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THE EFFECTS OF THE EXTERNAL QUALITY CONTROL ON THE AUDITOR MARKET IN GERMANY, LATVIA AND AUSTRIA

– With Focus on Small and Medium-Sized Audit Companies –

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Abstract

After numerous spectacular balance scandals in the United States and Europe an international discussion about the quality of audits as well as the necessity to rise the quality of financial audits arose [1]. After each scandal there was the question: "Where were the Auditors?" So the legislator has to react. The United States of America responded to this discussion with the "Sarbanes-Oxley Act" [2], while the European Union decreed the directive 2006/43/EC.

The mentioned directive updated the statutory provisions for the professional guild of auditors to increase the quality of audits. In detail it demanded an external quality-control-system combined with public supervision for the profession of auditors to ensure a better quality. Due to this fact the audit companies now have to fulfil a large range of requirements to provide evidence of their auditing-quality and furthermore of the quality standards within their company. Since many small and medium-sized companies aren't able to fulfil these new requirements, the number of small and medium-sized audit companies decreases noticeably.

In my paper I will present the results of my research concerning the effects of external quality control – given by law – on the auditor market in Latvia, Germany and Austria focussing on small and medium-sized audit companies. Additionally I will examine, if the external quality control, which was one of the justifications of the conversions of the EU-directive 2006/43/EC, is able to increase the quality in audit companies at all or whether it is an overregulation for the profession, with disproportionate burden for small and medium-sized audit companies.

I. Introduction

After the spectacular balance scandals in the US and Europe, a discussion about the rise of the quality in financial audits has came up. Even the justifications of the conversions of the EU-directive 2006/43/EC talk about the rise of quality. If you want to take any measurements, which raise the quality of financial audits, it is necessary to determine who understands what is meant by the term "quality".

What is quality in financial audits? Does this definition distinguish from the sight of the contemplator?

To answer these questions the term quality needs to be defined first.

II. The Term Quality

1. Origin and Classification

According to its origin, it came from the Latin word "qualitas" [3], which means condition, characteristic, property or condition. Because of the different meanings of the words, it is to distinguish between the objective condition of an object and the subjective quality, which means how an object will be perceived and rating by the receiver [4]. Both dimensions of the term quality represent a unit [5].

So, my research starts with a review of the question "what is quality?" The business discussion of the question "what is quality?" is about with which criteria a product or a service can be evaluated [6]. So a part of the business literature holds the opinion, that fulfilling the expectations of the customers is the only right approach. So Peter Drucker [7] defines quality as "Quality in a product or service is not what the suppliers put in, it is what the customer gets out and is willing to pay for it.

So the author points out that there is no generally valid understanding of quality in businesses.

To answer these questions the term quality needs to be defined first. In order to give a detailed explanation on "what is quality" many definitions need to be taken into account. The most important definitions for this research were presented in a former paper, and so the author will now only report the results and will explain his own definition of the term quality, because it is important for the results of the research.

The different definitions are analyzed regarding to:

- Quality in Business Administration
- Quality in Services
- Quality in Audits
- Own Definition of Quality in Audits

The following focuses will only be on the definitions of quality in Audits and the author's own definition of "Quality in Audits".

2. Quality in Audits

After analyzing the concept of quality in services and business administration, quality in audits needs to be investigated more in detail for the purpose of this study.

In the last years there are a lot of discussions about the term "Audit Quality". So according to Schmidt [8] that means that the quality of audits hinges whether the auditor is able to give a trustworthy judgment about the conformity annual financial statement computed on the basis of the accounting policies. "The quality of the final audit is the qualification of the annual auditor (meaning his ability and independence to judge) and accomplishment of action of audit (that means the appropriate judgment) for given a reliable audit judgment about accounts." [9]

It seems, according to Marten [10], that the term Audit Quality is understood as "synonymous for the compliance with requirements and statutes." [11] For a long time, the receiver of the services of the auditors, the companies which are audited or the interested public, are not in the focus by the definition of quality in audits. [12]

One of the first who extended the term quality was Leffson. [13] He describes "quality as trustworthiness of the judgment which includes as essential component accuracy belongs." Thereby however is assumed, that trustworthiness in the auditor's judgment only can be evaluated by the receiver.

Dr. Anke Müßig searches for the definition of the term "quality", as well. She comes to the conclusion, that in the case of financial audits, it is all about the fulfillment of expectations. [14]

So, to define what "quality" means for financial audits, you need to question whose requirements and expectations need to be fulfilled. Does a judgment about the definition distinguish from the sight of the observer?

Already at this point of the research it became clear, that an absolute definition of this term is not existent, because the subjective requirements of the service recipients for financial audits distinguish.

The auditor himself will define "quality" in another way than the enterprise that is been audited. Similarly the chief executive officer (CEO) does have another definition than the supervisory board.

