

2 Literature Review and Current Issues

2.1 Agency Theory and Audit Services

Before discussing the quality of audit services, it is essential to understand the need of and the demand for audit services. On the one hand, financial statement audits are required by law and depend in most jurisdictions on both the company's legal structure and the company's size, such as total assets, turnover, and/or number of employees.¹¹ On the other hand, the principal-agent problem delivers the economic reasoning for a financial audit. It is based on the dilemma of different interests of both parties – the principal and the agent. Although the agent is hired by the principal and has a mission to fulfill according to the principal's interest, the agent tends to follow his own interest and to maximize his own benefit, whenever there is the opportunity. Such opportunities are given in situations of asymmetric information. Having less information than the agent, the principal cannot ensure that the agent is always acting in the principals' best interests.

The Agency Theory provides approaches to tackle the problem.¹² For this purpose, it categorizes three types of asymmetric information: hidden characteristics, hidden action/information, and hidden intention.

Hidden characteristics are characteristics of the agent itself or characteristics of the agent's services and goods. These characteristics are not known before the contract between the principal and the agent is signed. If the principal knew the hidden characteristics, he probably would not have signed the contract. Hence, the principal always faces the risk of adverse selection. One of the first research papers on adverse selection was composed by Akerlof (1970) in his paper "The Market for Lemons: Quality Uncertainty and the Market Mechanism". The counteracting institutions to avoid adverse selections are signaling and screening.¹³ Signaling is the action of the agent, who signals that information provided are

¹¹ Compare to the mandatory audit requirements in Germany: mid-sized and big corporate companies (mittelgroße und große Kapitalgesellschaften) have to undergo an annual financial audit (Sec. 316 of the HGB); non-corporate companies have to undergo also annual financial audits, if they are subject to the German Disclosure Act (Publizitätsgesetz).

¹² The approaches to encounter the principal-agent dilemma are always connected to additional costs either for the principal or the agent, the so-called agency costs.

¹³ Akerlof, George A. (1970), p. 492.

credible.¹⁴ The agent may take costly actions in an attempt to convey the information (a car seller as agent offers a warranty).¹⁵ Screening is the action of the principal. The principal attempts to elicit information from the agent by letting him choose, for instance, the type of contract.¹⁶

Hidden actions or hidden information occur only after the contract between the principal and the agent is signed. Hidden action means that the agent has an arbitrary leeway, which the principal cannot fully observe.¹⁷ Examples for hidden actions exist in employer-employee relationship, car repair services, and all kinds of insurance relationships.

Hidden information exists where the principal can indeed observe the actions, but cannot estimate the quality of them (e.g. due to the lack of expertise).¹⁸ Examples where hidden information occurs typically are seller-buyer relationships, physician-patient relationships, and all kinds of experts' consultations. The principal's risk in both cases is referred to moral hazard.¹⁹ One approach to mitigate moral hazard is a (strict) monitoring over the agent, which is not always possible. Another approach is to provide incentives to influence the agent's interest.

Hidden intention is similar to hidden characteristics as the hidden intention may exist already before the contract between the principal and agent is signed. Even if the principal has all the transparency and control over the agent's actions (this means there is neither a hidden action nor hidden information), it may still be the case that the unknown intention of the agent causes conflicts. In cases, where the agent makes an irreversible investment and the principal relies on the good will of the agent, the principal may get caught in a dependency relationship with the agent, because of the irreversible investment. Literature speaks in these cases from a hold-up risk for the principal, if the agent can exploit the situation.²⁰ Approaches to resolve such problems are based on attempt in aligning and harmonizing the interests of both parties. This can be reached by adding contractual

¹⁴ Varian (1992), p. 469.

¹⁵ Varian (1992), p. 469; Kessler (2012), p. 14.

¹⁶ Kessler (2012), p.25.

¹⁷ Arrow (1985), p. 38.

