

ISSUES IN SUPERVISING CPA

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Abstract: Analyzed from the demand and supply in the auditing market, we can draw the conclusion inevitably that the CPA has the common feature of any kind of “economic person”, that is the maximization of benefit; but, viewed from the demand of the market, a converse conclusion should be drawn that CPA is a “social person” instead of an “economic person”; and that is why more limitations are put on the CPA than any other industry. By comparing the history of independent auditing in both China and the United States, we should not rely on the government or the market solely, because they both have their flaws in some aspects. How to set a rational boundary between the market and government is just what embarrass the government of every country.

Key words: economic person, agent, supervision, boundary of the market

Viewed from the history of auditing, it can be regarded as the outcome of the change of social economic structure. The early South Sea Company Incident led to the birth of the first civilian auditor in history--Charles Snell, who was hired by the special committee of the British Parliament to audit the South Sea Company. Viewed from the perspective of the client, the consignor is the King of Great Britain and the auditing was entrusted by the government; from the perspective of the auditor, he is not a government official but a civilian. As a result, Charles Snell was defined by history as the first civilian auditor. However, the birth of civil auditing was followed by a dilemmatic problem: CPA should be the extension of the government functions or a completely independent civil organization? CPA should at first be a “social person” or an “economic person”? Altruist or egoist? The definitional repetition of CPA’s role confuses, to some extent, our expectation and supervision of CPA.

1. AUDITING MARKET PROVIDER--“ECONOMIC PERSON”

What the CPA provides is the paid service, which follows from the emergence of the market demand and has therefore its unique economic interest. According to the “invisible hand” theory of the classic economics, the working staff of any industry in any society are always pursuing their own interest, which simultaneously boosts the society. Actually the CPAs are the rational persons who also pursue the maximization of their profit. From the point of pursuing advantages and avoiding detriments, the fundamental characteristic of the economic person, CPAs do not differentiate themselves from other paid-service industries except that the services provided by the CPAs are the information certification.

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Following this point, it is not difficult for us to understand that the major business of the CPA industry turned from Financial Statement Auditing to the high-income and low-risk counseling and also why the audit risk model turned from transaction-based to system-based and then to risk-based steering. The CPAs as the business entity should first consider the relations between risk and income. At the same time, it is not difficult to comprehend the definition of CPA according to the theory of Marketing Audit. The theory holds that: in a highly commercialized market economy, no economic activities could be carried out without the label of commercialization; meanwhile, the fierce competition within the same industry, the price competition between clients and the civil auditing and the liability risk caused by auditing misoperation force the modern civil auditing organizations to treat auditing as the product of the market economy, which leads to the birth of the new concept “Marketing Auditing”.

2. AUDITING SERVICE DEMANDERS’ REQUIREMENT OF CPA—“SOCIAL PERSON”

Civil auditing was born with the obvious characteristic of “economic person”, but should also shoulder the social responsibilities in order to keep its long-term development. Thus, auditing should take into consideration the service demanders’ purchase intention and serve as the information certification agent, the role played by a “social person”. However, with the development of the capital market, the connotations of the role display obvious differences.

2.1 Early Period of Independent Auditing—Financial Capital Owner as the Agent

At the early period of the capital market development, the property relations of the economic entities were relatively simple; the enterprises funds mainly came from the banks or a limited number of capital owners. Therefore, the relations involving the three auditing entities in this period were unambiguous. In the triadic relations, CPAs often served as the agents with obvious contractual relations, such as the agents of the creditors and the agents of the capital owners. Therefore, what the CPAs should accomplish was the responsibilities written down in the contracts. In this period, the relations of the contractual sides were unambiguous and the economic interests of other people were not emphasized, which caused the contract items to be less limited or influenced by the external factors. Thus, the characteristic of “incompleteness” of the contract was not particularly obvious. The two sides could easily reach agreements on such items as the auditing fees and the service scopes. In this period, there was an absence of the restriction of auditing fees or the amount of the fees.

2.2 The Period of the Ripe Capital Market—Public Agents

The evolution of the capital market and the gradual dispersion of the capital owners transformed the traditional one-to-one contractual or accountability relations between the capital owner and the CPAs into the multilateral relations between the mass capital providers and other interest-related people. With the CPA aim changing from “accountability” to “decision-making availability”, the company financial statement audited by the CPAs shoulders the similar responsibility of offering useful information for the decision-makers. The expansion of the auditing statement users also means the increasing responsibility for the CPAs, who shoulder the responsibility of “protection of the public interest and the investors’ legal rights and promotion of the healthy development of the market economy”, or, from another perspective, maintains the order of the market economy. In this sense, the public are the only clients of the CPAs. When the auditing service is offered, there not only exist the visible contractual relations among the three auditing sides, but also an invisible triadic auditing relations of “public—capital managers—CPAs”. It is due to this double contract that the CPA’s role as a social person is given more prominence. The shift of the auditing relations demands the consideration of the social consequences at the time of the auditing

contract signing, which further influences the continuation of the business and the creation of the contract terms.

2.3 The Intervention of the Government Laws and Regulations—the Role of Government Agent

With the expansion of the auditing statement users, the CPA's social responsibilities in this period far exceeded its contractual responsibilities. The "non-exclusiveness" of the auditing statements makes them public. The auditing services maintain, to some extent, the order of the overall social economy, which could find the evidence in the British and American economic development history. The development of the capitalist economy displays a periodical characteristic: the first economic crisis in Britain in 1815 was followed by the economic crisis every eight to ten years, which caused the economic order to be in a mess. The British government realized the need to control the development of the stock companies. The methods employed were to impose the social supervisions on the stock companies by means of legislation to keep the integrity and stability of the capital market and to protect the mass investors' interests.

