


## Chapter 3

# Auditors in the Economy and the Impact of Rent-Seeking Behaviour and Penalties

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### ABSTRACT

*Society often relies on information disclosed by enterprises and verified by auditors to decide on an efficient allocation of capital. Auditing sector serves as a means of verification to protect investors from making decisions based on inaccurate information. However, auditors can use their superior information for extracting additional rents. This study explores an economy where entrepreneurs choose their financial reporting quality considering incentives imposed by the society, and rent-seeking auditors may manipulate their reports to extract gains in the expense of public interest. The analysis captures the dynamics of strategy changes among different actors by introducing a population game framework. The steady-state equilibrium analysis shows that there is a pure state and mixed states whose stability is affected by policy parameters such as subsidies, taxes, competitive auditor fee, and rate of adjustment of different behavioral dynamics. It appears that corruption in auditing sector and poor quality in financial reporting may arise as a temporally persistent outcome.*

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## **INTRODUCTION**

Investors and governments require financial information to evaluate a company's performance because they make their economic decisions based on their interpretations of this financial information. However, the information does not serve much if it is not reliable. Today's competitive market conditions put a great pressure on companies' managements to meet their investors' expectations. Due to this pressure, under-performing companies become much more inclined to manipulate their financial statements (Carruth, 2011). There are significant losses due to investments based on inaccurate financial information, as in the cases of Enron and WorldCom (Brickey, 2003). These experiences have highlighted the importance of obtaining reliable attestation over financial statements.

Self-interested actions of individuals in an economy may eventually result in market failures. In the context of this research, an example is an economy where some public companies report manipulated financial information, extracting additional gains through overstated performance, which undermines the efficient allocation of capital. Although the vast majority of companies avoid engaging in any sort of financial misconduct and play by the rules, even a couple of consecutive corporate scandals is enough to collapse the market, as in the cases of early and late 2000s of the U.S. Public authorities (i.e. governments) often intend to solve market failures by intervention in the market mostly through the use of agents (or bureaucrats) with relevant expertise and skills for collecting required information. However, this process inevitably creates room for other potential problems for the economy: inefficient spending, information asymmetry and principal-agent problem. Thus, there is a trade-off for public to consider when opting for and out of market interventions (Dollery & Wallis, 1997).

The independent auditors are considered to be the "watchdogs" of public interest. Their existence in the economy is for ensuring that all information published by public companies, are accurately stated, so that the investors supply their funds and capital to companies, conditional on their actual performance (Miller, 2006). Given the difficulty of understanding the complex nature of business models and the reporting standards that should be used to interpret the accuracy of the financial information, it would not be feasible for the investors to audit all the financial information regarding the performance of companies they plan to invest in, without the professional intermediacy of auditors who possess the required expertise and skills. From the perspective of the companies being audited, the intermediacy of auditors helps them in contractual terms, protecting their confidential private information from potential breaches in the absence of bilateral legally binding agreements. Therefore, the auditors have an important role in achieving a higher output for the society through a more efficient allocation of funds.

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