Auditors and the Firm

Auditors contribute their services to the firm in exchange for a fee. Therefore, we can think of auditors as agents who seek their own goals through participation in the organization. There is, however, a difference. Resource contributions of other agents enter into an organization's production function, while auditors' contributions are necessary only when the organization takes specific forms. The audit function in a proprietor-run grocery store is quite different from that in a chain store, even though the production function of the two is similar. Auditors play an important role in defining, operating, and enforcing the contract set of the firm.

A managerial or performance audit of publicly held firms can expand the scope of an audit beyond the accuracy and fairness of accounting reports. In private-good organizations it is possible to design contracts for the managers in such a way that the operational and internal audit functions can be entrusted to the managers themselves. For reasons we discuss in Chapter 13, it is not efficient to entrust operational audits to the supervision of managers in public-good organizations. In this chapter we concentrate attention on external auditing.

Neither the measurement and reporting of the auditor’s resource contribution to the firm nor the determination of the audit fee can be entrusted to the accounting system of the firm. The auditors’ primary contribution to the firm is verification of the system. The determination of their entitlement on the basis of the firm’s accounting system would create a moral hazard. Therefore, monitoring their input is carried out at a higher level, through peer reviews within the auditing community, enforcement actions by the Securities and Exchange Commission (SEC) and, ultimately, through the courts. We return to the regulation of auditing in a later section of this chapter and in Chapter 12.

Audit fees are negotiated between an auditor and a committee of the nonmanager members of the board of directors, outside the accounting system. The firm's accounting system records, but does not determine, the audit fees.
The input of auditors is not monitored by other agents in the client firm. In exchange for a negotiated audit fee, auditors accept certain responsibilities for the veracity of financial statements and disclosures. The auditors' obligation is determined and enforced by law and not by the contracts specifically negotiated for the firm. Thus, auditors have a vital interest in the laws that detail how much responsibility they bear for the accuracy of financial statements. Allocating the fees received from the client among profit, verification efforts, and the development and application of audit technology is the range of auditor decision making.

Auditors form partnerships to marshall sufficient audit resources to meet the demands of their larger clients. The structure of the audit firm can be understood by modeling it as a set of contracts among individual agents and by examining the problems of measuring resource inputs, entitlements, and the performance evaluation of auditors and their staffs. Alchian and Demsetz provide an interesting economic analysis of professional partnerships as a form of business organization.\(^1\) We touch on some issues of audit firm organization in a later section of this chapter. For simplicity, and to retain the focus of this book on the client firm, we treat the auditor as an individual and not as a multiagent organization. We start by analyzing the economic functions of the audit in the firm, followed by an analysis of the various decisions that auditors make.

The Function of the Audit in the Firm

Why hire an auditor? If firms were technological black boxes consuming inputs and producing outputs by a fixed and specified production technology, the involvement of auditors, who contribute no tangible goods or services to the black box, would be parasitic. Perhaps our socioeconomic-political system has inflicted the dead-weight loss of auditing on itself. After all, many aspects of external auditing in the United States and elsewhere are governed by laws and regulations issued by governmental agencies.

Perhaps, but not likely. External auditing not only predates the U.S. socioeconomic-political system, it is coextensive in other societies. Many forms of auditing (e.g., internal auditing and quality control) exist without any significant government role.\(^2\) It is incorrect to think of all external auditing as a creature of government regulation. On the contrary, such regulation arises as a societal response to the public-good aspects of external auditing. Abandoning the mechanistic model of the firm, we seek to understand how auditing as a service can add to the size of the organization's pie of resources.

When two agents act without sharing all information, and their acts affect each other, they are usually unable to generate as large a "resource pie" as they could if the information had been shared. This larger pie is called the "first-best" solution. The shortfall relative to the first-best solution is referred to as agency cost. Agency cost arises under uncertainty, not because agents act suboptimally relative to their information, preferences, and opportunities, but simply because two sepa-
rate, rational individuals, working independently in the best way they can, still cannot achieve a total output as large as could be attained if all resources, actions, and information were endowed in a single individual. Agency costs are truly the cost of organizing. The economic role of auditing is to reduce agency costs.

