THE AUDITOR AS AN ELEMENT OF IN- AND EXTERNAL CORPORATE GOVERNANCE: THEORETICAL FINDINGS IN THE GERMAN TWO TIER SYSTEM

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Abstract

This article is focused on the assisting role and gatekeeper function of the external auditor in the German two tier system. From an agency-theoretical view, the auditor is part of the in- and external corporate governance. Conflicts of interests may arise from different tasks of the assisting role and gatekeeper function of the auditor, influencing the quality of the in- and external audit. Thus, future research is needed to provide theoretical foundation of the auditor’s assisting role for the benefit of the shareholders.

Keywords: Audit theory, principal agent theory, gatekeeper function, assisting role of the external auditor

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1. Introduction of the double-level principal agent theory

Several theoretical approaches focus on the correlation of the various corporations management parties and their relation to the external auditor. This paper will dwell on the double-level principal agent theory according to Tirole (1986). The theory is based on the single-level agency theory of Ross (1973) and Jensen/Meckling (1976) and is extended by the supervisor, representing a third party in addition to the principal and agent. In the German two tier system the principal is represented by the shareholders, providing the necessary capital. The shareholders delegate the corporate management to the management board. Hence, the management board acts as an agent for the shareholders and is obliged to report to them. This authorization may give rise to conflicts of interests between the involved parties as both seek to maximize their individual benefits. The shareholders are interested in increasing the company’s value to profit from high dividend payout (Jensen/Meckling (1976)). According to Tirole (1986), the management board aims for a positive correlation between salary, additional private revenue and the effort and time spent while managing the company. Due to a lack of time and expertise, the shareholders also delegate the internal supervision to the supervisory board (Jaschke (1989)). The supervisory board is then accountable to the principal. The management board acts as an agent for the supervisory board, while the supervisory board is in the position to appoint and recall the members of the management board. On the one hand, the supervisory board is elected by the shareholders and represents in a historical view the shareholder’s committee. However, it cannot be assumed that the goals of the supervisory board (agent) correlate with the interests of the shareholders (principal). In fact, the supervisory board strives for the same additional benefits as the management board in the single-level principal-agent theory. Hidden characteristics, information, action and hidden transfers lead to information asymmetries between the supervisory board and the shareholders. This lack of information may then give rise to adverse selection and moral hazard. On the other hand, in firms with more than 500 or respectively 2,000 employees within Germany, the employees are also represented in the supervisory board. Therefore, one-third of the supervisory board members in enterprises with more than 500 employees and one-half of the members in companies with more than 2,000 employees are representatives elected by the employees (§ 4 One-third participation act or respectively § 7 Para. 1 Co-determination act). In firms with more than 2,000 employees, the chairman of the supervisory board has the casting vote in the case of split resolutions (§ 29 Para. 2 Sentence 1 Co-determination act). Due to the fact, that the principal-agent theory mainly considers relationships between shareholders and their agents, the principal agent relationship between employees and their representatives in the supervisory board are neglected in this paper.
In addition to the implementation of a supervisory function, Tirole (1986) is addressing the question of agency theoretical hidden transfers. Hidden transfers can emerge from profitable coalitions between agent and supervisor at the expense of the principal. While the partners of a coalition always profit from monetary and/or non-monetary transactions, they will not be accessible to the principal. Hence, hidden transfers are the consequence of the moral hazard originating from the coalition. They only exist within the frame of the double-level principal agent theory and may lead to post-contractual information asymmetries. Apart from Tirole (1986), Caillaud (1988), Petersen (1989) and Wessels (1994) also dwell on a coalition-based approach.

Due to the fact that the supervisory board in the two tier system may strive for the same additional benefits as the management board, a coalition between both would have negative effects on the shareholders. If the supervisory board refrains from the internal supervision of the management board and manipulates the report at the expense of the shareholders, it could influence the management board’s performance in a negative way.

Introduction of the auditor

Based on the double-level principal agent theory, the auditor acts as a third agent for the shareholders in addition to the supervisory (and management) board. In the context of the principal agent theory, the external audit provides an incentive for building, respectively strengthening the shareholders trust with regard to the financial statement of the management board. According to Jensen/Meckling (1976) and Chow (1982), the external audit constitutes a monitoring and bonding instrument for specific management board activities; in particular the development of the accounting instruments, and ought to motivate true and correct reporting. Due to a lack of time and expertise among the shareholders, the external audit is used as an instrument to strengthen corporate governance (Watts/Zimmerman (1983)). The authorization of the auditor is quite similar to the shareholders delegation of the management board’s supervision to the supervisory board. As a result of the diversification of risks among the involved parties, the external audit represents a reassurance for the contracting partners. The relation between auditor and shareholder is hereby summarized in the gatekeeper function of the external audit. The assisting role of the auditor results from his support with regard to the internal supervising of the management board. The auditors support primary consists of the audit of the financial statement and subsequent oral and written reports on the audit results.

