

**The Economics of Audit Quality:  
Private Incentives and the Regulation  
of Audit and Non-Audit Services**

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To Marisa with gratitude for her love,  
support and patience



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## Foreword

This book focuses on market mechanisms which protect quality in the provision of audit services. The role of public regulation is thus situated in the context defined by the presence of these safeguard mechanisms. The book aims to contribute to a better understanding of these market mechanisms, which helps in defining the content of rules and the function of regulatory bodies in facilitating and strengthening the protective operation of the market.

An analysis at a more general level is provided in the three chapters making up Part 1. In the four chapters of Part 2, on the other hand, this analysis is applied to a particular problem to determine how those non-audit services often provided by auditors to their audit clients should be regulated. Finally, Chapter 8 contains a summary of the analysis and conclusions of the work. The conclusion with regard to non-audit services is that their provision generates beneficial effects in terms of costs, technical competence, professional judgment and competition and, moreover, need not prejudice auditor independence or the quality of these services. This assessment leads, in the normative sphere, to recommending a legislative policy aimed at facilitating the development and use of safeguards provided by the free action of market forces. Regulation should thus aim to enable the parties—audit firms, self-regulatory bodies and audit clients—to discover through competitive market interaction both the most efficient mix of services and the corresponding quality safeguards, adjusting for the costs and benefits of each possibility. Particular emphasis is placed on the role played by fee income diversification and the enhancement through disclosure rules of market incentives to diversify.

This book has benefited greatly from the help and comments received from numerous colleagues. In particular the stimulus given by Jürgen G. Backhaus has been fundamental in writing and publishing it in its present form. With his usual perspicacity and enthusiasm, Luis Garicano discussed the mechanisms for safe-

guarding quality and normative proposals, making a substantial contribution to better understanding and refinement of the arguments involved. Several earlier collaborations with Cándido Paz-Ares to a large extent assisted in comprehension of the role of the regulatory framework in its constant interaction with the private activity of economic agents. Neither can I overlook initial steps in relation to the role played by the existence of specific assets and quasi-rents in audit quality, taken in collaboration with Jesús Lozano, nor the comments of other colleagues based on various public presentations of other works in some way connected with this one, particularly William J. Carney. In addition, numerous participants at conferences (The University of Barcelona School of Law-CIDDRIM, The Catalanian Association of Public Auditors), seminars (The Carlos III and Pompeu Fabra Universities) and scientific congresses (12 and 14 Annual Conferences of the European Association of Law and Economics, the 1996 International Symposium on Audit Research, the 21 Annual Congress of the European Accounting Association) at which I have had the opportunity to present and discuss various parts of the study have also suggested and put to the test many preliminary ideas, thus helping to improve them. Anna Cano, Georgina Folguera, Manuel González, Uriel González-Montes and Luis Vázquez have, at different stages of the work, generously helped me in compiling and processing the different bibliographical and empirical materials used. I would like to express my most sincere gratitude to them all. Needless to say, none of these individuals has any responsibility for the errors and value judgments which the work surely contains, for which the author alone bears sole responsibility. Finally, my thanks and appreciation to Bill Harrison, M.A. (Oxon.), Solicitor and translator from the international Legal Language Services group of lawyer-linguists, for his work in translating the manuscript into English and, at one stage, pointing out to me that Japan is not *yet* a member of the European Union!

# Part 1

THE DEMAND FOR QUALITY  
AND ITS SAFEGUARD IN  
AUDITING



# 1 AUDITING QUALITY

As with any other goods or services it is appropriate to examine the quality of auditing services from the point of view of their value to those who make use of them. These are both direct users—those who purchase them—and indirect but perhaps the more important users—those for whom audited accounts are destined. This latter group includes the shareholders in and creditors of organizations whose accounts are audited as well as their customers, employees and the public bodies with whom they deal.<sup>1</sup> In some cases such users employ the accounts to monitor the conduct or performance of those taking decisions in the organizations being audited. In other cases, however, they use the accounts in a prospective manner as an instrument to assist them in taking decisions, whether direct investment, lending, purchasing or employment.

## 1.1 The demand for financial auditing

In both cases, economic agents acquire auditing services to increase the informative value of accounts in the hands of those using them. As a starting point in the analysis, it will therefore be assumed that the clients of a firm of auditors desire good quality auditing. In particular they thereby reduce the transaction or agency costs that they incur in their contractual dealings (mainly those with creditors and shareholders); in short, they achieve better contractual terms in their exchanges.<sup>2</sup>

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<sup>1</sup> In this respect the classification made by the Auditing Practices Board is interesting in establishing decreasing degrees of auditor liability in relation to three sets of stakeholders: primary (shareholders and regulators), secondary (creditors and employees) and tertiary (potential investors, intermediaries, tax authorities, etc. not included as primary stakeholders). See APB (1994, pp. 25-6).