Why could two or more individuals not act as one, and eliminate the agency cost? To act as one, their preferences must be combined to eliminate a clash of interests. The elimination of ego is a precondition for sharing information in such a manner that each agent, and the group as a whole, acts as if it had all the information. With less-than-perfect elimination of ego, the sharing of information cannot be perfect either. Residual selfish motives leave open the possibility that the “information” shared by the individuals is incomplete or even incorrect. We cannot overestimate the difficulties of completely eliminating agency costs. Small, kinship-based groups can achieve this substantial elimination of ego under environments hostile to the group as a whole. To this day, many specialist firms at the nerve center of that bastion of commercial culture, the New York Stock Exchange, are run by kinship groups.

There are two hurdles to engaging an auditor. First, the reduction in agency cost must be at least as large as the compensation necessary to persuade the auditor to do the work. Only when agency costs become large, due to the difficulties of direct mutual monitoring (e.g., in shareholder-manager, borrower-lender, or corporate-divisional executive agencies), is an auditor engaged.

The second problem is that the introduction of a third agent into a two-person agency not only alters the relationship between the first two, but gives rise to two new relationships and the associated agency costs that did not exist before. In a shareholder-auditor-manager system, the shareholder does not know what the auditor actually discovered or how diligent the investigation and preparation of the audit report were. Everything is possible: a cursory audit, less than truthful reporting, and auditor-manager collusion. To justify the addition of an auditor to the contract set, shareholders must believe that the expected losses from these possibilities, plus the audit fees, are less than the expected benefits of the audit report. Both managers and auditors have an information advantage over the shareholders. In addition, managers have an information advantage over the auditors, while auditors have the advantage of their accounting expertise. The resulting three-agent contract set must promise better prospects to each of them, compared to what they could get alone or by forming smaller coalitions.

However, people cannot be fooled all the time. Shareholders protect themselves against manager-auditor collusion by engaging large, reputable audit firms who can provide a degree of insurance through their deep pockets. DeAngelo argues that audit firm size and the quality of audit services are related to each other. The responsibility for monitoring against auditor-manager collusion is thus transferred from the shareholder to the internal quality control of the audit firm, to the audit profession, and to the regulatory and judicial systems, while the economic cost is added to the price of the audit services. Publicly held firms almost univer-
sally require an external audit. When audit fees rise, or when agency costs between managers and investors decline, we should expect that marginal public firms will pass into private ownership.

**Auditor Decisions**

Each type of auditor decision can be analyzed from the economic perspective of finding the desirable course of action, after examining the costs and benefits of various options. While economic self-interest has always been assumed to be the primary motivation of investors, it has not been customary to think of auditors in that manner. We review the structure of the various decisions that auditors make from an economic perspective in order to integrate the auditor into the contract theory of accounting as an economic agent. Starting with short-run decisions, the following discussion is ordered by the time span over which these decisions are made or are effective. Cushing and Loebbecke and the Public Oversight Board provide other classifications of auditor decisions. Mautz and Sharaf conduct a broad survey of auditing.

**Allocation of Resources in an Audit Assignment**

Auditors are inclined to spend as little money as possible on the audit and maximize their net remuneration, but reduced audit effort also exposes them to greater risk of material misstatements in the audited reports, and therefore diminishes their welfare. They must devise an audit resource allocation plan that achieves a balance between profit and risk, after considering the past performance of the firm and its managers, the cost of various audit resources, and the effectiveness of each resource in reducing the audit risk.

Auditors also have to decide how much of each resource is to be used to observe and evaluate the internal controls, analytical review, and the direct tests of transactions and balances. The cost-effective ways of reducing audit risk must be identified. Formally, the problem could be stated as one of minimizing cost, subject to resource and risk constraints, or of minimizing risk, subject to a cost constraint. The theoretical optimum allocation of resources among audit tasks is reached when the marginal cost of reducing audit risk is equal to the marginal benefit across all instruments of risk reduction in the auditors' arsenal. Beginning in the 1950s, Cyert, Davidson, Trueblood, and others developed the tools of statistical decision theory to identify the most effective opportunities for the application of audit effort. Statistical sampling represents a landmark innovation in auditing technology.

