

Study on CPAs' Audit Activities from System Perspective

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Abstract: This paper studies the nature of CPAs' audit activities based on neo-institutional economics. CPA auditing is not only a kind of technical activity serving for particular parties, but also systems arrangement for coordinate interests conflict in the capital market. The common belief in the elimination and prevention of fraud is the foundation of CPA audit system. Professional auditors and audit organizations possess skills and positions matching the stock market. The incentive of audit fees and the binding force of audit liabilities both guarantee the self-implementation of audit system. Audit reports signal the fairness of accounting information in simplified forms. CPA audit system also has inherent contradictions. The CPA audit activities should be viewed from a system perspective in order that ideas for the perfection of audit activities can be raised from system construction perspective.

Key words: system; CPA auditing; monitoring mechanism

CPA auditing is a kind of activity performed by market intermediary organizations to testify accounting information. People used to regard it merely as a kind of technical work that provided procedure and method for paying testimony of accounting information and the technique and method could serve particular parties or monitor economic behaviors of certain people. Such kind of understanding is limited. CPA auditing is market monitoring mechanism provided by market intermediary organizations and is systems arrangement for the coordination of social economic activities. The activities of CPAs are universally applicable to the economic life, in particular providing testimony of accounting information for the capital market. It signals the fairness of accounting information through audit report. Audit activities of CPAs should be viewed from system perspective.

People have different understandings towards system and there are three major viewpoints: (1) Important organizations, regarding system as game participants such as guilds, technical societies, universities, law courts, governmental institutions and judicial offices (Nelson, 1994); (2) Game rules; (3) Game equilibrium.¹

Aoki M. (2001) believes that the definition of system depends on the analysis purpose. He proposes that system be generalized into the self-maintenance system of common belief in the principle manner of repeated games and that regards the manner of repeated games as game regulations. He believes that game regulations are endogenous upon strategic interaction between participants, lie in participants' consciousness and are able to self-implement. As a self-maintenance system of common belief, the nature of system is generalized reflection (condensation of information) of game equilibrium to coordinate participants' believes. Aoki defines system as the third that: System is a self-maintenance system of common belief about games. The nature of system is the condensed reflection of remarkable and intrinsic character of equilibrium game path, which can be perceived by

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¹Aoki, Masahiko. *Towards a Comparative Institutional Analysis*, Translated by Li-an Zhou, Shanghai: Far East Publishers, December 2001.

almost all participants of the related fields and be regarded as relevant to their strategic decision-making. System constrains participants' strategic interaction in a self-implementing way and gets reborn under their actual decision-making in the continuously changing environment.

This paper, for the purpose of analysis, adopts Aoki's system perspective. CPA auditing is believed to be a self-maintenance system of common belief in the repeated games of capital market's participants. The common belief results from people's worry and discontent towards fraud in capital market's accounting information, from their great eagerness to testify the fairness of the accounting information, and from their fundamental belief in open, fair and impartial capital investment. The common belief demands the emergence of CPAs' audit activities and laws of CPA auditing monitor have been produced in the game process of repeated investments in the capital market. The kind of activity can self-implement due to the incentive of audit fees and the binding force of audit liabilities. The result of the activity is audit opinion which is to be passed to the capital market. The audit opinion, as a kind of condensed information and generalized reflection, is the result of game equilibrium of the capital market and carries comprehensive knowledge in concise form. The signal carried in the generalized reflection to rectify capital merchandise price influences people's investment. CPA auditing is the endogenous monitoring mechanism of market economy; It is a kind of societal establishment, the product of game equilibrium, and a society's monitoring mechanism.

1. The Common Belief in the Elimination and Prevention of Fraud Is the Foundation of CPA Audit System

Common belief is rooted in mankind's fundamental values, which is defined as the strong preference revealed in human being's selection and public behaviors. It is placed at a higher order by most people for most of the time, which can be proved by the subordination of other preferences to it. Examples of the values include freedom, justice, safety and economic welfare. These fundamental values underlie CPAs' audit activities, with justice and safety most important of all as they are represented as the common wish to eliminate and prevent fraud.