<sup>2</sup> Despite the difficulties inherent in observing this type of variable, the effect of audit quality in improving contractual terms has been quantified in some specific situations. For example, Balvers, McDonald and Miller (1988) and Beatty (1989) found that the discount typically associated with public share offers granted by companies seeking a stock exchange listing for the first time was lower when their accounts had been audited by prestigious firms. Balvers *et al.* (1988) also reveal that the effect is

### 1.1.1 Financial auditing as a contractual facilitator

Auditing is generally understood in terms of Agency Theory as a type of bonding contracted by an “agent” management team which does so in relation to its own shareholders in large companies with specialized ownership and control, or the proprietor of a business in relation to his creditors and/or partners.<sup>3</sup> Reference will be made in this work to the auditor’s “clients” in a generic sense. This concept of client comprises both the currently predominant circumstances in which the client is an agent who, by means of the audit, wishes to bond his activities, and those of a principal who wishes to monitor an agent. This duality is the result of the fact that although auditors are usually contracted by a company itself in legal terms, the economic relationship is more complex and the contracting party can be considered as being either the management of the company or its shareholders depending on the circumstances. In virtually all countries auditors contract with the company itself, the contract being approved by the shareholders’ meeting on the proposal of the directors.<sup>4</sup> The existence of an audit committee may however modify this allocation of roles, converting the audit into a *monitoring* rather than *bonding* mechanism, in which the contractual initiative comes from the *principals*, particularly shareholders when they are represented on a relatively independent audit committee.<sup>5</sup>

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complementary to that produced by the fact that the operation is handled by a merchant bank of high standing. In a more recent study, Hogan (1997) shows that the owners of businesses must choose between accepting greater underpricing—i.e., a higher discount on the share price—and providing increased guarantees by means of an auditor of higher standing.

<sup>3</sup> In order to facilitate the study of contractual relationships Agency Theory makes an abstraction by considering a single relationship between two individuals in which, moreover, only one of them, the “agent”, is obliged to provide some service to the other, who is usually referred to as the “principal”. In this type of abstract contractual relationship it is appropriate to classify the contractual costs and safeguards on the basis of which of the respective parties initiates and pays for them. In an agency relationship all the costs aimed at reducing a deviation in the agent’s performance from the interests of the principal are referred to as “agency costs”. Three categories are usually distinguished: (1) “monitoring costs”, which are those paid for by the principal, (2) “bonding costs”, paid for by the agent, and (3) a certain “residual loss”, which is the result, even with optimum levels of monitoring and bonding, of the fact that it is usually preferable that a certain deviation persists in the conduct of the agents from what would be optimum in the hypothetical or ideal case in which there are no contractual costs. For an introduction to the theory, see the classic work of Jensen and Meckling (1976).

<sup>4</sup> Auditors were appointed by a government body in Korea until the 1980 reforms (Park, 1990). In many countries a similar mechanism is used for appointments by the courts and the Companies’ Registry. A lottery mechanism has also been proposed on some occasions (see, for example, *Cinco Días*, 17 October, 1995).

<sup>5</sup> It has nevertheless been argued that companies may create audit committees purely for image purposes (Bradbury, 1990). The study by Menon and Williams (1994) shows that audit committees voluntarily created by US companies have in general had a very inactive life, although their activities increase with the presence of external (non-management) members on the board of directors. This outcome seems logical; the audit committee can operate as a body which assists the board in its monitoring work but this function only makes sense if the board itself also acts as a monitoring body and is to some extent

Demand for external auditing is directly related to the fact that it is the directors or management (when considering the relationship with shareholders in the context of a company with specialized ownership and control), or debtors (in the context of credit relationships) themselves who prepare the accounting information. This leading role of the agent or “party to be monitored” in producing the information used to monitor his own conduct is based on cost reasons—a large part 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.<sup>6</sup> The auditor is a specialist who 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 his reputation. From this point of view the client can be taken in a certain way to acquire or hire the reputation of the auditor in order to improve his contractual opportunities.<sup>7</sup>

This argument, which treats demand for auditing as a result of the need to safeguard contractual conduct, is usually situated in a context of “moral hazard”,<sup>8</sup> in which the audit contributes to making the degree of contractual performance observable *ex post* and therefore provides an incentive for it. The audit can also be, on a complementary basis, a remedy for problems of *ex ante* contractual asymmetry (*ex ante* and *ex post* meaning here before and after contracting, respectively),<sup>9</sup> sig-

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independent of management. (There is another explanation, however, related to the desire of external directors to be seen to be independent, particularly in relation to any possible liability suits).

<sup>6</sup> This view of auditing is derived from Jensen and Meckling (1976, pp. 338-9). Auditing is obviously not the only safeguard nor perhaps the most important. Auditing services can in fact be replaced by other monitoring mechanisms. Anderson, Francis and Stokes (1993) examined such replacement by empirically analyzing the relationships which exist in Australian companies between external audit fees, salaries paid to internal auditors and the overall remuneration of the board of directors. One of their results shows that as the percentage of the value of a company of a less tangible and therefore more conflictive nature increases so also does the cost of auditing in relation to board remuneration.

