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Ethical Implications of Independent Quality Auditing

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Abstract: Business ethical violations are being reported almost daily in business journals. Are auditors of these businesses at fault? This study addresses possible lack-of-ethics issues in quality assurance auditing. Examined are the factors that may lead to unethical auditing behaviors of auditors, registration companies, and companies being audited. Also analyzed are: how auditor personal characteristics and audit firm quality control and review producers are linked to quality audit ethics.

Key words: Ethical implications, quilty auditing

INTRODUCTION

Are auditors being challenged to defend their tarnished integrity? Arthur Anderson, one of the five biggest financial auditing firms, was shut down in the wake of the Enron and WorldCom scandals. Bridgestone / Firestone tires on Ford Bronco vehicles were involved in many traffic fatalities and both companies were QS-9000 quality certified. Such incidents have prompted the general public to question the accuracy and reliability of certified auditing reports that credit grantors, current and prospective investors, government agencies and other interested parties who rely upon these reports to make decisions. Since the certified reports are used extensively by nearly all stakeholders of a company, it has been suggested that auditors must assume a moral responsibility not only to the client who pays fees to the auditing firm, but also to all interested parties[1]. However, recent unethical and fraudulent auditing activities suggest that auditors have, to a certain extent, deviated from their incumbency to carry out thorough investigations prior to certifying a management report as qualified. Malone and Roberts[2] reported that a large number of auditors failed to pursue questionable management reports, accepted weak explanation from clients, carried out superficial reviews, failed to research technical issues and performed less audit work than required. Auditors' such behaviors tend to compromise accuracy and quality of reports presented to all interested parties. Auditors' decisions, that if lacking, tend to reduce the quality of the audit and is considered to be unethical practice. Such practices are prevalent in not only the field of financial auditing, but also in the quality assurance auditing field. However, the unethical practices in quality assurance systems involving both company managers and auditors have gone unnoticed[3]. Elizabeth Keim, the former president of ASQ, warned that the belief that companies are committed to quality assurance is in danger of going the way of other shattered myths – that audited financial statements accurately reflect the financial condition of the firm.

Despite such issued warnings relating to unethical auditing in the field of quality auditing from Keim and other quality assurance scholars, very little information is available on the topic of quality audit ethics.

PURPOSE OF STUDY

The purpose of this study is to address this possible lack-of-ethics issues in quality assurance auditing. Examined will be the factors that may lead to unethical auditing behaviors of both auditors and companies being audited (auditee). Also analyzed are: 1) how auditor personal characteristics and 2) audit firm quality control and 3) review producers are linked to quality audit ethics.

BACKGROUND

Since the era of Plato and Socrates, the study of ethical decision making has perplexed scholars from almost every academic field. The ethical questions arise when a decision maker knows right from wrong and is faced with having to pick one in spite of other demanding criteria. This enigma has prompted scholars to analyze this topic using both individual and organizational intrinsic environmental factors affecting auditors' behaviors. Kelly and Margheim[4] and Malone and Roberts[2] studied whether individual intrinsic personality and engagement characteristics have any effect on audit quality. Both studies reported an insignificant relationship between auditors' personality (type A and type B) and auditors' propensity to take actions that tend to reduce audit quality. It is important to note that any decisions that are likely to compromise accuracy and quality of audit are considered unethical. From this definition we can conclude that personality types have no bearing on the types of ethical or unethical decisions that auditors make. Individual engagement characteristics also came short in explaining why some auditors make decisions that tend to reduce audit quality. On the other hand, organizational intrinsic factors such as quality control standard[2] and the perceived necessity of audit steps[4] help auditors make the right choices, thus increasing the quality audits. The later findings are very important in understanding and promoting ethical behaviors among quality assurance auditors. In particular, company managers have a greater control over organizational internal environmental factors and could make appropriate changes to them in order to encourage ethical decision making. Whereas, organizational managers do not have any control over an individual auditor's personality, any attempt to change a person's personality would be unethical[5].

In addition, auditors tend to engage in activities that reduce the quality of audit when the auditor firms also provide non-audit services to their clients[6-9]. Parkash and Venable[7] pointed out that auditing companies are likely to be economically bonded with their clients, thus impairing auditor independence, when they serve a gamut of non-audit services to auditees. The Parkash and Venable study found that between 1978 and 1980, Arthur Anderson's total non-audit fees were 43.92 percent of the total audit fees, which was much higher than the industry average of 23.78 percent. This economically strong bond among Arthur Anderson and its clients may provide some explanation concerning why Arthur Anderson engaged in unethical accounting practices. It would be unethical for Anderson's auditors to audit their own consultants.