¹⁸ Glossary of the Department Business Administration, University of Muenster, Germany, <http://www.wiwi.uni-muenster.de/06/toplinks/glossar/glossar.php?begriff=2> (December 15, 2012, 15:00 CET).

¹⁹ Herzig/Watrin (1995), p. 750; Picot/Dietl/Frank (2005), p. 75.

²⁰ For instance, Herzig/Watrin (1995), p. 792; Picot/Dietl/Frank (2005), pp. 79 et seq.

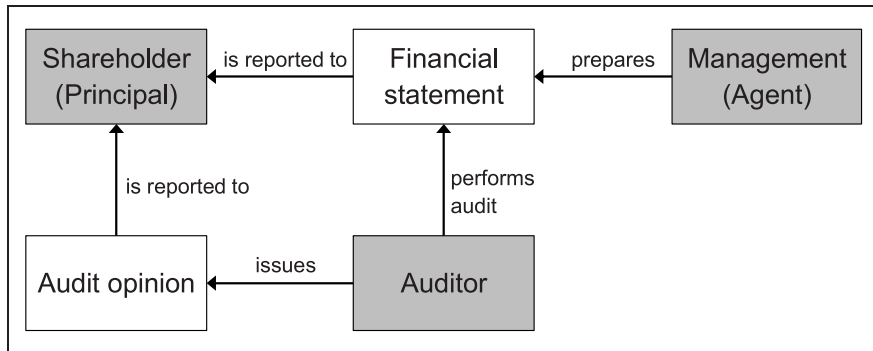


Figure 2.1: Shareholder-Management-Relationship including the Auditor
(source: chart based on Messier 2003²¹)

penalties for such cases to the contract or by requesting (supplementary) collateral from the agent.²²

In context of the shareholder-management relationship, all three types of asymmetric information may occur; however, hidden information and hidden actions are the predominant risks (moral hazard) in this relationship. In order to dissolve the information asymmetry of (financial) information between the shareholders (principal) and the management (agent), auditors are engaged to ensure the completeness, accuracy and reliability of financial information. Audits, in general, are a tool to review management's actions and management's reporting on a regular basis, which decreases the information deficit of the principal. Figure 2.1 shows the principal-agent-relationship between shareholder and management, including the auditor.

²¹ Messier (2003), p. 6.

²² Herzig/Watrin (1995), p. 792; Picot/Dietl/Frank (2005), pp. 79 et seq.

2.2 Definitions of Audit Quality

2.2.1 *Two Main Schools of Thoughts*

2.2.1.1 DeAngelo's Definition of Audit Quality

Indisputably, the most cited definition of audit quality stems from DeAngelo (1981a). DeAngelo defines audit quality as “the market-assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system, and (b) report the breach”.²³ This definition contains two aspects of audit quality: (1) the competence of the auditor for detecting misstatements and (2) the independence of the auditor for reporting such misstatements. Although this is the most cited definition of audit quality, the problem is that audit quality according to this definition cannot be observed let alone measured.²⁴ Hence audit quality measures based on this definition are indirect methods of measuring audit quality with the aid of indicators.²⁵ Probably the most used proxy in audit quality research studies is the statistical estimation of discretionary accruals in financial statements. The assumption is that companies’ representatives attempt to manage the annual results such they benefit the most. Audit quality in this sense means how well the auditor can prevent discretionary accruals in the financial statement. Others proxies for audit quality based on DeAngelo’s definition for example are restatements, accounting (and auditing) enforcement releases and going concern reports.

2.2.1.2 Level of Compliance with Standards

Another approach how to define audit quality is a more normative way of thinking. The auditor performs with excellent quality if he/she complies completely with all relevant standards.²⁶ In this perspective, the level of compliance with auditing standards reflects the level of audit quality. Peer review findings, inspection results of oversight boards (such as the PCAOB in USA and the APAK in Germany) as well as lawsuits against auditors are in this case the best indicators for audit quality. Criticism of this approach is evident. The overall objective

²³ DeAngelo (1981a), p. 186.

²⁴ Knechel, W. R. (2009), p. 2.