The economic crisis erupted in the United States in 1929 put a number of investors in severe damage. The U. S. began to put emphasis on the importance of financial reports and enacted a series of laws. The *Law of Securities* of 1933 and *Securities Exchange Act* of 1934, based on which the government endorsed the legal auditing rights to the independent auditing, marked the beginning of the CPA as the role of government agent. Viewed from the role played by independent auditing in the economic society, the responsibilities shouldered by the CPAs are an extension of the government functions. Therefore, the CPAs are often named "economic police" which refer to those staff organized to maintain the social securities and investigate the criminal activities. In most of the countries, police are incorporated into the contingents of the country, states or cities. In Germany and Japan typical of the governmental supervision model, the government's all-around involvement in the approval of the industry access, operational scope, enactment of the professional rules, important personnel management and the right of supervision and punishment is the typical reflection of the CPA's role as a social person.

3. PROBLEM OF ROLES AND SUPERVISION

It is not realistic to require the CPA to fulfill the social functions while neglecting his role as an economic person, because it does harm to the industry's existence and development, strangles indirectly the market demand and sets obstacles on the road of market economy development. However, if the CPA puts as its priority the maximization of the profit at the cost of the special social responsibilities, the industry loses its meaning of existence. It has been proved from the Enron Event and the recent American financial scandals that the CPAs could not act based on the exclusive principle of maximization of profit. Although the services provided by the CPAs and those jewel or antique appraisers are similar, they have some differences. The consequences of Information certification, the services offered by the CPAs, are not only confined within the relations between the agents and clients but extend to the overall economic order, due to the universality of auditing users. Thus, the CPAs enjoy less freedom and the bonds over them are far bigger than the ordinary appraisers, so the CPAs have to show the characteristic of a "social person". How to set a clear boundary between the "economic person" and the "social person" to make the CPAs shoulder simultaneously two contradictory responsibilities is a tough issue that has long beset the supervisors.

4. THE BOUNDARY BETWEEN MARKET AND GOVERNMENT

Market and government are traditionally treated as opposite, replaceable and mutually exclusive. The development of Sino-US independent auditing reveals that market and government are not completely opposite; the mutual promotion of government regulation and market will optimize the social welfare.

In terms of the market-government relations, I believe that market achieves the automatic resource allocation by means of the price mechanism while government functions through the system mechanism. The power allocation leads to the resources allocation and set a proper boundary for the market. The market entities accomplish the resource allocation within the set boundaries. The resource allocation is finished by means of price mechanism, which is the carrier of a large number of compressed information in the market and thus plays an essential role in resource allocation. The full display of the government functions have to rely upon a series of strict preconditions, such as the universality of market, diminishing of incomes, perfectibility of market and maturity of information. Among all the functions, when one or several do not match, there appears market dysfunction, which will fails to achieve the Pareto Optimality and even distort the mechanism. Actually the Pareto Optimality is only ideal and the market dysfunction is common, which call for the government regulations. The government could replace or constrain the market functions, or expand and supplement the market functions. Without government's compulsive legislation, the market order could not have been maintained and the market could not have accomplished its resource allocation.

On the other hand, there are also limitations on government functions, such as: 1, due to government's limited scopes and capabilities, setting a too wide boundary over the public affairs will make the government feel unreachable and fall into the anarchistic state, causing the disorder of the whole society. 2, lag of the government functions will lead to a waste of the social resources. 3, the information asymmetry caused by government interest group's interference and the cognitive abilities will lead to decision-making misplay. 4, the government executors may not make the decisions based on the maximization of social benefit and government officials' achievement is an important factor affecting policy-making. The consequences of "government dysfunction" caused by inappropriate government intervention is related to the development direction, which far exceeds the consequences of "market dysfunction". Due to this, in the public affairs industry of a new round of economic system reform, China introduces the mechanism of market competition and the open, fair and just principles. What is special about the industry of independent auditing is that it bears some characteristics of public affairs viewed from the services it offers; it is the natural person who has independent economic interest viewed from the auditing executor. Consequently, the division of government and market becomes more complicated, which is also the nodus of the current supervision.

CONCLUSION

No matter how the boundary of government and market is set, the core of industry supervision is the independence and the professional knowledge of the auditors. From the above analysis, both overfull supervision and freedom are not acceptable; market and government have their advantages and disadvantages, respectively supporting different market interest entities and CPAs' different social roles. There exists a proper boundary between government and market, which will change according to different market structures and market qualities. Even in different development period of the same market, the boundary needs constant change: when the market power is too strong to be supervised, government interference is necessary; when the government power is too strong to constrain the full development of market, government retreat is necessary. In order to make clear the government function in the market, it is necessary to first clarify whether the government is "crossing" or "retreating" from the boundary, or both, and in which industrys. The government-market boundary is a constantly adjustive and contestable process and also a shared topic in both developed and developing countries. In other words, despite the route differences in the process of the supervision model establishment between China and the United States, both countries share a common understanding and aim: market and government are not separable. What is at issue is how to set a proper boundary to maximize the overall

social benefit rather than the problem who supervises. In terms of the problem of boundary division at the micro-level (such as the service areas of auditing, the auditing price and the enactment of the professional rules, etc), I have special illustrations which are not included in this thesis due to the limit of the space.

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