Virtually all the decisions auditors make in allocating their resources have to be based on their subjective judgments and beliefs about the client and its business. Objective probability distributions are scarce. Much of auditors' training and experience can be seen as the opportunity to accumulate experiential frequencies and subjective probability distributions. Learning probability calculus does not
come naturally to most people, and auditor errors in handling such information can be costly. Consequently, auditors face the challenge of training their staff either to develop their intuition to correctly handle probabilistic data or to use mechanical decision aids. Ashton, Felix, Jamal, Joyce, Kinney, Libby, Mock, Waller, and many others have conducted a fruitful research program to assist auditors in this respect.⁷

**Audit Opinions**

After the examination, the auditor might recommend that the managers alter some accounting numbers, methods, or disclosures, implicitly threatening an adverse opinion if these recommendations are not accepted. In pressing the manager to alter financial statements, the auditor risks losing a client. A firm always has the option to fire its auditors instead of acceding to their demands for changes in financial statements and disclosures. Corporate audit committees, consisting largely of outside directors, are supposed to mediate the auditor relationships to minimize the chances of such breakdowns.

When the client declines to comply, the auditor weighs the potential loss of business against the chances of audit failure, with its consequent cost of litigation and settlement, and losses of reputation and bargaining leverage with other clients. Cash costs can be significant. The *Wall Street Journal* reported that during the fall of 1984, a single U.S. audit firm reached out-of-court settlements in three unrelated cases involving payments of $65 million owed to various parties who claimed to have been injured by faulty audits.⁸

Auditors needed malpractice insurance because, until the early 1990s, their firms were organized as partnerships and their personal wealth was not protected by the limited liability provisions that apply to corporations. The professional environment turned litigious in the 1980s, and insurance premiums rose sharply, doubling in some years.⁹ Due to increased litigation, auditors’ legal costs have also gone up. This cost inflation influences both stages of auditors’ decisions—evidence gathering and opinion rendering—in the direction of defensive auditing.

In negotiating with the client, auditors evaluate the consequences of a range of options (from unqualified opinion to denial of opinion). Opinions may be qualified with respect to the consistency of accounting methods, the scope of audit examination, or the uncertainty associated with major, unresolved contingencies. At the end of the negotiating process, auditors choose an opinion that suits them best, considering the chances of its various consequences.

**Pricing Services and Bidding for Clients**

Audit firms compete with one another on price, quality, location, and special services. As in other professional services, the cultivation of personal relationships is an important instrument of marketing. Because clients do not monitor the number of hours their auditors spend on the assignment, the hourly billing rate is not a
meaningful measure of price. The total price of the audit assignment—the cost of buying the audit certificate—is the relevant price variable. In his study of the pricing of audit services, Simunic found that the audit fee is roughly proportional to the square root of the assets of the firm within an industry. However, it is difficult to compare the size of firms across industries by a single measure because the audit effort needed for a bank and a manufacturer, both with one billion dollars in assets, is quite different.

Simunic and Dopuch also examined pricing policies in the audit industry and concluded that the audit industry is price-competitive. Audit firms also compete on the basis of the quality of services offered. The reputation of an audit firm, built over the years through careful quality control, is probably the most important measure of the quality of services it provides. Activities that build reputation (e.g., information seminars and distribution of literature and media advertising) cost money, and the audit firm expects to earn rents on its investment in its reputation. For example, in his pricing study, Simunic found that Price Waterhouse & Co., one of the oldest audit firms in the United States, was able to charge higher fees than its competitors on similar audit engagements. Whether selling higher quality service at higher prices is more profitable depends on the price elasticity of demand with respect to quality. Econometric estimates of the price elasticity of demand are not available.

Audit firms also compete by providing a variety of special services to their clients, such as the advice of industry specialists on accounting policy, tax planning, the design of internal controls, and so on. Auditors save marketing costs when they also sell advisory services to their audit clients. Do auditors pocket the entire savings, or do they share it with the clients who buy both kinds of services from them? In his study of consulting services sold by auditors, Simunic found that the clients who buy such services from their auditors pay more, not less. The evidence suggests that audit firms earn rent on their reputations.

When firms switch outside auditors or engage them for the first time, they invite bids from various audit firms. In bidding for a new engagement, auditors evaluate potential revenues over several years, because large publicly held firms do not change auditors frequently. A change of auditors alarms the investors. The cost of changing auditors confers some advantage on the existing auditor, who can extract extra fees. When new bids are invited, auditors have an incentive to “low ball” in order to get the assignment, and then raise fees in later years.

There is, however, another side to the story. Lack of familiarity with the client and its control system raises the cost of an audit during the first year of engagement. Aware of the up-front costs that auditors incur in familiarizing themselves with the firm, clients may be willing to pay a higher audit fee during the first year of engagement and then expect a lower fee in subsequent years. Given the transaction costs of initial engagement on both sides, the auditor and the client face each other in a bilateral monopoly. Neither side can quit without having to abandon its initial investment. Whether this leads to the initial price being too low
or too high relative to competitive equilibrium cannot be determined without measuring the characteristics of demand and supply and competitive conditions in the market for audit services.