²⁵ In contemporary research, in cases where indirect measures of audit quality are discussed, indicators are also referred to surrogates or proxies.

²⁶ Krishnan, J. and Schauer P. C. (2001), p. 85.

of an audit is not to comply best as possible with relevant standards, instead it is to ensure high quality financial reporting. The European Commission explicitly stated in its green paper “Audit Policies: lessons learned from the crises” that “more substance over form” is needed not only in IFRS accounting but also in financial statement auditing as the following citation describes:

“From a user perspective, auditors should provide a very high level of assurance to stakeholders on the components of the balance sheet and the valuation of those components at the balance sheet date. The Commission wishes to explore the case for ‘going back to basics’ with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work i.e. tasks that should primarily remain the responsibility of the client and in the main be covered by internal audit. Auditors could disclose which components were directly verified and which were verified on the basis of professional judgment, internal models, hypotheses and management explanations. To provide a ‘true and fair view’, auditors should ensure that substance prevails over form.”²⁷

2.2.1.3 Financial Reporting Quality and Compliance with Auditing Standards

DeAngelo’s definition connects audit quality one to one with financial reporting quality. A financial report where all accounting breaches have been detected and reported by the auditor represents high audit quality. Hence, the level of assurance that no material error remains undetected and unreported is the metric of audit quality in DeAngelo’s definition. Followers of this thought of school, for instance, are, Palmrose (1988) “the probability that an auditor detects and reports misstatements”²⁸, Titman/Trueman (1986) “accuracy of information auditors provide to investors”²⁹, Leffson (1988) “Urteilsfähigkeit, Urteilsfreiheit und sachgerechte Urteilsbildung (judgment capacity or competence, judgment freedom or independence, and proper judgment development)”³⁰ and Knechel (2009) “Audit quality is the achieved assurance level”.

The other approach where audit quality goes along with the level of compliance with auditing standards is represented, for instance, by Copley/Doucet (1993), Krishnan/Schauer (2001), McConnell/Banks (1998), Aldhizer/Miller/Moaglio (1999) and Niemann (2004).³¹

²⁷ European Commission (2010), p. 7.

²⁸ Palmrose (1988), p. 55.

²⁹ Titman/Trueman (1986), pp. 159 et seq.

³⁰ Leffson (1988), pp. 66-67.

³¹ Wiemann (2011), p. 43.

