EXPLAINING AUDIT MARKET STRUCTURE AND REFORMS

Understanding Contexts and Implications (Part 1 of 3)

BY
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This article is the first of a series of three articles analysing key aspects of the audit market reforms in major jurisdictions. There is an active conversation about audit market reforms among accounting professionals which often assumes that the participants understand the contexts of the reforms. Concurrently, the strategy and work plan for 2014–2018 of the ethics standard-setter – the International Ethics Standards Board for Accountants – has specific projects to re-examine the ethics code relating to the long association between auditors and their clients, and provision of non-audit services by incumbent auditors (sections 290 and 291 of the code). The analysis in the forthcoming two articles provides a basis for thinking about these issues.

Auditors are expected to provide independent opinions on whether the financial statements are "true and fair"[1]. The post-Enron audit market reforms – from the US Sarbanes-Oxley Act in 2002 to the European Union reform package announced in 2014 – target preserving the auditor's independence and consequently audit quality. The concern with preserving independence arises because auditors are paid by the firm and appear beholden to the pay master. Historically, auditing arises from the need of shareholders to monitor managers as business becomes complex (the stewardship argument). The firm has always been the party paying the auditor, even before the 1934 US Federal Securities Acts that literally jumpstarted the market for external audit.

This independence concern alludes to the peculiarity of the arrangement in the audit market. The firm pays for auditing but has an incentive to show better earnings – therein lies the inherent tension that audit market reforms are trying to correct. An article in *The Economist* magazine's December 2013 issue states, "Auditors have a conflict of interest at the heart of their business – they are paid by the companies they are supposed to assess objectively. Unless that changes, there will be no substitute for investors doing their own due diligence."[2] This assessment begs two questions, whose responses would provide the context to

[1] "True" means free from material misstatement; "Fair" means the accounting information reflects the economic substance rather than the legal form. Accounting conservatism still applies and the phrase "true and fair" should be interpreted in that context.

[2] "Shining a light on the auditors", *The Economist*, 7 December 2013; www.economist.com/news/business/21591227-making-companies-auditors-more-independent-will-be-tough-task-regulators-shining-light

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STRATEGY AND WORK PLAN FOR 2014-2018

discuss audit market reform: Besides the historical reason of stewardship, what is the economic logic of auditing? Why has the arrangement that the firm pays its auditor survived so many rounds of audit reforms?

We used a thought experiment to explain the economic logic of auditing in today's capital market.

A THOUGHT EXPERIMENT

Suppose there are two types of used cars – good ones worth $2,000 and bad ones worth $1,000 each – with equal numbers of good and bad cars available for sale. If buyers and sellers do not know the type of car they have, used cars will be sold at $1,500 because at that price, both parties have an expected gain of zero. If you are a seller, there is a 50% chance you have a bad car and gain $500 from selling it at $1,500, a 50% chance you have a good car and lose $500 from selling it at $1,500, and therefore have an expected gain of zero. If the price is higher than $1,500 under the condition that neither party knows the quality of the car, the seller will gain at the expense of the buyer, and the buyer will refuse to buy.

If only the sellers know the car quality, owners of good cars will withdraw because $1,500 is below the value of good cars, but owners of bad cars will remain eager to sell. There is no longer an equal chance of getting good or bad cars. The price must drop to maintain a zero expected gain, thus making it even worse for owners of good cars. In the end, only bad cars remain in the market and sell for $1,000.

The moral of the story is that if only the sellers know the quality at the point of sale, good cars will disappear from the market because no one will pay the price of a good car. This situation is bad because buyers willing to pay for a good car cannot have one.

What if there is a trusted and competent mechanic to certify good cars for a fee? Good cars re-enter the market and contribute to the happiness of drivers.

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The value of audit is to enable the smooth functioning of the capital market; the capital market – and consequently the market economy – would be much smaller without auditing.

WHO SHOULD PAY THE MECHANICS?

There are three candidates – buyers, sellers and the government. Buyers seem to be the obvious choice. However, potential buyers need the certification before deciding to be buyers. Once the certification is produced after payment by the first potential buyer who decides not to buy, the value of the information is undiminished for subsequent potential buyers. This situation is a free-rider problem where nobody is willing to pay first.

What if sellers pay the mechanics? This arrangement overcomes the free-rider problem. Moreover, it is socially less expensive to pay for one certification than having each potential buyer pay for a certification. However, if sellers are paying the mechanics and possibly making them beholden to the sellers, then the certifications are not very credible to buyers.

There is always the government, which as a last resort, might pay for a public good. This arrangement will remove the free-rider and credibility

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problems. However, the government collects its revenue from tax payers who include non-participants of the used car market. Hence, this arrangement may not be equitable or politically feasible.

LESSONS FOR THE AUDIT MARKET

The thought experiment explains the economic logic[3] of auditing, without which the allocation of capital becomes inefficient. Therefore, the value of audit is to enable the smooth functioning of the capital market; the capital market – and consequently the market economy – would be much smaller without auditing. The discussion of the problem of who should pay the mechanics laid out the trade-offs in the three choices.

The current audit market chooses the "seller pays" approach for historical reasons, and puts in three safeguards to ensure the credibility of audit to the users of audited financial statements. First, most companies that require statutory audit handle audit matters through their Audit Committee to inject independence between management and audit staff, and ensure that the board is fully aware of audit issues. Second, auditors are licensed and therefore subject to sanctions for malpractice on top of existing tort and criminal laws. Third, professional norms based on ethics have a strong influence on the auditors.

These safeguards are not foolproof, and reforms follow with each round of crisis. Radical reform away from the "seller pays" approach suggested by *The Economist* magazine risks throwing the baby out with the bath water, and is currently a minority view.

This article points out the trade-off in radical reform, and provides the basis for our assumption that reform will continue on the "seller pays" basis (to be discussed in the next two articles).

Current audit market reforms in major capital markets focus on a package of several measures, where each measure is based on an analytical relationship between a variable and audit quality. For example, the (assumed) negative relation between audit tenure and audit quality gives rise to some policy combinations of mandatory firm rotation, partner rotation and re-tendering of auditors. The (assumed) negative relation between provision of non-audit services and auditor's independence gives rise to prohibition and limitation of the incumbent auditor to provide non-audit services. We will examine these policy measures with empirical evidence about the analytical relationship in the next two articles. ISCA

[3] We did not invent this logic. The credit goes to George Akerlof, Nobel Laureate in Economics, whose pioneering work on adverse selection arising from asymmetry of information cites the used car market as the example. Akerlof's paper is "The Market for Lemons: Quality Uncertainty and the Market Mechanism".

Look for Parts 2 and 3 which will be published in the January and February 2015 issues of the ***IS Chartered Accountant*** journal.

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