Due to the complexity of capital merchandise and accounting information, parties in the capital market are liable to take unequal positions with interests infringed and financial fraud taking place. People are eager to eliminate fraud and obtain equal positions so as to guarantee the safety of capital. With support of the common belief, CPAs' audit activities are produced and promoted to be developed and perfected.

Viewed from the history perspective of CPA's birth and growth, the common belief in the elimination of financial fraud has always supported CPA audit system. British South Sea Company encountered financial fraud in 1720 and the Parliament assigned Charles Snell to conduct the investigation. After the inspection he put forward a report which explained the conditions there. This report was regarded as the first audit report proposed by CPA and CPA auditing thus came on stage. The 1929 world economic crisis is a crisis of overproduction and a crisis of information distortion in the economic life. American stock market at that time was quite free almost without any control with various kinds of stock companies. False information about the future operations capabilities of businesses abounded. Credulous investors readily believed in the rootless rumors and news. This reason together with other reasons resulted in the 1929 economic crisis. Economic information, in particular accounting information being not able to reflect the actual market demand and production level brought out false prosperity and the later breaking out of economic crisis when false economic information and accounting

information falsification were disclosed. The crisis made people perceive the urgency of financial fraud prevention and thus the appearance of *Stock Act* of 1933 and *Securities Exchange Act* of 1934 in USA. It is stipulated in the *Stock Act* that the accounting statement of listed companies in the stock exchange must receive CPA auditing and the auditor's report should be announced to the public. Thus CPA auditing transformed from optional audit to statutory audit and statutory audit became a key way of fraud elimination in the capital market. In 1938, the financial fraud of the US Mckesson & Robins Pharmaceuticals further promoted the development and perfection of CPA audit system. CPAs' audit activities thus obtained standards and procedures and independent audit principles were produced. The cases of financial fraud since 2000 like Enron event made people strongly indignant at financial fraud and long for fraud prevention and equal competition so as to maintain capital market's economic order. On July 25, 2002, the US Congress passed *2002 Sarbanes-Oxley Act* which was signed on July 30 by President Bush and took effect as law. In this act audit independence is specifically stipulated in details: Scope of CPA's business is limited not to provide non-audit services to clients; All audit services and non-audit services should be authorized in advance; System of audit partner's periodical compulsory rotation should be established; Systems like report to the board of audit and CPA audit evade should also be established.

These historical facts prove that the foundation of the emergence and development of CPA auditing is people's worry about economic defects, their strong anxiety over the elimination and prevention of financial fraud. People hope that CPA auditing can act as a line of defense against false accounting information and thus function as monitoring mechanism in the capital market.

2. Professional Auditors and Audit Organizations Possess Skills and Positions Equal to That of Stock Market

The precedent CPA Mr. Charles Snell was an accounting teacher and had practical experience in accounting inspection. Then CPAs should receive strict professional trainings and pass special exams and have worked for some time on audit to become certified. They should also get follow-up professional trainings to keep up with later development in business development. Professional skills demanded of CPAs are quite high: He should be proficient at accounting so as to form right judgments on accounting operations; He should also be familiar with economic laws, tax laws and financial management expertise, all of which are mere foundations of his professional activities. His real advantage lies in his skilled manipulation of various audit procedures and methods and his great judgment. As a reviewer, CPA should be capable of broadly collecting information and dealing with it. His opinion is thought to be expert opinion. Due to capital market's development, CPAs have become professionals specifically for the testimony of accounting information, which is a result of division of labor. Division of labor promotes the proficiency of skills. During the long process of specialized work, people of the same profession exchange work experience frequently, make summaries of effective procedures and methods, and study theories of audit so as to direct the effective operation of audit practice.