The already mentioned agency theoretical problems between shareholders (principal), management board (agent) and supervisory board (supervisor) can also be associated with the auditor who is an economic agent according to Antle (1982). Thus, the benefit of the external accounting is rather unknown to the shareholders (Ballwieser (1987)). Similar to the supervisory board, the auditor may seek to maximize private earnings in the first place, thus neglecting his impartial monitoring function. Consequently, the auditor may get involved in adverse selection and moral hazard (Herzig/Watrin (1995)). The principal agent problems assigned to the auditor may impair his judgement and objectivity. Adverse selection represents a pre-contractual principal agent conflict and can be caused by a lack of skills or by fraudulent preference of the respective company. Post-contractual information asymmetries may give rise to moral hazard by means of incorrect auditing. Certainly, this kind of shirking is incompatible with impartial judgement in terms of the traditional audit model according to Jeffson (1988).

Coalitions between auditor and management board can provoke moral hazard conflicts at the expense of the shareholders (Ballwieser (1987)). Such coalitions could be based on the auditors acceptance and intentional concealment of shortcomings with regard to the management board’s financial statement. In addition, the supervisory board may join the respective coalition and encourage the arrangements made at the expense of the shareholders. In accordance with Jeffson (1988), the agency problems may lead to restrictive judgement of the auditor and hence to false reporting on the respective audit.

The auditor acts as a double agent for the supervisory board and the shareholders (principals) (Jaschke (1989)). Whereas the shareholders appoint the auditor, the supervisory board is obliged to authorize him officially. This arrangement gives rise to an intensified conflict of interests between agent and principals which will be discussed later.

Assisting role

The German legislator justified the introduction of the assisting role of the auditor with the inadequate and bias supervision of the management board’s activities by the supervisory board. Thus, the officially appointed auditor is due to assist the supervisory board to compensate certain shortcomings in financial expertise and time. As a result of the oral and written report of the auditor, the supervisory board is performing the audit through the eyes of the auditor (Hommelhoff (1981), p. 945). However, this does not mean that the supervisory board is released from its independent internal audit of the financial statement. Consequently, the auditor is solely providing support to the supervisory board regarding its expensive supervising obligations, thus increasing the efficiency of the board’s supervising activities.

According to the double-level principal agent theory of Tirole (1986), a coalition between supervisory board and auditor (agent) is invariably to the disadvantage of the shareholders (principal). Such
coalitions may result from the coercive existence of hidden transfers. Still, the required close collaboration between auditor and supervisory board incorporates the superior objective of the principal agent theory, the demanding for a reduction in information asymmetries between the corporation’s management and the shareholders. The close collaboration between supervisory board and auditor may cause positive synergy effects. Accordingly, the assisting role of the auditor shall contribute to the improvement of the audit quality with regard to the management board’s accounting. Basically, the double-level principal agent theory assumes the existence of hidden transfers with regard to the auditor’s assisting role. However, the shareholders should not prejudge the assisting role of the auditor in general, but rather evaluate every situation differently. In this context, the shareholders are due to identify the risk of potential collusive behaviour between management board and supervisory board.

Another economic reason for the introduction of the auditor’s assisting role (with regard to the supervisory board) is the concept of lean auditing. This concept aims for the avoidance of duplicate auditing and the rationalisation of the auditing workflow. Substantial increase in efficiency and effectiveness of the internal audit are a result of the cooperation between supervisory board and auditor (with regard to their auditing obligations).

Apart from economic reasons, legal interpretations of the auditor’s assisting role are quite diverse, depending on the classification of the auditor as a “body” of the corporation. According to the prevailing opinion in Germany, the characteristics of a “body” of a corporation are not compatible with those of the auditor. Kropff (2001) specifies the auditor as a participating expert who is obligated by law and audit contract only. Though, the assisting role of the auditor must not be interpreted as being subordinate to the supervisory board. The supervisory board has no authority to issue directives to the auditor because such influences would interfere with the objectivity of the audit.

Gatekeeper function

As already mentioned, information asymmetries result from the delegation of the corporation’s management (to the management board) and supervision (to the supervisory board) by the shareholders. Both, the supervisory board and the management board may act self-interested at the expense of the shareholders. Hence, to improve decision-useful audit information for the shareholders, the supervisory board audit is amended by external revision. Corresponding to the gatekeeper-function, the external audit is carried out by public interest only. The same applies to the issuing of the auditor’s certificate. Hence, the auditor is considered to be an information intermediate between company and public. Within the scope of his gatekeeper function, the auditor can be classified as a guardian of public interest. By contrast, the prevailing opinion limits the target audience from the public community to the shareholders and investors of the company. This limitation is consistent with empirical audit research. Chow/Rice (1982) and Keller/Davidson (1983) found evidence for a correlation between negative reactions on the capital market and restrictions or rejections of the auditor’s certificate as a result of the audit (in the interest of the shareholders).

In a historical view, the mandatory nomination of an external auditor was an answer to the accounting scandals within the framework of the global economic crisis and several striking corporation’s collapses. According to Loitsberger (1997), the gatekeeper function has to be distinguished from the assisting role of the external auditor. While the assisting role is based on mutual trust, the gatekeeper function is characterized by mistrust and a critical attitude of the external auditor toward the management board and supervisory board.