Competitiveness in the audit market is another important consideration in bidding. Only a few auditors command enough resources in the United States and abroad to audit the larger corporations. Some firms specialize by concentrating their practice in certain industries or cities, thus reducing the number of effective competitors.

Just as audit firms have opportunities to build reputations, so do their clients. A client firm pays an extra fee to buy into the reputation of a good auditor, and an audit firm pays by accepting a lower fee from a firm that has developed a reputation for good financial management and integrity. Soundly managed clients impose less risk on the auditor, who can afford to issue an opinion with fewer hours of examination. In a competitive setting, at least a part of this saving in audit costs is passed on to the client. On the flip side, auditors screen client firms for poor business and manager risks. The auditors' involvement in management recruitment raises troubling questions about their independence, but it does facilitate screening out poor risks.

**Audit Policies, Training, Quality Control, and Self-Regulation**

An audit firm, itself being a set of contracts, requires a system to ensure smooth cooperation among its participating agents. These contracts must induce the audit partners and the staff to choose actions consistent with what others expect of them. These contracts take the form of audit and compensation policy, training, and internal quality control in the audit firm.

Cushing and Loebbeke provide extensive evidence in their comparative study that audit firms design procedures and guidelines to inform their staff about what they are expected to do under different circumstances. The staff is trained in the use of these procedures. Many audit firms use statistical sampling and computer-based statistical techniques such as linear regression because their use can help increase the consistency of audit judgments even if they do not increase efficiency. Consistency is a useful defense in a court of law against charges of negligence or poor judgment.

Audit firms also conduct internal audits and quality control reviews. Auditors periodically scrutinize the work of their partners for conformity to the firm's policies. Clients cannot monitor auditor input. Auditors have to monitor themselves to ensure that one partner does not benefit by doing substandard work at the expense of the firm as a whole.

In addition to individual and firm-specific components, auditor reputation also has an industry-wide component. Since the mid-1970s, the SEC Practice Section of the American Institute of CPAs (AICPA) and the Public Oversight Board, created by the auditing industry, have undertaken a program of "external audit" of procedures used by firms that audit publicly held firms. This costly program,
called peer review, limits the incentives for a firm to get a free ride on the reputa-
tion of the audit profession as a whole. Critics of the self-regulatory program see
the Public Oversight Board as institutionalized mutual back-scratching.

The Technology of Audit

There have been two major developments in the technology of auditing since the
1950s. The first is the application of statistical methods of sampling, estimation,
and search in auditing by Cyert, Trueblood, Davidson, and their colleagues. Audit firms have devoted substantial effort to developing statistical techniques,
writing and testing software, integrating these new procedures into more traditio-
nal methods, and training their staff. In making these decisions, auditors trade off
the cost of audit technology against the increased audit efficiency, the reduc-
tion in cross-sectional variation, and greater legal protection.

The second major change concerns the audit of computer-based accounting
systems, electronic data processing (EDP) auditing. Pen- and paper-based ac-
counting systems are fast disappearing, even in small businesses, limiting the ap-
pliability of the traditional techniques of audit. When a transaction is authorized
and recorded electronically, the absence of paper radically changes the nature of
the auditor’s task. Computerized accounting offers new opportunities for both
mistakes and fraud. A major part of the effort to develop EDP auditing is directed
at these problems.

Institutional Structure of the Audit Profession

The institutional structure for setting standards influences the choice of standards.
Auditors have sought to maintain a significant influence over the structure, as well
as the personnel, of these institutions.

The Development of Audit Standards

Although the promise of examination “in accordance with the generally accepted
auditing standards (GAAS)” started appearing in audit certificates in 1941, work
on the development of auditing standards did not start until 1947. This work has
been carried out by professional auditors, and few others participate.

The U.S. courts do not accept a proof of compliance with the auditing stand-
ards as conclusive evidence that the auditors have met their responsibility. In the
Continental Vending case, the auditors were found to have met the auditing stand-
ards. However, this defense was insufficient, and an audit manager and two part-
ners of the defendant firm were found guilty.18

The AICPA launched a major effort to develop auditing standards after this
judgment. Though adherence to auditing standards does not constitute a complete
defense for auditors against a charge of negligence, they still have an incentive to
seek standardization of auditing across audit firms to reduce cross-sectional vari-
ability. It is safer for auditors to follow a standard, and attribute any inadequacies to the generally accepted practice and, therefore, to the entire profession. Modification of extant standards seems more appropriate than punishing the auditor. There is safety in numbers.