<sup>7</sup> One of the principal creators of modern organizational economics views thus the role of auditing as hiring reputation with the safeguard of the reputation of the auditor himself: “owners win the confidence of investors by renting the reputation of auditors for accuracy and fairness. Auditors earn a market rate of return on their investment, via the costs of quality audits, in building a reputation among investors” (Wilson, 1983, p. 305). This rental of reputation is valuable because the client only needs it occasionally (particularly when having recourse to capital markets) whilst the auditor is permanently present as a supplier of contractual safeguards. The auditor’s role as specialist who stakes his reputation when backing part of the activities of his clients is similar to that of other specialists, such as merchant banks (Gilson and Kraakman, 1984), underwriters of security issues (Downes and Heinkel, 1982; Booth and Smith, 1986), debt rating agencies (Wakeman, 1981) and insurance companies to the extent that they also monitor certain assets (Mayers and Smith, 1982).

<sup>8</sup> In the economics of contracts moral hazard problems arise as a consequence of post-contractual information asymmetries leading to performance failures.

<sup>9</sup> See, for example, Titman and Trueman (1986).

nalizing the good quality of the audited business. This is particularly appropriate in circumstances when the firm undertakes a major reorganization of its contractual structure, as exemplified by going public on the Stock Exchange.

The existence of a public or regulatory demand for auditing does not diminish the relevance of an analysis based on voluntary demand.<sup>10</sup> This is so for several reasons. Firstly, it is clear that there is a demand for auditing beyond the regulatory minimum (in terms of quantity and particularly quality), a minimum which could be achieved at a much lower cost.<sup>11</sup> Companies that choose auditors of proven quality are in the majority—at least in terms of value—despite the fact that the minimum legal requirements could be covered at a lower cost using auditors with lesser reputations. A substantial demand of a purely voluntary, contractual origin can also be seen even after the introduction of mandatory auditing.<sup>12</sup> A substantial part if not the majority of audits of large companies obviously also form part of contractual demand as evidenced by the fact that many of them submitted their accounts to external auditors before it became mandatory to do so.

It is true that voluntary demand for auditing has historically been weak in continental Europe and Japan. Nevertheless, it is doubtful whether it would also be weak now on the hypothetical basis of no mandatory auditing legislation. This doubt is based on the notion that circumstances have radically changed. Low historical demand was probably due to traditional features of continental financial

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<sup>10</sup> Mandatory auditing has been established by the domestic legislation of EU member states on the basis of different Community directives (mainly the Fourth Directive, 78/660/EEC, of 25 July 1978, which has already been implemented in all member states). (See in this respect Buijink, Maijoor, Meuwissen and Witteloostuijn, 1996, pp. 25-31). Except for some countries in which all companies are obliged to have their accounts independently audited (Finland, Ireland, Norway [not a member of the EU] and Sweden), in the remainder the rules only make it obligatory when they reach a certain size. Mandatory auditing and a more detailed disclosure of financial statements by listed companies was adopted in the United States by the Securities Act of 1933. The adoption of mandatory auditing in the US was explicitly supported by the auditing profession and not opposed by firms, with scant discussion by the legislature (SEC, 1994, pp. 5-6). This has also been the case in many European countries. The effects of the rule are not clear, however. For empirical attempts to assess the consequences of the Securities Act, mostly focusing on stock exchange prices, see Simon (1989), Chow (1983), Jarrell (1981), Benston (1973) and Stigler (1964).

<sup>11</sup> The birth and historical evolution of the profession is testimony to the extent of voluntary demand for auditing, which in greater part took place outside the framework of legal obligations. This was particularly the case in Britain where much nineteenth century company legislation did not make it obligatory to carry out audits or make it necessary for them to be carried out by professionals. At the end of the nineteenth century, when the 1900 Companies Act made auditing generally mandatory for companies listed on the stock exchange, virtually all accounts of such companies were already being audited by professional chartered accountants. For a discussion and several historical references, see Watts and Zimmerman (1983, pp. 628-9), who demonstrate how the auditing of accounts came about a long time before any type of legal or regulatory obligation and appears as far back as the thirteenth century.

<sup>12</sup> For instance, after six years of mandatory audits of large and medium-sized companies, voluntary audits accounted for 23.01 percent of the total audits carried out in Spain in 1995 (*Boletín Oficial del ICAC*, no. 25, 1996, p. 38). Moreover, this voluntary demand has been growing since 1992.

systems, such as weak competition, close links between banking and industry and cross shareholdings. It is plausible that when these circumstances changed there would have been growing demand for safeguarding services. Moreover, in the years prior to mandatory auditing a substantial increase could be seen in demand amongst 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.