The gatekeeper function derives from the basic explanation of Gilson/Kraakman (1984). Kraakman (1986) describes gatekeepers as private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers. According to Coffee (2006), the gatekeeper is distinguished by two fundamental characteristics. He can be described as a reputational intermediary while the criteria of receiving only a limited payoff from any involvement in misconduct must be met simultaneously. By nominating a gatekeeper, the legislator is able to raise the possibility of deterrence by creating a necessary actor whose compliance with the law can more effectively influence. In addition to rating companies and investment bankers, auditors may act as gatekeepers. These repeat players need to prove themselves on the audit market and are striving for good reputation. They offer the service of issuing a legally mandatory certificate on the capital market, which can be evaluated accordingly. The perceived quality of the audit depends on the investors’ opinion with regard to the independence of the respective auditor. If the investors are convinced that an impairment of his judgement and objectivity is on hand, the perceived quality of the audit will be inferior. According to Coffee (2006), the gatekeeper should only receive a regular salary in addition to an established reputation. Correspondingly, remuneration depending on the supervisory board and management board objectives would foil the benefit of an external audit, because the risk of collusive behaviour would increase.

Pursuant to Coffee (2006), the gatekeeper function always includes a public watchdog function. In accordance with Anglo-American literature (Shapiro (2004)), the public watchdog function of the auditor is based on the stewardship-hypothesis. This view conflicts with the assisting role of the auditor and consequently his double role in reporting to the
supervisory board (auditor’s report) and the public (auditor’s certificate). Moreover, this view categorizes the shareholders as the “true” client of the auditor. Within the scope of the gatekeeper function, the auditor may influence the decisions of the management- and supervisory board. In the event of a poor management board’s financial statement and an insufficient reaction of the supervisory board to the respective failure, the auditor may threaten to restrict or reject the auditor’s certificate. This monitoring role of the auditor implies no impairment with regard to his judgement and objectivity and that he is actually able to detect erratic behaviour. However, even professional gatekeepers might get involved in accounting scandals of certain companies. Though, the potential losses of reputation exceed the benefits of individual hidden transfers by the respective company.

**Conflict of objectives**

The position of the auditor within the in- and external corporate governance is influenced by his double role to act as an agent for the supervisory board (assisting role) and for the shareholders (gatekeeper function) simultaneously. From an agency theoretical perspective, this differentiation of roles may lead to conflicts of interests. Pursuant to Shapiro (2004), „dealing with two masters” effects the „present dilemma of the independent auditor. While the management- and supervisory board may ask for a certification audit in terms of a mere favour audit, the shareholders demand for a detective audit, implying an objective judgement on the financial accounting. Hence, the objectives of the assisting role and the gatekeeper function are not always consistent. In fact, emphasis placed on the assisting role may impair the gatekeeper function and vice versa.

In the double level principal agent theory within the German two tier system, coalitions between management- and supervisory board at the expense of the shareholders give rise to conflicts of objectives regarding the assisting role and gatekeeper function of the auditor. Such coalitions may be based on common objectives such as the issuing of an illegal financial statement or the intentional minimizing of workload (shirking). Within the scope of the auditor’s gatekeeper function, the shareholders do not only ask for a monitoring of the management board activities, but for a monitoring of the supervisory board’s activities. If the auditor does not comply with the gatekeeper functions, he may (un-)intentionally get involved in the coalition between management- and supervisory board.

In addition to the shareholders, the auditor himself is interested in factoring the management- and supervisory board’s activities into the auditing within the scope of his gatekeeper role. His motivation derives from the fact that the estimated auditing risk is influenced by the quality of the supervisory board’s internal supervision. For this purpose, the auditor has to anticipate potential misconduct of the supervisory board in his decision behaviour. However, the respective necessary critical attitude toward the supervisory board may conflict with the assisting role of the auditor, since an offensive monitoring of the supervisory board would negatively influence the mutual trust between the agents.

**Conclusion**

The aim of the present paper is the practicing of the German two tier system (management board, supervisory board, shareholders) and the function of the external auditor in the double-level principal agent theory according to Tirole (1986). The supervisory board assumes a supervising function, while acting as an agent for the shareholders and as a principal for the management board. The auditor is a double agent for the supervisory board and the shareholders. The shareholders are especially interested in the gatekeeper function of the auditor. Their interest is based on the delegation of the company’s supervision and the auditing of the financial accounting. They expect an objective statement of the auditor with regard to the work of the supervisory board and management board and seek to counteract possible losses of information. The interdependency between in- and external audit requires for the assisting role of the auditor with regard to the supervisory board and is economically justified by the utilization of synergy effects. However in some cases, the assisting role of the auditor may interfere with his gatekeeper function substantially. In the event of an actual or planned involvement of the auditor in a coalition with either or both management parties, the conflicts of interests resulting from his double function might increase significantly. Corresponding to Tirole (1986), the existence of coalitions between the agents of the shareholders is always accompanied by hidden transfers and negative effects on the principal. It is hence an ideal starting point to address the question of a theoretical foundation of the auditors assisting role to the benefit of the shareholders. In addition, such findings would support the prevention of a collusive behaviour between management board and supervisory board as well as between management board and auditor.

**References**