When Price Waterhouse & Co. failed to discover the fraud perpetrated by Phillip Coster, an ex-convict working as the president of McKesson & Robbins under a false name, they had never sought to verify the inventory. Nor had they attempted the direct confirmation of the receivables. Their defense that physical verification of inventory and direct-mail confirmation of receivables were not the prevailing practice in the mid-thirties saved the day for Price Waterhouse.

This case was followed by basic changes in U.S. audit practice. The Special Committee on Audit Procedure, established by the AICPA after the McKesson & Robbins hearings, recommended that auditors physically observe the inventory count and directly confirm the receivables as part of normal audit procedures. Further, they should report in the certificate if either of these tests were omitted. It required that the auditors' testing be based on a review of the internal control system of the firm. These recommendations extended audits in the United States beyond the books of the firm to establishing the actual existence of assets and liabilities shown on the balance sheet. Six decades later, in the mid-nineties, the first step of an audit program is a review of the internal control system, which largely determines the direction and extent of subsequent steps.

It is conceivable that auditors could use practice standards to enlarge their share of the corporate pie. Given the cost and time it takes to enter the partner ranks, existing partners could extract economic rents from raising the demand for audit services by insisting that the amount of work they need to perform in order to issue audit certificates must be greater than that currently performed. This could happen if there were no substitutes for audit services, and if standards could be used as an effective device to collude. Competition among auditors ensures that even if they write collusive standards intended to raise the demand for their services, individuals continue to have incentives to cut corners. Given the difficulty of monitoring such behavior, collusive standards by a cartel of auditors are not effective.

The internal controls and internal audit of a firm are partial substitutes for an outside audit. For one multinational corporation, external audit hours decreased from 65,000 to 40,000 over a period of five years (1978–83), while the number of internal audit hours increased from 25,000 to 70,000 over the same period. The cost-effectiveness of an internal audit places an upper limit on how far the external auditors can use standards as a device to increase the demand for their services.

Standardization of auditing procedures cuts the costs of training auditors and collegial monitoring of the quality of the work. Training the staff to develop their personal judgment, and exercising control on the quality of the subjective judgments they make, is more expensive than developing standards.
Standardization of the audit also carries some risks and additional costs. First, auditors accustomed to standardized procedures are less likely to recognize innovations in fraud and concealment. Even if they recognize such incidents, their standard operating rules may not allow them enough flexibility to pursue the clues of wrongdoing they may find. Second, it is more costly to adjust standardized practice to match a changing environment and technology. The introduction of computers has altered the environment of auditing and the way auditors do their work. It is not difficult to see the pitfalls of commitment to audit standards just when flexibility is needed to keep pace with the revolution in information technology. The revolution brings new opportunities for the cops as well as the robbers.

The Development of Accounting Standards

Most efforts to standardize accounting practice in the United States have originated from the AICPA and its predecessor body, the American Institute of Accountants. Zeiff and Chatfield chronicle the history of accountants' participation and initiatives, starting with the joint bulletin with the Federal Reserve Bank in 1917, the Committee on Cooperation with the Stock Exchange in 1930, the Committee on Accounting Procedures in 1939, the Accounting Principles Board in 1959, and the Financial Accounting Standards Board in 1973. Standardization of accounting methods reduces an auditor's risks. Unlike auditing standards, accounting standards afford a significant protection from third-party lawsuits to an auditor who stays within the boundaries.

When auditors disagree with the accounting method or disclosure used by managers, it is easier for them to read the rule book to the manager than to argue on the basis of their judgment. Many standards issued by the FASB originate from auditors' demands for explicit and situation-specific rules.

The FASB's Statement No. 44 issued in 1980 is a good example. Trucking licenses to operate on interstate freight routes, carried on the balance sheets of trucking firms as intangible assets at their amortized purchase price, became largely worthless when the industry was deregulated. Trucking firms that had substantial intangible assets of this type were reluctant to write them off against their current income. Managers of these firms argued that these assets represented the goodwill they had earned on the routes. Instead of resisting the client pressure on the basis of a general standard for treatment of intangibles contained in APB Opinion No. 17, auditors found it more convenient to press the FASB for an industry-specific ruling to require immediate write-off of these trucking licenses. The FASB complied.

