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Auditing the Auditors: Oversight or Overkill?

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A growing number of high-profile companies have had to restate their earnings at substantially lower levels to correct the prior use of "aggressive" and even fraudulent accounting practices. Because the companies' auditors approved the original reports, policymakers have questioned the capacity of public accounting firms to promote fair financial reporting. In response, recent legislation has instituted several reforms, including the creation of the Public Company Accounting Oversight Board, which together with the Securities and Exchange Commission will investigate alleged lapses in accounting practices. But how much oversight is really necessary?

Jeffery Gunther and Robert Moore examine recent events in the light of research findings. Based on this analysis, they conclude that market forces have tended, over time, to shape the role of auditors to match or correspond to the needs of investors in monitoring individual companies' performance. Despite current sentiment to the contrary, substantial government involvement in the business of auditing appears to be needed only when other types of government intervention, such as bank deposit insurance, have already disrupted market-based incentives for effective audits. In the more typical situation, both government and industry policymakers should avoid restrictive measures that unnecessarily increase audit costs, instead taking into account market forces' successful track record in disciplining ineffective auditors and promoting an effective audit function.

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Recent debacles involving "aggressive" and even fraudulent accounting practices are focusing public attention on corporate management's potential for failing to serve investors' best interests. But potential conflicts of interest between a corporation's managers and its owners have been recognized for centuries. More than 200 years ago, Adam Smith noted the following about the joint-stock companies of his day: "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own" (Smith 1921, 262). While Smith's language is antiquated, his conclusion seems more on target than ever: Managers of an enterprise funded by other peoples' money face different incentives than they would had they funded the enterprise themselves.

Much of today's concern over corporate accounting involves the audit function. A growing number of high-profile companies have had to restate their earnings at substantially lower levels to correct prior lapses in accounting practices. Of central interest is why the companies' auditors approved the original reports.[1] These accounting scandals have rattled investors and prompted legislation that instituted a number of reforms. Among them was the creation of the Public Company Accounting Oversight Board, which together with the Securities and Exchange Commission (SEC) will investigate alleged lapses in accounting practices. But here, too, the problem is not as new as it might first appear. Just as conflicts of interest between a corporation's managers and its owners are not new, the need for auditors to address these conflicts also has a long history, one that holds valuable lessons about effective auditing.

To address current concerns over the auditing of corporate accounts, it may be useful to first study the nature and evolution of the audit function. This article examines recent events in the light of research findings. In the process, we answer some key questions: Why do we need auditors? What makes a good auditor? What promotes good auditing? What lies behind recent accounting problems? And finally, how can these problems be fixed?

WHY DO WE NEED AUDITORS?

A relatively early study by Jensen and Meckling (1976) examines some of the issues associated with the distinction between managing and funding a business and demonstrates how the separation of the two gives rise to the need for audits.[2]

[1] In addition to auditors, other private parties expected to help safeguard markets from misleading financial information—corporate boards, security analysts, rating agencies, institutional investors, and law firms—also failed to prevent or expose the accounting misstatements (Greenspan 2002).

[2] The separation of management and funding leads to a number of issues related to how investors persuade a company's managers to invest in good projects and return some of the profits, rather than just steal the capital provided or waste it. This article focuses on auditing's role in this process, without addressing other issues that fall under the broad topic of corporate governance. For a good survey article, see Shleifer and Vishny (1997).

The study shows how a role for auditors arises naturally from the existence of outside ownership, or equity, claims against a firm. As managers' share of firm ownership declines, they have the incentive to boost their own total compensation, including all types of fringe benefits, at the expense of the other owners. Potential investors, recognizing the owner–managers have this incentive, reduce the price they are willing to pay for shares in the firm. But if the owner–managers can commit to limiting their perquisites, investors will be willing to pay more for shares, benefiting the owner–managers' efforts to expand the firm. Subjecting the firm's financial records to an independent audit can enhance the credibility of such a commitment by the owner–managers.