Furthermore, it might be argued that for these purposes the position of private users of accounting information and that of public users are largely comparable. Certainly, the latter cannot protect themselves by increasing the explicit price of their contribution to the company. They can however increase their regulatory and monitoring work in relation to it, both in fiscal terms and in complying with other types of legislation. This is the case, for example, with inspections of financial institutions in respect of which this same argument has been used to defend the conventional deposit insurance system based on a fixed explicit premium independent of the level of risk.

### 1.1.2 Empirical evidence

The contractual costs of businesses vary substantially depending on their structure. Consequently, they tend to demand auditing of differing quality. This is a demand *derived* from that of their contracting parties, who are usually more specialized the more complicated the contractual structure of the business (exemplified by the separation—specialization—of ownership and control inherent in going public on the Stock Exchange). It should be noted that regulatory demand also has an interest in audits of differing quality, increasing with the scope of the external effects of the business, which increase not only with its size but also through involvement in particular activities (such as banking, for example). It is therefore understandable that mandatory auditing legislation covering all types of company of a certain size is usually preceded by mandatory auditing legislation of a specific and/or sector nature.<sup>13</sup>

Many empirical studies support the theory according to which audit firms provide differing quality (increasing with the size of the firm and highest, in particular, in the case of the “Big Five” firms)<sup>14</sup>, in response to a varying demand for quality

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<sup>13</sup> This was the case in Spain, for example, where financial institutions were obliged to audit their accounts a long time before a general obligation was laid down by Act 19/1989.

<sup>14</sup> Empirical works in this respect particularly include that of Craswell, Francis and Taylor (1995), which restates and improves on several preceding works, showing that part of the price differential previously considered as a “reputation premium” (see Section 2.1.3 in this respect, below) should in fact be

amongst clients. The explanation lies in the fact that different companies have financial and contractual structures with a highly varying degree of potential conflict, in short with different levels of agency costs. As a result, they also have a demand for different degrees of quality in auditing their financial statements.

A large number of empirical works have in fact verified the existence of a positive relationship between different variables which are connected to the intensity of agency costs and the choice of higher quality auditors. In a retrospective analysis, Chow (1982) showed that in 1926, prior to legislation in the United States making auditing obligatory, voluntary demand for auditing amongst American companies depended on different indicators which it seems reasonable to believe were directly related to the degree of conflict between management, shareholders and creditors. Such indicators included the proportion of shares not owned by management, levels of indebtedness, the size of the business and the number of clauses linked to accounting information in loan agreements. Other empirical studies have demonstrated the significance of agency cost variables on change of auditor, revealing the expected effect even after taking account of varying client size and growth, the variables considered to have the greatest influence on change of auditor decisions.<sup>15</sup> This is also shown by the fact that most companies which go public on the Stock Exchange (and therefore increase potential contractual conflict) switch auditor to one of the large firms. Carpenter and Strawser (1971) documented this in the United States in a classic study. It has furthermore been shown how companies going public are more likely to obtain audit services from larger firms the greater their agency costs (Firth and Smith, 1992).

## **1.2 The dimensions of quality**

### *1.2.1 Technical competence and independence*

As an initial approximation to understanding the meaning of “quality” in auditing services let us assume that these services concern a particular set of data and that the information which the auditor needs to use in issuing his opinion is also fixed.<sup>16</sup> In these conditions, the quality dimensions are essentially technical competence and

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attributed to the investment required to produce specialized auditing. The interested reader will find references to these works in Craswell *et al.* (1995, p. 298, n. 2).

<sup>15</sup> See, in particular, Francis and Wilson (1988), as well as Defond (1992).

<sup>16</sup> Section 1.2.2 deals with a more complex scenario in which the auditor can use a more or less extensive series of variables on which to base his opinion, in which event the regulatory system can have a decisive effect by favoring or preventing the use of qualitative indications which are not verifiable by third parties or, on the other hand, restrict the auditor to just using indicators which can be verified (in what can be known as “defensive auditing”), which safeguards him from any potential liability in the event of future litigation.

independence. *Technical competence* is defined as the auditor's ability to detect errors or shortcomings in the financial statements being checked. *Independence* on the other hand is taken to be the willingness of the auditor to reflect in the audit report all problems and defects he has detected in the financial statements. In probability terms, technical competence can thus be defined as the probability of detecting defects in financial statements and independence as the probability of reporting them once they have been detected.<sup>17</sup> Auditing quality is thus defined by the combined probability that the auditor will detect and report on defects in accounts.<sup>18</sup>

These quality dimensions fit into the typology classifying different goods and services (or rather their different attributes) on the basis of the greater or lesser capacity of the client to evaluate their quality. From this perspective auditing presents characteristics of "experience goods" and "credence goods" rather than "search goods".<sup>19</sup> As with experience goods, the purchaser of auditing services is only aware of some quality attributes after acquiring them: mainly technical competence. Similarly, as with credence goods, the independence dimension can take even longer to ascertain. This is so, in particular, when there are no conflicts between the auditor and the client or when the auditor behaves independently with respect to that client but not with respect to others (any lack of independence by the auditor in relation to one client could easily take time to be ascertained by others).