Wooden[9] suggested that it is easier for clients to change auditors than for auditors to develop new business. As a result, auditors may not be willing to report observations regarding unsafe conditions and illegal practices or report them to appropriate authorities in order to keep their clients. Moizer[10] suggested that ethical challenges in auditing pretend to two basic decisions how much audit work should be taken and what should be done if auditors find misstated reports and the directors refuse to correct the misstatements. Therefore, the auditors' decision to not observe and/or report unsafe conditions and illegal practices in an effort to keep clients can be seen as unethical. Also many auditors offer additional non-audit services such as consulting which is related to installing or maintaining the management quality assurance systems. Under such circumstances, auditors may end up auditing their own company's work, thus prompting auditors not to observe illegal or unsafe conditions. DeAngelo (1981) auditors must detect material misstatements which must be reported. Based on this two dimension definition of audit quality, the auditors' decision to not observe or report illegal and unsafe conditions to appropriate personnel can be considered unethical.

SOURCES OF UNETHICAL BEHAVIOR

A plethora of articles published in both accounting and quality improvement auditing fields assumes that individual auditors and auditor firms are to be blamed to a greater extent for unethical auditing practices. This premise has prompted many scholars to focus primarily on auditor side environmental factors that compromise audit quality. A strong economic tie between auditor and auditee would encourage auditors to go easy during the audit processes. It is our belief that further review of this premise will make only little contribution to the already identified factors contributing to unethical behaviors. It is also necessary to understand auditees' behaviors and practices that encourage unethical quality auditing. This research will focus primarily on the later aspect of auditing.

AUDITOR BEHAVIORS/PRACTICES CONTRIBUTING TO UNETHICAL PRACTICES

The following list of factors contributing to unethical quality auditing was compiled from scholarly articles published in the accounting and quality auditing fields.

- Need for the retention of businesses
- Offering of non-audit services (consulting)
- Lack of standards to control audit quality
- Failure to offer education relating to ethics to all parties

Some scholars have reported factors other than those listed above that encourage unethical audit practices. However, the factors listed above have been studied more extensively. As stated in the ISO audit standards, the choice of third-party quality auditors by registration companies must be to choose auditors who can maintain the required independence and objectivity over time of many audits. However, this requirement is compromised when retention of auditee leads to higher profits for both auditors and auditing firm. It is relatively easier for audited companies to switch auditors than for auditors to find new clients. In addition, auditors also may provide a variety of non-audit services to the auditee. As pointed out in the literature review section, about 23 percent of the revenue in the accounting industry comes from recurring non-audit services. From these observations, it becomes apparent that auditors wanting to retain businesses and to increase their overall revenue, override the independence and objectivity that quality auditors must maintain. It has also been reported that higher established audit standards and ethics education offered by the auditor companies tend to discourage auditors from engaging in unethical audit behaviors.

AUDITEE BEHAVIORS/PRACTICES CONTRIBUTING TO UNETHICAL PRACTICES

As pointed out in the previous section, very little research has been conducted in this area even though an auditees' behaviors in encouraging unethical audits is as important as those of auditors' behaviors. In a January 27, 2004, Wall Street Journal article, some scholars pointed out that auditees' reluctance to hold auditors accountable for incorrect advice may encourage auditors to go easy "on the company's books in the future." Such deliberate moves by the auditee also plays a vital role in encouraging unethical audit practices. Below are listed some auditee behaviors and practices that may contribute to unethical audit practices.

- Attempt to establish economic ties by purchasing non-audit services
- Intimidate auditors by showing buyers' bargain power
- Deny access to premises or hide unsafe practices that are vital to accurate auditing

In some cases, auditees ask auditors to help their company with non-audit services such as the establishment of management quality improvement systems, ISO registration and recurring consultation. In other words, auditees will make an offer that auditors cannot resist. Auditors who assume these non-audit roles, end up in auditing their own work, and contributing to the audit lack-of-independency problem. Auditees who attempt to thwart audits should be looked at very carefully because many of these companies may implement ISO standards to satisfy customer demands or yield to external economic pressures. Van der Wiele and Brown (1997) reported that over 65 percent of ISO registered small businesses were forced by their customers to apply for ISO series certification. In a subsequent study, Sun and Cheng (2002) found that managers who do not believe that ISO registration can help their company to improve overall organizational quality will never implement a successful ISO quality management system in their company. There is an obvious reason why non-believing managers of ISO 9000 registered companies coax auditors to go easy during the audit process. This can be easily done by tying auditors economically with auditees. These managers will shop around to find an auditing company and its auditors who will condone practices that come short in meeting ISO standards. In other words, auditees have more bargaining power than do the auditors and their auditing firms. This uneven balance of power may also contribute to unethical business practices.

CONCLUSION

This study's intent is to present some quality auditee demand side behaviors that encourage unethical business behaviors. On the supply side, the willingness of quality auditing firms and their quality auditors to attain higher standards in audit practices and crack down on unethical practices alone will not eliminate this problem. On the demand side, the auditee must demand that the auditor perform independent and objective audits. Auditors will never be able to fully carry out industry required thorough quality audits unless auditees fully understand the importance of ISO registration and demand meaningful audit reports. And then there are the dishonest employees at all levels of the organization and their effect on inappropriate business behaviors.

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