Jensen and Meckling show that similar considerations apply to a firm funded by debt, or bonds. In this case, the owner–managers borrow money to run the business. Here, too, the managers' incentives differ from those of the individuals funding the firm. After managers have raised funds from debtholders, they can benefit by investing the money in high-risk activities. If those investments pay off, the managers can repay the debtholders the promised amount and keep the remainder for themselves. If the investments perform poorly, they can simply default on the debt. In this case, shareholders are on the side of the managers, since they, too, could benefit from high-risk activities once the debt has been issued.

Debtholders recognize the managers' and shareholders' incentive to pursue high-risk activities, potentially at their expense, and therefore demand a higher rate of interest, or a risk premium, on the money lent to the firm. However, by committing in a debt covenant to policies that limit debtholders' risk exposure, the managers and shareholders may be able to reduce the premium. An independent auditor can help the managers and shareholders demonstrate to debtholders that such risk-limiting policies are being followed.[3]

Similar considerations apply to the role of debt covenants and auditing in addressing the underinvestment problem Myers (1977) analyzes, in which the shareholders of a firm with outstanding debt can have the incentive to reject investment projects with a positive net value if the proceeds would accrue to debtholders. Smith and Warner (1979) describe various types of covenants to protect bondholders from managers' and equityholders' incentives to act against their interests. Auditing can help verify the accounting criteria in such covenants and help ensure the agreements are honored.

In short, Jensen and Meckling show how equity and debt claims against a firm affect managers' incentives and why managers have an incentive to hire independent auditors to certify the financial reports provided to investors. Because managers have the incentive to consume perquisites and increase risk at the expense of investors, they may be tempted to hide these activities by issuing false or misleading reports

[3] In addition to auditing's role in enhancing the accuracy of financial information, a legal framework must exist to support the writing and enforcement of debt contracts and protect shareholders from expropriation by management. La Porta et al. (1998) discuss the laws protecting corporate shareholders and creditors. These authors find countries with greater legal protection for investors tend to have more participation by small investors in the ownership of large public companies. Similarly, these same authors (2000) also find that companies in countries with stronger minority shareholder rights pay higher dividends.

about the firm's financial policies and condition. But managers can use independent audits to enhance investors' confidence in the firm's financial statements.

Conflicts between managers and investors can take a variety of forms. Managerial compensation linked to firm revenue, for example, may entice managers to exaggerate the amount of revenue reported, thereby boosting their pay.[4] Investors would therefore be eager to have an independent auditor check the numbers.

The costs associated with the tension between managers and investors are a form of agency costs, which are generally present in any relationship in which a principal (investor) endows an agent (manager) with the authority to make decisions on the principal's behalf. Jensen and Meckling argue that the desire to minimize agency costs plays an important role in shaping a firm's financial arrangements. Auditing reduces agency costs by verifying that the financial statements managers issue represent a company's financial policies and condition fairly.[5]

WHAT MAKES A GOOD AUDITOR?

By definition then, a good auditor effectively reduces the agency costs described above by verifying the fairness of company financial statements. But what are the characteristics of such an auditor?

Good Auditing in History

Watts and Zimmerman (1983) emphasize that independence from the party being audited has always been a key feature of effective auditing. Without independence, it may be difficult for an auditor to provide a check on managers' behavior. A reasonable measure of independence is the likelihood that an auditor will report any breach of the contract between the principal and agent.[6]

These authors point to an early example of auditing in the context of the merchant guilds of medieval England. Officers of a merchant guild managed property owned by its members and conducted business transactions on their behalf. However, the potential existed for the officers to act against the best interests of the guild members. Recognizing this conflict of interest, contracts circumscribed managers' behavior. To promote compliance with the contracts, a committee of guild members typically audited the guild's accounts.

[4] In a broad review of the literature dealing with the role of financial accounting information in corporate control mechanisms, Bushman and Smith (2001) discuss ways in which accounting information is used in incentive compensation contracts for management. DeFond and Park (1999) provide evidence that relative and firm-specific accounting information help boards of directors identify unfit principal officers and replace them.