Could the managers of other industries be blamed for demanding to see industry-specific rules from their auditors before agreeing to their recommendations? Auditors may have to return frequently to the board for more specific rulings. In using the process of standardization to win battles against recalcitrant clients, the auditors may lose the war for maintaining the role of judgment in financial reporting.
Accounting standards affect the risk borne by the auditor. General price-level adjustments (GPLA), for example, can be made by mechanically applying the government's price indexes to historical cost numbers. Current cost methods, on the other hand, require estimation and judgment on the part of the accountant and the auditor, and expose them to risk. They have generally sided with GPLA proposals during times of high inflation.

**Who Sets the Standards?**

The audit-standard-setting institution in the United States is a committee of the AICPA (Auditing Standards Board or ASB), consisting of part-time, unpaid volunteers supported by a full-time staff. A similar structure is used in Canada. Since investor interests are protected by common law that transcends auditing standards, such standardization has been left almost entirely to the auditors themselves. In their report, the Special Committee on Standard Setting established by the Canadian Institute of Chartered Accountants stated:

Accounting standards have considerably higher public profile than auditing standards and the need for outside involvement is correspondingly greater. We do not see a need for . . . direct involvement of nonauditors in technical preparation of auditing standards. From a practical standpoint, it is difficult for nonauditors to sustain an interest in, or be capable of contributing to, the highly technical discussion that takes place among auditors developing standards of professional audit practice. Auditing standards, generally speaking, are developed by auditors for auditors.21

The National Commission of Fraudulent Financial Reporting recommended the participation of nonauditors in setting standards. The AICPA opposed the proposal, and few outsiders have clamored to climb aboard.

The audit-standard-setting body is large enough to allow representation of a variety of experience and points of view within the profession. The voluntary, part-time nature of the membership allows many members of these bodies to represent the interests of their own firms and clients, without burdening them with the responsibility of taking unbiased positions. Differences among members can be thrashed out through bargaining and negotiation. The level of generality at which standards are written, and the differences in the audits of small and large firms, have been two of the recurrent issues before the ASB.

The control of accounting standards has gradually slipped out of the hands of U.S. auditors. The Committee on Accounting Procedure and the Accounting Principles Board were committees of the AICPA, as is the case with Canada's Accounting Standards Committee. The FASB was set up as an independent body in 1973, with a provision that a clear majority of its seven members should have been auditors in public practice. Over the years, the formal requirement that a majority of its members be auditors was dropped, and the representation of auditors on the FASB declined from five to three. In the mid-nineties, auditors continue to be the single largest group represented among the members of the board. Its Advisory
Committee, staff, and financial supporters. In early 1996, the Financial Executives Institute proposed that the membership of the FASB be cut from seven to five, with a vote of four to approve a new standard. They also asked for two seats on the board, which will give corporate executives an effective veto power over its decisions. Audit firms and corporate executives respond to discussion memoranda and exposure drafts issued by the FASB, participate in their hearings, and remain the most influential groups in setting accounting standards.

The Auditors’ Responsibility for Detection of Fraud

Fraud is an attempt to directly withdraw more resources from the firm’s pool than one is entitled to. Managers can also commit fraud by misleading other participants about their entitlements. For example, some division managers of TRW, Inc. falsely inflated the cost of certain components supplied to the U.S. Department of Defense in order to make the divisional performance look better than it was. Such fraud can be carried out through fictitious transactions, transactions without economic substance, or the deliberate misapplication of accounting methods to actual transactions in order to produce misleading results.

The public believes that auditors are responsible for the detection of fraud. Indeed, they see it as the reason why they are willing to pay for the audit. The SEC has listed the detection of fraud as an important objective of the audit, saying in Accounting Series Release (ASR) No. 19 and again in ASR No. 153, that “the discovery of gross overstatements in the accounts is a major purpose of . . . an audit even though it may be conceded that it might not disclose every minor defalcation.” In the 1980s, courts held auditors responsible for their failure to detect fraud if it could be proven that they failed to exercise due professional care.

Responsibility for fraud detection presents auditors with a difficult economic problem to be resolved at the social, not the individual, level. Either a complete denial or a complete acceptance of such responsibility would quickly put auditors out of business. Nobody would have reason to hire them in the former case, and nobody would be willing to be hired to do the audit in the latter. The higher the level of their responsibility, the greater is the value placed on their services by other agents, and the greater is the risk they must bear. There is no contractable measure for defining this level of responsibility, nor are these values and risk functions known. As the following historical summary indicates, auditors have been engaged in a continual and difficult balancing act to define their responsibility during much of this century. Gode presents an interesting economic analysis of the auditor liability problem.