Other than CPA's expertise, CPA's independence is of greater importance. Previous studies of audit theory have shown much emphasis on independence. People have found that simply as a kind of technical work, accounting information inspection can be performed by many people like accounting personnel of the business, relevant government divisions or investors' representative; While only independent inspection can illustrate nature of audit activities. Limitations should be set before the inspection to explain the importance of CPA's position and attitude. Independent position and objective attitude are the primary demand for participants of CPA audit system.

In order to resolve interest conflicts in people's cooperation, an independent public coordinator is needed by parties concerned. CPA plays such a role of public coordinator and division of labor enables CPA to testify the accounting information independently and professionally.

3. The Incentive of Audit Fees and the Binding Force of Audit Liabilities Guarantee the Self-implementation of Audit System

Compared with government audit, CPAs have much motivation to do their work as they will obtain compensations and returns from the work. Although the return is different from that of general merchandise production and sales, which is perfect equivalent transformation, it does give sufficient motivation to CPAs. Among different professions of the society, CPAs have relatively high payment. With the growth of CPA business and elevation of reputation, the payment can also be raised. Generally speaking, motivations for people to conduct various activities stem from three aspects: passion, command, and interests. Passion works in a rather small group, while command and interests are the motivating factors for large-scale groups. If state audit works upon commanding mechanism, CPA audit mainly depends on interests: while providing monitor services to the capital market, CPAs gain their interests. CPAs mainly gain interests from audit fees and besides this they have non-material interests in the form of professional honor.

Professional honor is associated with social status. The work of CPA is praised by most people in the society because CPA works for public interests and his work has features of public product. The common opinion of the society approves of CPA's work and gives social status to the profession. This social status also acts as an incentive for CPA and motivates them to work hard.

Systems network of the market regulatory structure is a binding force for CPA. CPA auditing is a kind of horizontal monitoring. The object of his service is extensive, concerning various parties of the society. While state audit is a longitudinal monitoring in which one's superior but not subordinate or peer should be in the charge of. The binding force of longitudinal monitoring mainly comes from command of the superior, conditions are relatively simple and easy to break through. While the crosswise monitoring of CPA auditing inter-balances with other monitoring mechanisms and is supervised and checked by many forces. If the monitoring is from up to bottom, the problem that who supervises the supervisor always presents. While inter-balance has horizontal checks so there is no need for a hyper-supervisor and the supervisor is under more effective monitoring. In capital markets, CPAs are mainly under the supervision and restraint of the following factors: information-demanding party, legal sanctions and economic indemnity, public monitor, and monitoring of other professional bodies.

4. Audit Report Signals the Fairness of Accounting Information in a Concise Form

System must be easy to be understood and be efficient. So it should be simple and definite and punishment for violation of rules should also be clearly disseminated and understood. The primary function for system is to reduce the demand for knowledge in coordinating interpersonal relations. In order to highlight the economy of system in knowledge saving, people would use signal composed of symbols to define system. Take the traffic lights as an example: red color quickly and definitely tells us to stop. The symbol is very convenient in representing and indicating the complex rules. CPA audit system has the complex information of accounting information testimony condensed and the final result of audit is the presentation of audit report that is simple and easy to be understood and which delivers the signal of price rectification to the market in a simple form. In the

course of accounting information inspection by CPAs, they will do a lot of work to collect audit evidence of indicated and implied assertions in the accounting information. After the sorting-out and evaluation of audit evidence, audit conclusion can be reached and opinion can be formed. Before the publicity of audit opinion, they need to consult with the company audited and suggest re-adjustment to those concerned problems. Based on the complex work, CPAs finally deliver to the external world various audit opinions that are distinctly shown in the audit report. There are four kinds of audit opinions: unqualified opinion, qualified opinion, adverse opinion, and disclaimer opinion. Each occasion with standardized terms concisely and definitely delivers the quality of accounting information of the audited business. Punishment for the rule-breaking businesses is also reflected in audit opinion. The audit opinion is the result of multi-aspects game equilibrium.