[5] In addition to auditing, Fama and Jensen (1983) emphasize that another important mechanism for reducing agency costs is internal checks and balances inside a firm and its board of directors.

[6] This article focuses on independence as a primary ingredient of effective auditing. Obviously, a good auditor must also be technically competent. An auditor's willingness to report any problems is of little use if the auditor lacks the expertise necessary to identify problems in the first place. Assuming technical expertise, independence appears to be the crucial factor.

The audit arrangements fostered independence—and therefore effective auditing—in two ways. First, any lack of independence would damage an auditor's reputation and could result in the loss of property or guild membership. Second, auditing by committee, rather than by an individual, likely enhanced independence because it would have been more difficult for guild officers to collude with an entire committee than with a single auditor.

Watts and Zimmerman also point out auditing's important role in a subsequent form of business organization—the joint-stock company, the type of company Adam Smith criticized for having potentially severe agency costs. Joint-stock companies emerged in the sixteenth century as a way to finance voyages undertaken for foreign trade. Investors' shares in the companies entitled them to part of the profits.

Joint-stock companies were audited regularly by a committee of shareholders or directors, like the audit committees the guilds employed. As with the guilds, an important incentive for the auditors to maintain independence was preservation of their reputation, which influenced their opportunities for prominent positions in other companies. The audit committee continued to serve its role at joint-stock companies well into the nineteenth century, as this form of organization became increasingly popular in various business contexts, including banking.

Good Auditing Today

A company's board of directors typically forms an audit committee to oversee the firm's financial reporting. The committee selects an outside auditor and oversees the firm's management and internal audit function. And boards are generally required to determine the independence of directors named to audit committees. (See, for example, New York Stock Exchange 2002.) Despite auditing's greater complexity and scope today, independence is as important to successful audits now as in the past.

In a broader sense, the essence of auditing is to provide assurance that someone's claims or actions are exactly what they purport them to be. If such assurance is for someone within a business organization, such as management, an internal audit by the firm's own staff may suffice, since in many cases staff auditors can be expected to maintain some independence from the business units they audit. But if such assurance is to be provided to investors—particularly in a publicly traded company—external auditors hired by the firm's shareholders or the board's audit committee are usually necessary, since only these auditors could generally be expected to have the capacity for independence from management.

This is not to say effective auditing of publicly traded companies rests on external audits alone. Today, fair financial reporting relies on the combined efforts of a company's board of directors, including the audit committee; the company's financial management, including internal auditors; and external auditors (New York Stock Exchange and National Association of Securities Dealers 1999). Nevertheless, external auditors are especially important in certifying the financial reports of publicly traded companies, as it is these auditors who can enhance auditor independence.

Kofman and Lawarrée (1993) demonstrate that external and internal auditors serve complementary roles. Because of their employment at the firm, internal auditors are generally able to gather information at a lower cost than external auditors. However, because of their close association, they are more likely to collude with managers to falsify a firm's financial reports. External auditors, on the other hand, face a higher cost of gathering information about a firm but are also less likely to collude with management. By bringing greater independence to the audit, external auditors can actually help prevent collusion between internal auditors and a firm's managers.[7]

Kofman and Lawarrée emphasize that the distinction between internal and external auditors may not be as simple as it appears. If an accounting firm is hired by management and does extensive consulting work for the company it audits, the firm may in effect be an internal auditor, despite its existence as a legally separate entity. Similarly, an accounting firm that is selected by the audit committee of the board of directors but that has close ties to management also may in effect count as an internal auditor. Only if the accounting firm is hired by the shareholders of the company being audited, or the board's audit committee, and also has no ties to management, can the firm be fully counted as an external auditor.