### 1.2.2 *The importance of professional judgement and the danger of inducing "defensive auditing"*

The view provided in the previous section whereby only the technical competence and independence dimensions of quality are taken into account, presupposes that the auditing relates to and in his assessments and judgement the auditor only uses a fixed certain volume of information. The problem becomes more complicated when taking into account that in his work the auditor may use different types of information, which vary in terms of third party verifiability.

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<sup>17</sup> It should be pointed out that this definition of auditing quality in terms of technical competence and independence provides a useful breakdown for analysis since it defines two relatively distinct problems and therefore enables specialized rules and practices to be designed to support each of them. The two dimensions are not totally independent, however, as emphasized by the fact that a lack of independence can be shown by decisions which reduce effective technical competence. This would happen when the auditor decides not to make an effort to discover problems which he does not wish to report on.

<sup>18</sup> This definition of quality was developed from the so-called Positive Accounting Theory. See, in particular, Watts and Zimmerman (1980, p. 8; 1986, pp. 314-5) and DeAngelo (1981b, p. 186).

<sup>19</sup> The concepts of "search" goods and "experience" goods were formulated by Nelson (1970) and that of "credence" goods by Darby and Karni (1973).

### 1.2.2.1 The informative content of auditing

From the point of view of informative content the auditor should use, and his report therefore convey to the market and end users, as much information as possible. The safeguards required for using different types of information, however, vary depending on the degree to which the information can be verified. Moreover, the auditor himself will have reservations in using information which may be of little use in justifying his opinion in a future dispute.

A superficial understanding of auditing functions and, in particular, overlooking the need for the auditor's opinion to incorporate his *professional judgement*, often means that the problem of auditor independence is treated in a very narrow manner. This happens when attempts are made to further independence by increasing legal sanctions since such policies mean that independence in fact becomes limited to mere compliance with a series of verifiable criteria. This superficial approach is deceptive and its application in the legislative field may be responsible for reducing the value of auditing. The reason is that when the legal system makes auditors liable to a disproportionate extent, there is a risk of trivializing independence. Borrowing a term coined in the medical field, the result could be catalogued as "defensive auditing":<sup>20</sup> the auditor decides to play safe, reporting any possible doubt which may be raised by the accounts produced by management on the basis of verifiable criteria.<sup>21</sup> In this situation, the auditor is constrained to base his decision only on information which can be judicially verified (the only information which those who consider independence to be an absolute value mistakenly seem to acknowledge as valid). He thus dispenses with that information regarding the company which is not verifiable since such information is useless as a defense in the event that the company ends up with unforeseen financial problems which generate litigation with the auditor.

From the company's point of view it is not generally optimum for auditors to be merely independent. What is required of auditors is that they exercise their professional judgment independently.<sup>22</sup> It would be prejudicial however if, in order to preserve his independence, the auditor is obliged to refrain from making a profes-

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<sup>20</sup> "Defensive medicine" is understood to be the administration of all types of treatments with very low expected benefits but which are administered in any event to avoid possible legal liability.

<sup>21</sup> Such consequences of the liability system are far from trivial, as shown by the results of research by the National Bureau of Economic Research which in 1996 reliably quantified its effects on "defensive medicine" in the United States (Kessler and McCellan, 1996). Various direct reforms of the professional liability system (maximum limits, abolition of punitive damages, calculating interest from the date of judgement only, reducing compensation by sums obtained from other sources) enabled medical expenses to fall by between 5% and 9% without adverse consequences in terms of mortality or medical complications. Another indication of the importance of the matter is provided by the fact that the benefits obtainable by reducing liability are estimated at 600 million dollars per year simply in relation to myocardial infarction costs.

<sup>22</sup> This requirement is highlighted in the report on good government of companies prepared by the Centre for European Policy Studies (CEPS, 1995, pp. 44-5).

sional judgement since this provides valuable information to those using the company's accounts. This, broadly speaking, is the argument as to the relative nature of auditor independence in terms of information economics propounded by Grout, Jewitt and Whittington (1994). In developing their argument they make a fundamental distinction in modern information economics literature and in the field of incomplete contracts in particular between information which is merely *observable* by the parties (in this case the auditor) and that which is also *verifiable* by third parties (here, the legal system).<sup>23</sup> Grout *et al.* consider that the auditor can use two types of information in his professional judgement: what they call "hard" information, which is observable and verifiable, and "soft" information, which is observable but not verifiable. Specifically, they assume (although similar conclusions can be reached on more restrictive assumptions) that in the case of auditing hard information can be suppressed from the accounts but not equivocally transmitted whilst soft information can be the subject of equivocation and subjectiveness in transmission.