In the early days of auditing, the detection of fraud was a chief objective of the independent audit. In the 1920s, it was recognized that normal audit procedures will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operations or by manipulation of accounts. During the 1930s, the auditor was expected to be concerned with management’s account-
ability for the company’s assets and to guard against fraud-induced material misstatements in the financial statements. In the 1950s, auditors asserted that the ordinary examination performed in order to render an opinion on the company’s financial statements was not designed, and should not be relied upon, to disclose defalcation, although it was often discovered. By 1960, the auditors’ position on fraud detection acquired a stronger negative tone. The ordinary examination was still not designed to uncover defalcation or similar irregularities. If the auditors failed to comply with generally accepted auditing standards (GAAS) during their examination, they had to share the blame if the fraud was later exposed.

In 1974, the AICPA appointed the Commission on Auditors’ Responsibilities in an attempt to close the gap that existed between the auditors and the public’s expectations of them. The Commission, in its 1978 report, recommended that the independent auditor was to be held responsible for detecting those frauds that could be detected through the exercise of normal professional skill and care. After the collapse of the savings and loan industry, and the related audit failures, the National Commission on Fraudulent Financial Reporting suggested in 1987 that auditors should provide reasonable, but not absolute, assurance that financial statements are free from material misstatements. It is difficult to be precise without resorting to extremes.

**Competition, Entry, and Discipline**

If audit services were an ordinary commodity, market competition could attain a socially efficient solution subject to the standard legal regime of commercial law. However, audit services have a special characteristic: their quality cannot be monitored by other agents at the time of delivery. Even after delivery, it is difficult to monitor their quality because the frequency of audit failure is low. Auditors’ reputation becomes all important. Open competition allows unscrupulous and incompetent auditors to prey on the reputation of the industry as a whole, with only a small probability of being exposed within a reasonable period of time. The regulation of entry, licensing, quality, and discipline by professional and governmental organizations is intended to remedy these weaknesses of free competition in the market for audit services. It is not always successful. Auditors actively participate in all phases of such regulation and often dominate, and even capture, the regulatory mechanism to serve their own ends. An analysis of the government’s role in the regulatory mechanism of the auditing profession is taken up in Chapter 12.

The conditions of entry into the public accounting profession are effectively regulated through the design of the Uniform CPA Examination, which all aspiring entrants must pass. State Boards of Accountancy set the standards for training and experience necessary to receive the license to practice as a CPA. With only a few exceptions (such as “snowbird repellents” in Florida that try to keep out the seasonal inflow of professionals during the winter), the control of entry into the CPA profession has not been used as an effective barrier to entry. The cost of meeting
the necessary college and experience requirements of entry to public accounting are lower than that of medicine, law, and dentistry. Unlike other professions, only a small proportion of qualified CPAs enter public practice, and an even smaller proportion stay there for their careers. All this suggests that the qualification standards for the certification and licensing of CPAs have not been an effective barrier to entry to the profession. In the 1970s, the AICPA floated a proposal to make a five-year professional graduate degree a prerequisite to entry. This effort coincided with the broadening of antitrust laws to include professional groups by the Federal Trade Commission, the U.S. Department of Justice, and the federal courts, and has made only limited headway.

CPAs have a major stake in monitoring the quality of audit done by others, both inside as well as outside their firm. Audit failures receive wide publicity and inflict a loss of reputation not only on the erring individuals, but on their partners and professional colleagues outside their firm as well. Punishment of errant CPAs alone is not an efficient disciplining device. CPAs have developed an elaborate system of peer review to monitor and identify weaknesses in audit practices before they lead to audit failure and to help their colleagues rectify such deficiencies.

As with other kinds of insurance, a policyholder of malpractice insurance does not bear the entire cost of mistakes or negligence. A substantial part of the cost is passed on to other auditors when insurers raise the premiums for the entire industry in response to higher malpractice awards against a few. This economic externality motivates auditors to band together to seek a common solution to the problem of audit quality by their peers.