For the auditor, quality means to perform the audit in a special expenditure of time and it means to reduce the risk of liability. For the profession of financial auditors "audit quality is not simply about following a rulebook of auditing standards and regulations (…). It is about professionals reaching the appropriate judgment in difficult and complex situations." [15]

For the CEO or the management, as the receiver of the service "financial audit", an audit with high quality is an audit that is run fast and without any problems, questions and discoveries.

In contrast to that, a supervisory board judges an audit positively if he gets the information fast and if the mistakes are cleared up fast. [16]

The public's expectation for quality in financial audits is again to receive an audit which contents no mistakes and which they can trust.

These examples already show that the answer to the question what "quality" means for financial audits cannot be standardized.

Regardless this, new laws, communiqués and standards are decreed, just to raise the quality in the financial audit.

3. Own Definition of Quality in Audits

After analysing important aspects of the term quality according to business administrations, service quality and quality in audits, an own definition has to be determined.

To fulfil all expectations of the different receivers of audit services and to fulfil the own expectations at the own services a definition of audit quality a term must be found, that will be very broad. Because of the term must also take into account the regulations given by law and by the professionals it must consider aspects of product-based, of manufacturing-based and user-based approaches [17].

But because quality in audits must be more than only a addition of these three categories my own definition of quality in audit is, according to definitions of Kellner [18] and Feigenbaum [19] my own definition of quality is:

Quality doesn't rise by quality control but will rise when it will be the task of the whole audit company exemplified by the auditor and each employee. Quality must be the unique selling point (USP) of the audit company, every task in the company must be aimed to fulfill the set quality requirements for itself.

At the same time the auditor must keep his **independence**, and by considering of his professional duty creating values by his work, which will fulfill the expectations as well of the stakeholders as of the audited company.

The auditor has the responsibility but he must include his employees in the whole process.

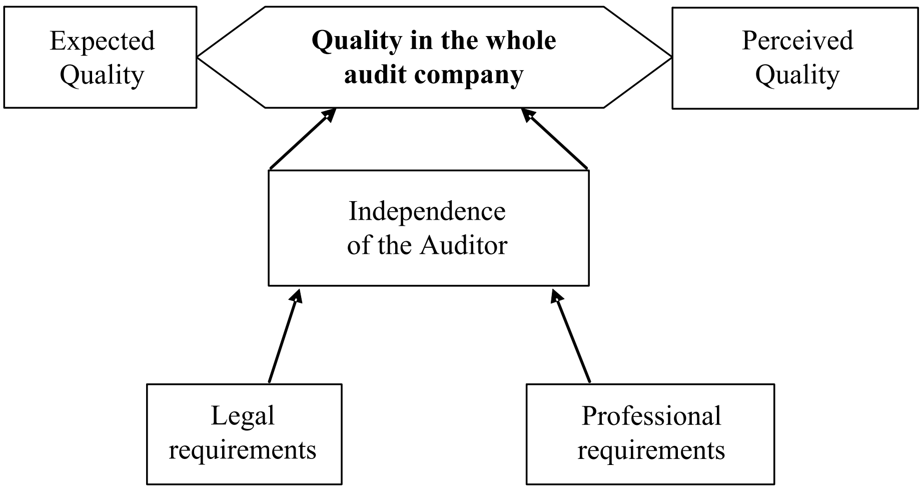

Figure 1. Own Definition of Quality in Audit Companies

3.1. Independence of the Auditor

To fulfill their statutory role and come to an objective jugdement the auditor has to be completly independent. So, the independence of the auditor attaches the greatest importance for the quality of his work.

To be independent is the basis for the quality in Audits and in Audit Companies. Auditor's independence can be divided in "independence in fact or independence of mind" and "independence in appearance". If an auditor is independent "in fact or in of mind", she or he has the ability to make independent audit decisions, even if there is a perception of lack of independence or if the auditor is placed in a potentially comprising position [20].

But it could be, that even when the auditor is "in fact" independent, that there are some facts, that may the public believe, that the auditor does not "appear" to be independent. So it may be, that users of financial statements believe, that they cannot rely on annual audits of financial statements [21]. So, the perception of the public and the users of financial statements is also an important consideration in the auditor independence discussion. It is necessary, that a reasonable third party recognizes that there are no conflicting interests which will prejudicial to auditor's independence [22].

Auditors have a legal systemically relevant task, they have the obligation to report deficiencies and a warning function. And because the goal of auditor independence is to support reliance on the financial statements, auditors must be independent "in fact" as well as independent "in appearance".

III. Results of the Research Questions

1. Aim of the Study

Aim of the study is a critically deal with the external quality control, which is dictated by the law, and its effects on small and medium-sized audit companies. This topic is of paramount importance for such audit companies. The empirical analysis shall approve some statements about the ability of external quality control as an instrument to raise the quality of smaller audit companies or audits in general or whether it is an overregulation for the profession, especially with disproportionate burden for small and medium-sized audit companies, so that the actual organization of the system endangers the smaller companies.

Another question is, completely in conflict to the literature of audit quality who believes, only big companies are able to execute audits right [23], if small and medium-sized companies and chancelleries anyway guarantee a higher level of quality.