In order to maximize the value of auditing, the regulatory framework must make it possible for auditors to use and transmit this soft information regarding the client to the market and third parties. To this end, he must exercise his professional judgement based on both categories of information. If the regulatory framework penalizes him excessively, he will only make use of the hard information. Consequently, the audit will contribute less information and may sometimes even be misleading. The latter may occur when the auditor is obliged to play safe and base his opinion on hard information. He would then, for instance, disclose his reservations even when he considers that the client's situation would not warrant such reservations after taking into account the soft information available to him regarding the client, information that he is not in fact allowed to transmit.<sup>24</sup>

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<sup>23</sup> Grossman and Hart were pioneers in differentiating between observable and verifiable information in their article on vertical integration (1986).

<sup>24</sup> Evidence regarding auditor switching provides some indirect indication that different economic agents have access to and can verify varying types of information. Krishnan (1994) found that a change of auditor is more likely when the auditor gives a qualified opinion applying apparently conservative criteria in relation to the *observable* financial position of the business. The results of another study (Krishnan and Stephens, 1995) are consistent with the following explanation: the first auditor has private information which leads him to be conservative and the second also has access to this information and therefore does not modify his opinion compared with that of the former auditor. Obviously, he also cannot previously commit himself to issuing an unqualified opinion given his lack of knowledge of the client. Although the set of information which is verifiable by a judge probably includes all the information observable by researchers carrying out this type of empirical study, a comparison of the two situations has at least an indicative value to the effect that those participating in economic activities use sets of information with different properties in terms of its observability.

Using this type of distinction, Grout *et al.* argue that negotiation between auditor and client as to the content of accounts should be positively reconsidered. In this way, accounts have a more subtle and contextual informative function:

the most informative thing about accounts as currently prepared might not be the literal interpretation of the information they contain (claimed debt-equity ratios, profits, etc.), but the fact that an apparently competent group of professional auditors, after exercising their professional judgement, are prepared to let the company make the claims that it does, even though the auditors thereby leave themselves open to the possibility of large law suits (1994, p. 332).

Pursuant to this line of argument,<sup>25</sup> the role of auditor decisions must be understood in the context of how recipients of accounts process the information (not simply shareholders but increasingly by investment analysts in a developed and therefore specialized economy). For example, assume that an auditor agrees to suppress detailed hard information in such a way that the accounts only include a generic and ambiguous statement of the “including adjustment of taxation reserves” type. It could be argued that this phrase is sufficient for readers to assume the worst in relation to the amount affected, which is not divulged.<sup>26</sup> The recipient of the information will positively assess the fact that the auditor has agreed not to detail the information as a signal of confidence, however. The reader knows that the auditor is taking a risk by allowing this and that he would only do this if he considered that it was unlikely that the matter would give rise to future litigation or loss of reputation. In other words: the suppression of negative hard information from some audited accounts in itself impliedly involves the dissemination of positive soft information. “In the signalling equilibrium, statements like ‘including a transfer from taxation reserves’ has a conventional meaning: the client firm has soft and hard information that together exclude the worst possible cases” (Grout *et al.*, 1994, p. 335).

#### 1.2.2.2 General normative consequences: the argument for rules which optimize the informative content of auditing

This analysis has far-reaching consequences for both the ends and means of legislative and regulatory policies in the auditing field. In the first case, it justifies legislators and regulators adopting the objective of optimizing the value of the information which the audit provides to users. To this end, they should consider that the rules define the type of audit which it is possible to carry out. Secondly, with

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<sup>25</sup> This contextual interpretation of financial statements also accounts for possible systematic bias, if any, as modeled by Antle, Nalebuff and Baiman (1991).

<sup>26</sup> This was the situation in the Royal Mail case, dealt with by Grout *et al.* (1994, pp. 333-4).

respect to the means for bringing about this objective, it must be taken into account that regulations which purport to advance independence to the limit can prevent auditors from transmitting the soft information available to them. If, consequently, they base their opinion on hard information only, the audit will be likely to have less informative content, however.<sup>27</sup>

From this point of view, when defining the context in which auditors work, legislators can make as many mistakes in one direction as in the other, laying down the rules in either too lax or too stringent a manner. If the rules are too stringent, auditors will tend to carry out “defensive audits” and only use hard information since this can be used as a defense in litigation. Moreover, they will refuse to base their decisions on soft information which will not assist in their defense if the client ends up with problems in the future. As a result, the accounts and audits will contain less information.

It could be thought on the other hand that if the rules are too lax auditors will bow to the demands of their clients and in turn will tend to be very lenient, giving their approval to companies which do not warrant it as a result of their high degree of vulnerability.<sup>28</sup> This consequence cannot be generalized, however. This may be the conduct of some auditors but the market provides incentives for at least part to develop a reputation for exercising balanced professional judgements. Let us consider an extreme case in which the law does not provide any system of sanctions against auditors and it is also impracticable to sue them. It is foreseeable that in such a situation there would be greater development of private enforcement and sanctioning instruments. These would be based on the auditor’s reputation and the castigating of underperformance through switching decisions.