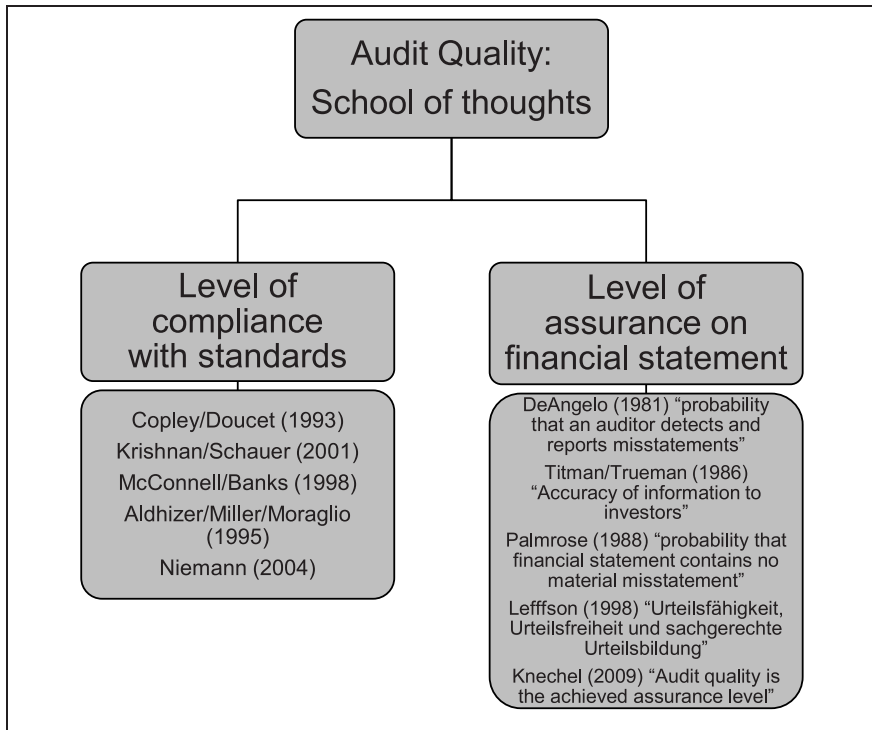


Figure 2.2: Audit Quality: School of Thoughts
(source: own development based on Wiemann 2012³²)

The hierarchy in figure 2.2 summaries the school of thoughts in audit quality research.

GAO (2003) combines both aspects (level of compliance with standards and level of assurance on financial statement) in its definition of (high) audit quality.³³ According to GAO (2003) a high quality audit is performed “(1) in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are presented in accordance with generally accepted accounting principles (GAAP) and (2) are not materially misstated whether due to errors or fraud.”³⁴

³² Wiemann (2011), p. 43.

³³ GAO (2003), p. 13.

³⁴ GAO (2003), p. 13.

This definition shall also include not only the actual audit quality but also the perceived audit quality. It assumes that “reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with GAAS and that, within the requirements of GAAS, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor’s opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company’s auditor of record and reporting the reason for the resignation to the SEC.”³⁵

2.2.1.4 Francis Framework on Audit Quality Research

Francis’ framework has six dimensions, which affect audit quality: (1) audit inputs, (2) audit process, (3) accounting firms, (4) audit industry and audit markets, (5) institutions, and (6) economic consequences of audit outcomes.³⁶

Apart from the financial statements and financial records which serve as well as inputs to the audit production Francis defines two *audit inputs*: (1) audit-testing procedures, and (2) engagement team personnel. The *audit process*, the second dimension of the framework, is the element where decisions and judgments are made by the engagement team with respect to the specific audit tests to be performed as well as the interpretation of evidence from these tests, and the ultimate engagement-level decision with respect to the audit report.³⁷

According to Francis (2011) auditing takes place within the context of an *accounting firm*. Accounting firms issue audit reports together with client’s financial statements. They hire, train, and compensate auditors and develop audit procedures.³⁸

Providing audit services accounting firms constitute an *audit industry and an audit market*, which itself affect other markets and economic behavior. Last, auditing takes place within a larger *institutional context* that affects the incentives and behavior of individual auditors and accounting firms.³⁹

³⁵ GAO (2003), p. 13.

³⁶ Francis, J. R. (2011), p. 125 et seq.

³⁷ Francis, J. R. (2011), p. 125.

³⁸ Francis, J. R. (2011), p. 126.

³⁹ Francis, J. R. (2011), p. 126.

The audit report – the only observable audit outcome – affects clients and users of the audited accounting information leading to *economic consequences*.⁴⁰

2.2.2 *Regulatory Definitions and Frameworks on Audit Quality*

2.2.2.1 Directive of the European Union

The European Commission defined audit quality implicitly while enacting a directive, which mandatorily constitutes a quality assurance system for auditors and audit firms. According to EU Statutory Audit Directive under Article 29 (1) (f) quality assurance reviews have to include the following components: (i) compliance with applicable auditing standards, (ii) independence requirements; (iii) quantity and quality of resources spent, (iv) audit fees charged, and (v) internal quality control system of the audit firm.⁴¹ This legal definition identifies the antecedents of audit quality dimensions and it has been the fundament to implement peer reviews and later oversight board inspections in European jurisdictions.

2.2.2.2 PCAOB's Definition of Audit Quality

The Standing Advisory Group (SAG), which is a sub-group of the PCAOB, has defined the quality of an audit firm's work as follows:

“The quality of a firm's work ultimately depends on the

- integrity,
- objectivity,
- intelligence,
- competence,
- experience, and
- motivation

of personnel who

- perform,
- supervise,
- and review the work.”⁴²

⁴⁰ Francis, J. R. (2011), p. 126.

