Imagine that you want to decide what auditor to select and there are two potential auditors on the market to audit your financial statements. One auditor will make sure that the whole world believes that the financial statements of your company reflect the economic conditions your firm faces and makes sure that this belief is warranted. The second auditor is less able to provide that level of assurance. Which auditor will the company select?

In the case I present the choice seems to be simple: the company will be choosing the auditor that provides the highest level of assurance. However, companies that want to conceal their real value may still want to resort to the low-assurance auditor as long as stakeholders (shareholders, customers, banks, etc.) in the end value the stock of that company higher when they are informed via the low assurance auditor than they would value a company audited by the high assurance auditor who does reveal the real value of the company. The question is, can companies fool the stakeholder by overstating their value and by finding an auditor who is willing to endorse the overstatement? According to the accounting researchers Donovan, Frankel, Lee, Martin and Seo this situation cannot exist because the following mechanism is bound to unfold. Companies that select auditors that either inadvertently present inaccurate financial statements or try to mislead stakeholders with their financial statements are very likely to be exposed (e.g., Dyck, Morse & Zingales, 2010). As a consequence the stakeholders will not embark into a business relation with a company selecting a low-assurance auditor that helps them to hide inaccurate financial statements. Hence, these companies do not come into existence, and if they did, they would immediately disappear as they would be unable to find a stakeholder that would want to do business with them. As far as audit firms are concerned Donovan et al. (2014) would predict that audit firms who render a subpar audit service cannot exist as no company could benefit from selecting a deficient auditor. As this mechanism is in place this would lead Donovan et al. (2014) to conclude that it is futile to conduct research into auditing:

“We [researchers] tend not to concern ourselves with the quality of products that result from a competitive equilibrium where we believe that consumers and producers are acting rationally with full information.”

DeFond presented the opposite opinion at the second auditing conference of the Foundation for Auditing Research (June 2017, see also DeFond & Zhang, 2014; DeFond, Lennox & Zhang, 2016). Who is right? Indeed, if it was the case that companies would not enter into the market unless they were at least clearly as good in producing value and in conveying their achievements as timely and accurate as their competitors and that if they were to enter the market that they would dissolve almost instantaneously than it would make no sense to study the work of auditors for inefficient auditors would not exist.

The economic literature, however, has advanced beyond the idea that Donovan et al. (2014) put forward. Indeed, this literature takes issue with the puzzle over the astounding differences in productivity between companies and countries. For example, for a U.S. sample Syverson (2004) shows that plants residing at the 90th percentile produce 400 percent more than plants in the 10th percentile on a per-employee basis. About 50 percent of these differences in labor productivity are accounted for by how inputs differ, like capital intensity. An important part of these differences, however, are explained by different management practices these companies have adopted (Bloom et al., 2007, 2010 and 2013). Bloom et al. (2007) group these management practices into four areas: operations, monitoring, targets and incentives. It appears to be the case that companies who operate under conditions where they have given little attention to either of these areas are relatively less efficient and effective. Yet, these companies do exist and survive (sometimes by lack of competition).

We can make the following observations based on the findings of Bloom et al. (2007, 2010 and 2013). First (1) less efficient companies exist next to more efficient companies, (2) companies differ in the composition of their input factors and (3) they differ in levels of management sophistication. This empirical evidence provides several reasons why it is important to study audit and assurance practices. Like with non-audit firms there is much to learn of how auditors create conditions that allow them to assume and retain a position in their environment (Pfeffer & Salancik, 1978). Firms compete for resources.
and their management procures and deploys input factors in differing ways. Auditors are not different than any other firm in how they must deal with a changing environment by adopting new working methods and management practices. However, as Bloom et al. (2007) show there are clear efficient and inefficient modes of organizing the work. We know extremely little of what these modes are in audit firms. We also do not know what are potential efficient combinations. In fact it is not even known what constitutes an effective or and efficient audit. Give way to audit research!

Notes

They find that frauds are at some point detected. In 24 percent of cases it is the auditor who reveals the fraud.

References