Firstly, there is no doubt that in this situation auditing firms have incentives to develop a good professional reputation since there will be clients who demand auditing with an optimum degree of independence and this would not be the outcome of a very lax legal system. On the other hand there is no risk that the market will itself generate an excessive level of sanctions which would be equivalent to a situation of excessively stringent rules. The reason is that the market is probably more competent than the legal system when it comes to verifying qualitative information, on several grounds. Without being exhaustive, it should be taken into account that (a) the market is not restricted to the use of specific types of evidence; (b) it acts by accumulating an almost infinite number of individual decisions and therefore individual variables are of little importance; (c) such decisions are taken largely by professionals who can be assumed to be well informed because they have incentives

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<sup>27</sup> The report from the Centre for European Policy Studies on the proper government of companies shared this view in relation to the regulation of accounting information by statutory rules in continental Western Europe (CEPS, 1995, p. 18).

<sup>28</sup> As do Grout *et al.* for example (1994, p. 336).

to be informed; and (d) their negotiating costs in this case are nil (as compared with their equivalent in the legal process or an out of court agreement). As a result, much information which is observable by auditors but not verifiable by the legal system is verifiable by the market and auditors will have no hesitation in using it if the potential sanction comes from the market rather than the legal system.

There is thus substantial asymmetry between the consequences of the two types of regulatory error. The risk with laxity can at least in part be corrected by the market and, moreover, does not pose obstacles to using all types of information. The risk with excessive strictness on the other hand cannot be corrected: all auditors, whatever their reputation, are forced to dispense with soft information when preparing their professional judgements. It should further be noted that if there is greater variability in the sanctions of a legal type, this adds force to the argument that increasing them tends to bias the content of the audit, making it less informative.

#### 1.2.2.3 Particular normative consequences: non-audit services as a source of information for professional judgement

If the informative value of auditing is taken as an objective and, therefore, there is some appreciation for the need for auditors to exercise their professional judgement, understood in the same sense as in the previous sections, the provision of non-audit services will have a doubly positive effect. Firstly, when such services are provided to audit clients the auditor can reach a more deeply grounded professional judgement since he will have a greater depth of knowledge of that part of the value of the business which is rarely reflected in the accounts, such as intangible assets (reputation, solid organizational structure, management capability, etc.). By carrying out purely auditing tasks, it is more difficult to gain a better idea of the extent of such assets. Those using the accounts would like to receive information on the existence of such assets, however. The audit can at least provide an indication of them and this indication will be more reliable the greater and better the knowledge serving as a basis for the professional judgement which the auditor must construct, a knowledge which can be substantially improved by providing non-audit services to the same client. In addition, the provision of such services will enable the auditing firm to contract and make efficient use of the experts required to improve and extend its professional judgement in terms of greater reliability and depth as well as extending it to highly specialized activities and undertakings.

### 1.3 The conflict with third parties and among clients regarding auditor independence

The greater part of the added value of auditing is generated as a contract facilitating service. As such, at least three parties (client, auditor and user of the accounts) have an interest in auditing quality. The asymmetries and conflicts that arise are thus more complex than in the majority of goods and services markets in which only two parties are involved. From this point of view, conflicts which arise on the basis of the two dimensions or attributes of auditing quality, i.e. technical competence (a) and independence (b) can be distinguished.

a) Conflicts in relation to *technical competence* in the strict sense have fairly ordinary characteristics inasmuch as it can be assumed that the client will always want the auditor to provide quality in this respect as with any other supplies. In such cases the only relevant informational asymmetry is that which may exist between client and auditor since the former always has an interest in preventing it from arising, which will tend to prevent it appearing in relation to third parties. Moreover, the quality can be perceived at the same time or immediately after the service and is therefore an attribute which can be categorized as an “experience” rather than a “credence” attribute.

b) *Independence* is the more complex qualitative attribute. Firstly, the role played by auditing in third party contracting means that the client will require independence or otherwise depending on his situation. In problematical cases, although the client in principle usually wants high quality auditing, after his financial situation changes he may prefer a low quality audit in terms of independence. More precisely, he would prefer a dependent auditor, although one perceived by third parties as being independent. The reason is that this deceptive audit will enable him either to contract with third parties on better terms than those available in his situation if the same is known to such third parties, or to postpone the review of those contracts which involve corrective action based on financial situation (as normally occurs, for example, in the case of loan agreements).<sup>29</sup> In order to practice this deception on third parties the latter must obviously attribute the auditor with superior quality to that which he is actually providing since otherwise they would discount a favorable report which would lose its value in terms of evidencing the client's situation.

