Regulatory problem of auditors

An audit is a confidential examination of the truth and fairness of a company's financial reports. Given their confidentiality, the working of auditors and their work papers cannot be examined by the public. We therefore do not discover until later whether or not auditors are carrying out their duties in a proper manner. It is often only when a company crashes that details of the auditor's conduct become public. They will be contained in reports issued by royal commissions, investigators or liquidators, and possibly through court cases.

Historically, the chief means of regulating auditors has been through court cases arising from breach of contract. When the auditing function was developed in nineteenth-century England, the government followed the principles advocated by Adam Smith in his book *Wealth of Nations*. The government did not favour legislation as a form of control (Edwards 1989, p. 13). The chief regulatory device was the contract between the auditor and the company. If the auditor was negligent and caused the company to suffer a loss, the company could recover its loss by suing the auditor.

The use of the contract as a regulatory device has many advantages for government. The first is that the costs involved are not a heavy burden on the government's budgets. The one cost government would bear is that of providing courts where disputes can be heard. However, there are minimal surveillance costs. It is argued that detailed regulations contained in government legislation can stifle industry, and extra costs are incurred by companies through ensuring they follow legislative requirements. As managers employed by companies work on a day-to-day basis with auditors, it could also be argued that companies, through their management, are in the best position to determine auditors' negligence and thus to overcome some of the problems relating to the fact that auditing cannot be observed by the general public.

The contract has probably declined in importance as a regulatory device for the following reasons.

The contract is between the auditor and the company; in law, therefore, the company is the client of the auditor. Many have argued that in reality the client has become 'management', since they have the power to select and dismiss the auditor and set fees. Also, management is responsible for awarding any consultancy services, and for these reasons the auditor would wish to remain in management's favour. Further, the duties of a director have become far more onerous, and directors or management may not wish to sue auditors, fearing that details revealed in court might give the Australian Securities and Investments Commission information that allowed them to prosecute directors or management.

Perhaps the main reason why contracts are a less effective regulatory device is the use of out-of-court settlements. Court cases involving auditors entail complex issues that can lead to high legal costs. Through partners of audit firms divesting themselves of personal assets, indemnity insurance is the only source of funds available to satisfy legal claims against auditors. The trade-off between high legal costs and limited indemnity insurance favours an out-of-court settlement. The main disadvantage of an out-of-court settlement is that it will not help us to evaluate the state of the auditing profession. For example, in Australia many legal suits against auditors arose from the corporate collapses of the late 1980s. Nearly all were settled out of court, so we have no way of knowing whether bad auditing was a factor in these collapses, and whether the mistakes made by auditors have been rectified.

The main regulatory device popularised through the collapses of the late 1980s was for companies to use corporate governance systems to control the excesses of executive management. Examples of corporate governance practices adopted by companies include:

- *Separation of the functions of chairman and managing director*. Segregation of duties is a feature of internal control systems. If one person held both of these positions, they would have immense power and might abuse that power.

- *Audit committee made up of non-executive directors to oversee the conduct of the audit*. This would have the advantage of giving non-executive directors more involvement in the day-to-day running of the company. This is important, as non-executive directors have onerous legal duties. Also, the auditors could take their problems to non-executive directors. It is argued that results (such as profits) directly reflect executive directors' management abilities, and they therefore have an incentive to reject any adjustment required by auditors that lowers profit. Non-executive directors are said to be less influenced by these pressures and will be more willing to consider the auditor’s adjustment to profit.

- *Risk committees whose task is to assess all major risks confronting companies and devise strategies to control those risks*.

Government favours companies’ adopting corporate governance systems, since companies rather than governments bear the costs of the systems. Also, no detailed legislative requirement is involved that would stifle industry, and such a non-legislative approach is consistent with deregulation. Deregulation has been a major policy of government over the past decades. However, critics of corporate governance systems argue that the companies who collapsed already had, at least on paper, adequate corporate governance systems.

References

Edwards, John Richard 1989, *A History of Financial Accounting*. London: Routledge.