitored' in producing the information used to monitor its own conduct is based on cost reasons – a large proportion of such accounting information is used internally (and this is perhaps its primary function) in decision making and internal control by management itself. In this context, the need arises for an external verification mechanism which to some extent ensures the reliability of, and reinforces confidence in, such accounting information.[6] The auditor examines the accounts in order to verify that they meet a series of requirements and give an assurance thereof to third parties backed up by the guarantee of its reputation. From this point of view, it can be considered that the client acquires or hires the reputation of the auditor in order to improve its contractual opportunities.

When an audit is obligatory, all users – real as well as expected – try to bend it to their own needs. In addition to imposing contradictory demands, these multiple principals naturally end up asking too much, as is often the case when services are not paid for. It is hardly surprising that auditing has become trivial, to the extent that accounts are sometimes just a compendium of subjective estimates and formalities, triggering a substantial 'expectations gap'.

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5 Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies; Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts; Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions; and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings.

6 This view of auditing is derived from Jensen and Meckling (1976: 338-339).

Moreover, especially in Europe, there is a confusing mix of interests. An increasingly wide range of stakeholders – from regulators to tax collectors and employees – all try to influence auditors' activity indirectly or through policies or regulations. The presence of these potentially opposing interests incurs the unnecessary risk that the audit will lose value in its contractual function. This is unnecessary, because such stakeholders are able to arrange or negotiate their own specialist audit, if they have not already done so, as with banking and tax inspections.

Attempts have been made to justify mandatory audits through the existence of externalities, but these are unlikely in firms that do not trade on the stock market. The effects of business activities on clients, suppliers, workers, the treasury and other agents can be negotiated, so they cannot justify mandatory audits. The presence of externalities is even questionable for most quoted companies and, where external effects do seem to exist (e.g. when financial intermediaries are involved), specific mechanisms, including specialised impartial official auditing, are already in place to prevent them. When regulators of these industries demand omniscient external audits, they are just casting doubt on their own efficacy. To put it plainly, taxpayers should question the very *raison d'être* and effectiveness of such regulators.

The most logical remedy is to limit the audit obligation to the companies for which it exists and where there may be a real social demand for information, that is to say, listed companies or those that receive public savings, provided that the audit is more efficient than direct auditing by the regulator. For other companies, in view of the likely absence of external effects, auditing and financial disclosure should be voluntary, so that demand by the contracting parties (suppliers, creditors or employees) will lead firms to audit and disclose financial data only when this is useful for facilitating such contractual relationships and when it does not damage their competitive strategies. This would allow innovation in financial information in line with real user demand.

Voluntary demand for auditing has historically been weak in continental Europe and Japan, but it is doubtful whether it would also be weak now on the hypothetical basis of non-mandatory auditing legislation, because circumstances have changed radically. Low historical demand was probably due to traditional features of continental financial systems, such as weak competition, close links between banking and industry and cross-shareholdings. It is plausible that, as these circumstances changed, there may have been growing demand for safeguarding services. Moreover, in the years prior to mandatory auditing, a substantial increase could be seen in demand among large companies for auditing services which, at that time, were largely voluntary and probably based more on a desire to provide positive solvency signals than to insure against future contractual hazards.

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