Third parties who contract with a client of an auditor trusting in an audit which they believe is independent are not the only economic parties prejudiced by a deceptive audit, however, nor perhaps even the most prejudiced when the legal system

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<sup>29</sup> See Smith and Warner (1979).

imposes strict professional liability on the auditor. They are not the only ones because other clients of the auditing firm will also be harmed. If it is assumed that, particularly in the view of third parties, auditors generally provide a uniform level of quality in their audits (particularly in terms of independence), the clients who continue wanting an independent auditor to demonstrate their financial good health will see their names associated with that of an auditor tainted by lack of independence. Moreover, unlike these clients of the auditor, affected third parties can have recourse to the legal system to obtain compensation for the loss which may be caused to them by the lack of independence.<sup>30</sup> They also have the active presence of professional bodies to support them along with regulators of the auditing profession.

As a result, a large part of the conflict regarding independence does not manifest itself so much between auditors and those using the accounts of a client in a difficult situation as between auditors and their other clients who do not wish the independence of their auditor to be diminished.<sup>31</sup> The cost to one of these clients of his auditor reducing quality and this being visibly so (by a scandal, for example) arises not only in respect of the direct loss to him from the fact that those using his accounts have less confidence in them, but also because of the deterioration in "specific" assets, those whose value is associated with continuity in his relationship with the auditor. If, by way of reaction, he decides to change auditor, he will lose all these assets. Alternatively, if the client decides to continue with his original auditor, he will suffer a loss in terms of the diminished value of the audit to recipients and, therefore, in terms in the increased agency costs he will incur in his relationships with them. It is true that since the scandal affects his negotiating power with the auditor it can also be expected that if he decides to continue the relationship he will transfer part of this loss to the auditor by means of a price re-

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<sup>30</sup> This compensation may also be excessive in those countries in which the auditor is subject to a system of joint and several liability, including several European countries (Buijink *et al.*, 1996, p. 96). This matter will be considered again in Section 3.4.3.

<sup>31</sup> Readers familiar with management practices and the economic literature of franchises will recognize a structure in this conflict very similar to that often arising between franchisees of the same franchisor. Franchisee establishments tend to reduce the quality of their services to the prejudice of the reputation of the brand name and the network of establishments of which they form part. For this reason, an essential function of the franchisor is to safeguard quality and take disciplinary measures against those who do not fulfil minimum standards. When taking disciplinary measures such as expulsion the franchisor does so to the benefit not only of himself but, and perhaps principally, to the benefit of the other franchisees. It is believed that the periodic collection of fees of a variable nature (which incurs a cost in lessening the incentives of franchisees) is precisely aimed at giving the franchisor an incentive to carry out this disciplinary function effectively. See, in relation to this aspect, principally the works of Rubin (1978, p. 227), Brickley and Dark (1987, p. 410) and Lafontaine (1992, p. 279). Moreover, litigation brought by franchisees against their franchisors as a result of inadequate control of members of the network is commonplace. A famous case in the United States was Creel Enterprises vs. Mr. Gatti's, in which the former sued the franchisor as it was harmed by the repeated breach by another member of the chain of obligations imposed on all the franchisees (Johnson, 1992, p. 18).

duction, as examined in Section 3.3. (From this point of view, the need to discipline the auditor who compromises his reputation for independence helps explain why under a system of freedom of contract auditing contracts are entered into on an annual basis, despite the fact that the relationship usually lasts for a much longer period, of between 30 and 40 years).<sup>32</sup> It will be shown later in this work that regulation would do better by modifying its current emphasis on the effect that auditing failure has on third parties, because in so doing it would strengthen market incentives.

Summarizing, auditing produces three principal types of conflict in relation to quality: (a) asymmetry between the auditor and client which is directly manifested basically in relation to technical competence which can be seen as an “experience” service and which is the least conflictive; (b) the indirect asymmetry between the auditor and client on the one hand and users of accounts on the other which is manifested in terms of independence and is of the nature of a “credence” service, since quality is only perceived with the passage of time and when the financial situation of the client deteriorates; and (c) the indirect asymmetry between the different clients of the auditor in relation to his independence in respect of *other* clients. The latter is probably the most distinctive and conflictive feature of auditing because the fall in quality is only perceptible on an occasional and delayed basis.

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<sup>32</sup> For European companies, data from Ridyard and de Bolle (1992, pp. 89-91) enable the average rotation period to be estimated at between 30 and 40 years. Large companies seem to have a lower change rate. Thus, in a study of 3,500 audits carried out between 1980 and 1988 in England it was estimated that the average length of each relationship was 40 years (“Auditors Too Cosy with Clients?” [*Accountancy*, January 1995, p. 11]). Ridyard and de Bolle provide similar data for Great Britain: in a sample of 137 large companies the rotation rate was lower than 1% between 1987 and 1990 (1992, p. 89). The figures are similar in the United States. There, rotation affects a percentage of between 1% of large companies and 6% of small companies each year. See, on this, the studies cited by DeAngelo (1981b, pp. 188-9) and Beck, Frecka and Salomon (1988b, pp. 68-9).