Through audit report auditors can approve right, reliable accounting information and deny unreasonable or unfair accounting information so as to efficiently help the investment decision of parties concerned and maintain the stability of capital market. CPA audit system, together with finance system, insurance system and accounting system, has become an essential link in modern economic mechanism.

CPA audit result is the opinion toward accounting information. Even though there is no perfect opinion, it is much better to have such an opinion than there is none.

Audit opinion is universally applicable. As a system, it is to coordinate general contradictions and problems but not specific one. Previous opinions on CPA auditing usually view the audit activities from a particular angle and believe it to merely coordinate relationship of certain aspect such as relationship between entrusting party and trustees or relationship between owners and managers. And so there are theories of trustee responsibilities and agency. Objects of CPA audit system are widespread, universal and uncertain. Although audit report has defined certain object, its application is not limited to certain party. It has properties of public product and can serve the society generally. It is to safeguard the society's public interests but not the interests of certain party. So the public is the only entrusting party of CPA according to some people. This proves that CPAs' audit activities are an important system to coordinate interests conflict between social community parties. The system can make up for the deficiency of price mechanism and government audit, and deliver personified price signals.

5. CPA Audit System Has Inherent Contradictions

CPA audit system is an economic monitoring system fitting in capital market. However, it is not perfect. It has inherent contradictions which are revealed in the following aspects.

5.1 Contradictions between the Natural Demand to Seek Public Interests and CPA's Pursuit for Individual Interests

The birth of CPA industry is the result of society's pursuit for public interests. Viewed from industrial perspective, CPAs must work for public interests at the public's standpoint to obtain his own interests. If the public's interests are lost, CPAs' interests are also lost. So individual interests of CPAs and public interests of the society are consistent in nature and CPAs should have independent status. However, as party interested of the market economy and rational economic man for personal interests, individual CPA or the accounting office may actualize their own interests at the cost of public or industrial interests in a short time.

5.2 Contradictions between the Natural Demand to Treat the Public Fairly and the Imbalance of Parties Interested

Market economy is an economy of equality which demands the same attitude and standard for all parties

interested. As safeguard for market economic order, CPAs are demanded to take an impartial standpoint and objective attitude, and their independence should not be affected by the advantage or disadvantage of certain parties. Parties interested in the market economy have different status with some in an advantageous position and others disadvantageous. They have different impacts on CPAs' opinions. When other systems of market economy are destroyed, CPAs' standpoint is also hard to be maintained.

5.3 Contradictions between the Natural Demand to Safeguard Public Interests and Certain Entrusting Party's Paying for the Audit Fee

Product of CPA audit has qualities of public product, non-exclusiveness and non-competitiveness, which can safeguard public interests. As for audit fees, it has quality of private product in the sense that certain party interested pays for the audit and usually it is the management. No matter who pays for the audit fee, he is bearing the monitoring cost of the society. However, certain party interested paying for the audit fee will inevitably cause CPAs liable to deviate from their foundations.

5.4 Contradictions between the Natural Demand to Provide Testimony and the Various Forms of Services CPAs Offer

The public demands for independent testimony of economic information provided by CPAs. In offering the service CPAs should take an independent standpoint and objective attitude. They should have unilateral status, specialized roles, and exclusive of non-compatible business. All those non-testimonial businesses are not their essential work and can be executed by other market economic establishments. Taking on those businesses may affect the independence of CPAs. In fact the public has entrusted the monopoly of accounting information testimony to CPA industry with other people or establishments not qualified or authorized, while CPAs perform their essential business with various forms of services. Besides the testimony business there are also consultancy, taxation and others with certain services requiring CPAs to take sided attitude or standpoint. This is also a source of contradiction.

CPA audit system is a constituent of the systems network of market mechanism. It should be coupled and conditioned with other systems in order to function properly. Studies on its effects should take overall and inter-complimentary perspectives.

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