⁴¹ European Parliament (2006a): Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts..

⁴² PCAOB (2011), QC Section 20.12, <http://pcaobus.org/Standards/QC/Pages/default.aspx>.

2.2.2.3 International Standard on Quality Control (ISQC 1)

ISQC 1 requires the audit firm (including sole practitioners) have to establish and maintain a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards as well as with regulatory and legal requirements and that reports issued by the firm or engagement partner are appropriate in the circumstances.⁴³

In order to ensure audit quality ISQC 1 sets out six areas which should be addressed by firm's quality control policies and procedures, and should be documented and communicated to the firm's personnel:⁴⁴

- Leadership responsibilities for quality within the firm,
- Ethical requirements,
- Acceptance and continuance of client relationships and specific engagements,
- Human resources,
- Engagement performance and
- Monitoring.

Leadership Responsibilities for Quality within a Firm

The standard emphasizes that audit firm's management is responsible for the firm's system of quality control.⁴⁵ Management shall establish policies and procedures which promote a culture of quality within the organization.⁴⁶ Further, the standard stresses that "firm's leadership and the examples it sets significantly influence the internal culture of the firm".⁴⁷ Policies and procedures shall ensure that audit work complies with professional standards and applicable legal and regulatory requirements as well that reports issued are appropriate in the circumstances.⁴⁸

Further, management shall also assign operational responsibility to persons, who have sufficient and appropriate experience and abilities for the firm's system of quality control in order to develop appropriate policies and procedures.⁴⁹

⁴³ IAASB (2012b), ISQC, Sec. 11 (Objective).

⁴⁴ IAASB (2012b), ISQC, Sec. 16-17.

⁴⁵ IAASB (2012b), ISQC, Sec. 18.

⁴⁶ IAASB (2012b), ISQC, Sec. 18 and Sec. A4.

⁴⁷ IAASB (2012b), ISQC, Sec. 18.

⁴⁸ IAASB (2012b), ISQC 1, Sec. A4.

⁴⁹ IAASB (2012b), ISQC 1, Sec. 19 and Sec. A6.

Relevant Ethical Requirements

According to IFAC, “the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements” such as the IESBA’s Code of Ethics.⁵⁰

The IESBA Code establishes the fundamental principles of professional ethics, which include:⁵¹

- Integrity (Code of Ethics, Sec. 110),
- Objectivity (Code of Ethics, Sec. 120),
- Professional competence and due care (Code of Ethics, Sec. 130),
- Confidentiality (Code of Ethics, Sec. 140); and
- Professional behavior (Code of Ethics, Sec. 150).

Acceptance and Continuance of Client Relationships and Specific Engagements

Auditors should consider the following factors when accepting or continuing audit relationships or engagements:

- Competence, Capabilities, and Resources (ISQC 1 Sec. 26a and Sec. A18),
- Integrity of Client (ISQC 1 Sec. 26c and Sec. A19),
- Continuance of Client Relationship (ISQC 1 Sec. 27a and Sec. A21),
- Withdrawal from engagement (ISQC 1 Sec. 28 and Sec. A19), and
- Considerations Specific to Public Sector Audit Organizations (ISQC 1, Sec. 26-28 and Sec. A23).

Human Resources

ISQC 1 requires audit firm to establish policies and procedures “designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles”.⁵² Personnel issues relevant to the firm’s policies and procedures related to human resources include, for instance:⁵³

- “Recruitment,
- Performance evaluation,

⁵⁰ IAASB (2012b), ISQC 1, Sec. 20.

⁵¹ IAASB (2012b), ISQC 1, Sec. 20 and Sec. A7; IESBA (2012), Sec. 100.5.

⁵² IAASB (2012b), ISQC 1, Sec. 29.

⁵³ IAASB (2012b), ISQC 1, Sec. A24.

Audit Quality

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