The peer review system works at both the firm and the industry level. Each CPA firm that audits publicly held firms is required to maintain and operate a system whereby partners review the work of their colleagues to identify weaknesses, to continually train their personnel, and to supervise their work effectively. To ensure that each firm actually does so, the SEC Practice Section of the AICPA arranges triennial peer reviews of firms by the staff of other firms. Firms that receive qualified peer review reports are required to make up their deficiencies and are helped in this effort to improve the quality of their audit services. The Public Oversight Board oversees the peer review system in order to protect the credibility of the system in the eyes of the public.

The system of peer review in auditing is supposed to raise the quality of audit services by limiting quality competition among auditors. It could also be criticized that it encourages CPA firms to cartelize the industry, especially because the demand for a certain quantity of audit services originates in the federal security laws. Given the peculiar characteristics of audit service as an economic good, the first-best competitive solution in the audit market is not attainable. The existence of a profession-wide component of auditor reputation requires a profession-wide mechanism for quality control to prevent market failure. The prohibition of such cooperation among auditors, and attempts to enforce conditions of perfect compe-
stitution among individual auditors, may well lead to an even less efficient result in the form of a market for lemons, a market in which firms will compete to provide the lowest possible quality of service.

When certain provisions of the AICPA's Code of Ethics were declared anti-competitive, and therefore unlawful, in the mid-1970s, audit firms began to advertise and to aggressively market their audit and nonaudit services to their current and potential clients. The introduction of express competition in the audit market, combined with the pre-existing competitive market for nonaudit services, has had the interesting side effect of growth in advisory services and the weakening of auditors' independence.

The problem is that the auditing service produces a byproduct for the auditor—information about the client's need for nonaudit services and a relationship of trust between the auditor and client personnel. The auditors may point out to the client the latter's need for, say, a new computer or software system, and the attendant cost savings on the basis of information acquired in the course of an audit. This knowledge is an economic externality and it gives a competitive edge to the audit firm in providing nonaudit services to its clients. Many audit firms have developed the capacity to provide such services to exploit their position.

As long as the audit market was protected from express competition, audit revenues remained high enough to mute the motivation to profit from the sale of nonaudit services to audit clients. The removal of competitive restraints in the audit market has also weakened any pre-existing qualms about exploiting this externality. The result is a decline in both audit revenues and the apparent profitability of the audit services, coupled with rising nonaudit revenues and their apparent profitability.

Assessing the real profitability of each service would require a system of transfer prices between the audit and the advisory divisions of the audit firm. The advisory services division would have to pay the audit division for the information about the client, and the reduction in the cost of marketing the advisory services. Likewise, the audit division would have to pay the advisory services division for the saving in audit cost and risk due to informational advantage provided by the advisory services. The difficulty of determining appropriate transfer prices in an imperfect market precludes most firms from properly reckoning the profitability of each type of service. Audit firms aggressively compete in pricing their audit services with the hope of recouping their losses by providing nonaudit services to their clients.

There is a second source of trade-off between competition and independence in the audit industry. Larger audit firms, receiving only a small fraction of the total revenue from any single client, can be more independent of the client. However, given the total amount of audit work that needs to be done in the economy, larger size means fewer audit firms, and therefore less competition. In any given economy, there exists a set of efficient combinations of number and size of audit firms. During the 1980s, U.S. audit firms grew in size by forming international al-
liances without significantly reducing the number. But there is a limit to how far this process can be carried out.

The effect of enhanced competition in the audit market has been to weaken the independence of outside auditors. Economic forces have linked the provision of audit and nonaudit services and their prices, and undermined the intent of the securities laws to ensure that the financial reports of publicly held firms be certified by outside parties who have no fiduciary interest in the firm. Whether the loss of independence is worth the gain in efficiency from competition is not known.

Summary

Much of the professional literature of the auditing profession remains garbed in the jargon of professional judgment, fairness, and ethics. Such language serves the purpose of peer review, quality control, and the coordination internal to the profession. Professional often show discomfort with the economic analysis of the decisions of auditors and the structure of the profession. Cost–benefit considerations and utility maximization were seen as the very antithesis of ethical professional judgment, which was said to govern the conduct of auditors. Without denying the usefulness of the ethical/judgment approach in operating a social system, this chapter has attempted to show that modeling auditors as economic agents can help us understand many aspects of their behavior and institutions. Understanding the behavior of individual auditors when they act by intuition requires methods and tools of cognitive psychology.

Notes


5. Mautz and Sharaf, op. cit.


9. Ibid.


"Simunic, op. cit.


"Cushing and Loebbecke, op. cit.


"Cyril Trueblood and Davidson, op. cit.


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