2. Development of Hypothesis

The following theses should be proved empirically:

H_1: The audit quality in small and medium-sized audit companies is as well as in the big ones.

H_2: Extern Quality Control does not rise the quality of an audit.

H_3: High degree of formalization of audit controls has only limited impacts on their quality, if relevant procedures remain undone.

H_4: Because of different structures, extern quality control has to be designed in a different way for small- and medium-sized companies.

H_5: Small and medium-sized audit firms are more and more less willing to face the higher requirements of the professional supervision.

H_6: A "Two-Class audit company landscape" arises.

H_7: The survival of small and medium-sized audit companies is acutely endangered by the professional supervision and the higher degrees of regulation and formalization.

H_8: Because of the tide of regulations, the profession of Accountants erases more and more from an independent profession.

3. Empirical Methods of Research

The research questions and hypothesis were analyzed scientifically and proved – to the current state only in Germany – with several expert interviews with different expert groups in Germany. With these interviews it should be shown, whether the extern quality control has had influence on the auditor market in the last years and if it was and is able to increase quality in audits and audit firms. It also should show what's about the independence of the auditors, and whether the earlier fixed hypothesis could be proved.

The groups include representatives of the auditors themselves, the professional representatives, the professional consultation and representatives of research and teaching.

Because the purpose of the data collection should be concrete statements the expert interviews were designed as open-guideline interviews, as most economically way [24]. It is typical for open-guideline interviews, that they based on open-formulated questions. To this the respondents can answer in a free way. A consistent use of the guideline will improve the data comparison and the data gets a structure by the questions [25]. A most important reason to make guided interviews is that they fulfill the demand for qualitative research [26].

Expert-interviews are a specific form of applying semi-structered interviews. "If expert interviews are used, mostly staff members of an organization with a specific experience and knowledge are target groups." [27]

4. Results

The **first hypothesis**, that audit quality is in small and medium-sized companies is as well as in big ones, is affirmative by all experts. They stated that auditor's of companies which were involved in balance scandals were never auditor's from small or medium-sized companies, it were always auditors from the "Big 4" Audit firms or other big audit companies. So, the statement, that a big audit company has more knowledge about accounting standards and more knowledge of the trade, only because they are big, is to disagree energetically.

On the contrary of that was the meaning of the respondents, that small and medium-sized audit companies guarantee a higher level of quality because the owner of the office is involved in every audit, in every process and he is engaged personally in every single audit.

Furthermore it is very important for small- and medium-sized audit companies to guarantee a high quality so they can resist against bigger firms in the market. Chancellery-owners are liable in greater dimensions than big audit companies. The owner of a small audit company is liable with his name, so they have a different awareness for quality.

Extern Quality does not rise the quality of an audit (**hypothesis two**), when the owner of the audit firm is not able to "live quality" during the whole audit process, in his whole company and with all his employees. For the same reason high degree of formalization of audit controls has only limited impacts on their quality (**hypothesis three**), if relevant procedures remain undone and the auditor does not realize it.

Most of the respondents are the opinion that there must be a different way, a different process to control the quality in small- and medium-sized companies compared to big audit companies (**hypothesis four)**. There are different structures, different working methods and direct ways of information.

Because of different structures and because of a quality which is in small and medium-sized companies as good (most said better) as in big companies, the owner of small- and medium-sized companies wants requirements which are specially designed to meet their needs (**hypothesis five**).

The view of the development on the audit and auditor market shows, that within the last 20 years some large audit firms have grown to even larger ones, which means that there are just a few firms that are able to perform audits of large and complex companies. If one of these firms collapses, there would be an enormous damage in the investor's confidence – which will lead to an even bigger damage for the stability of our financial system. These audits firms have reached, as some call it, "Systemic proportions". So the respondents see the risk, that there will arise a "Two-class audit company landscape", because small and medium-sized companies will be less and less able to fulfil the requirements and high degree of formalization of audit control (**hypothesis six**).

That is also the reason, the respondents see, why the survival of small and medium-sized audit companies is acutely endangered by the professional supervision and the higher degrees of regulation and formalization (**hypothesis seven**).

Auditors have a public function, the independence of the auditor is the most important element for his judgement and his work and hence for the quality of his work. Interviewed experts expressed the feat, that, because of the tide of regulations and the high degree of formalization, the profession of the Accountants erases more and more from an independent profession (**hypothesis eight**).

VI. Conclusion

The above remarks have shown, that there are a lot of different definitions of quality and audit quality in the existing research. But there is no one-size-fits-all definition or approach what quality in audits or audits firms is, because the respective reviewer always define quality as he define it from his side of view. So an own definition of quality in audits has to be determined.

A further consideration is, the "Big Four" audit companies, supported by the science [28], occupy quality in audits only for themselves [29], could be refuted. Exactly the opposite is in case, especially in small and medium-sized audit companies quality is particularly high, because of the owner of the company is leads in every audit himself and often assumes the personal liability for his work, his company and for his employees.

Next steps for research will be to make the expert interviews in Latvia and Austria to see, whether there are different results.

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