These considerations indicate some external auditors may be more independent than others. Carcello and Neal (2000) provide empirical evidence supporting this point in the context of a firm's audit committee. These researchers define affiliated directors to include current or former officers or employees of the firm or a related entity, relatives of management, professional advisors to the firm, officers of significant suppliers or customers, and interlocking directors. Because such affiliated directors have ties to management, their independence may be compromised. So if most of the directors on an audit committee are affiliated, the committee may exercise less effective oversight over the firm, giving rise to less rigorous audits. Carcello and Neal measure the effectiveness of oversight by the likelihood that the firm's auditor will issue a going-concern report. For firms experiencing financial distress, they find that the higher the percentage of affiliated directors on the audit committee, the lower the chance of the auditor issuing a going-concern report. Here again, independence is found to be critical to effective audits.

Empirical research has sought to document the importance of external audits to assuring investors of the veracity of financial statements. One indication of the market's confidence in financial statements can be found by looking at how stock prices respond to announced financial results. If investors are reasonably assured that financial statements are precise and fair, earnings announcements might affect the price of a firm's stock. Conversely, if investors do not find a firm's announced financial results credible, the results may have little effect on the firm's market value. The degree to which announced financial results prompt movement in a firm's stock price can be measured in terms of an earnings response coefficient (ERC), with a higher ERC indicating greater responsiveness to such announcements.[8]

[7] Despite the conceptual distinction between internal and external auditors, researchers have tried to determine whether in practice firms use the two types of auditors as substitutes. Even in theory, since both internal and external auditors produce information relevant to verifying financial statements, the work of one could arguably substitute for the other, to some degree. Evidence is mixed, however, on whether firms substitute internal for external auditing. Wallace (1984) finds internal audit expenditures offset external audit fees onalmost a dollar-for-dollar basis. Ettredge, Reed, and Stone (2000), however, do not find evidence of substitution. This latter study qualifies its results by emphasizing the difficulty of empirically detecting substitution between the two types of auditors.

[8] More precisely, it is earnings surprises that generally affect stock prices. Unfortunately, not all studies in this area separate the expected and unexpected components of earnings announcements.

Findings in this area support auditing's role in promoting investor confidence. Hackenbrack and Hogan (2002) find ERCs tend to increase when firms change auditors to increase service and monitoring. This supports the view that more robust auditing enhances investor confidence. These authors also find ERCs tend to decline when firms change auditors for other reasons, such as auditor resignations, that signal possible conflict in the relationship. This reduction suggests that audit problems diminish investor confidence in financial statements.

In addition, to the extent the size of the firm conducting an external audit serves as a proxy for the audit's quality, a positive relationship between the size of the accounting firm and the ERC of the audited firm supports the view that external audits effectively assure investors that financial statements are fair. Teoh and Wong (1993) find firms audited by a major accounting firm have higher ERCs than other firms.[9]

Separate evidence that the size of the firm conducting an audit serves as a proxy for the quality of the audit comes in the form of pricing. Craswell, Francis, and Taylor (1995), DeFond, Francis, and Wong (2000), and several earlier studies find major accounting firms earn significantly higher fees than other auditors. The higher prices presumably reflect quality-differentiated audits.

DeAngelo (1981) describes a rationale for the view that large accounting firms conduct high-quality audits. Because of transaction and start-up costs, firms switch auditors only infrequently. Accounting firms, then, earn client-specific quasi-rents. A client may try to prevent an auditor from reporting an accounting problem by threatening to end the relationship. The quasi-rents associated with the relationship give the auditor an incentive for not reporting the problem. However, for a large audit firm with numerous clients, the quasi-rents specific to other clients would discourage such behavior, since its disclosure could cost the firm all its business. As a result, investors may view having many clients as a kind of collateral against low-quality audits, thereby promoting greater independence in audits. Clients may be willing to pay more for an audit from a large firm, since investors will consider the audit of high quality. DeAngelo also suggests large accounting firms may possess relatively high levels of technical expertise in the audit areas of most concern to publicly traded companies.

WHAT PROMOTES GOOD AUDITING?

The findings reviewed above emphasize that auditor independence is key to effective auditing. But what promotes auditor independence? Can market forces establish the necessary independence? Or should the government oversee the accounting industry and perhaps even become directly involved in the audit function?

Market Forces

As Jensen and Meckling demonstrate, managers interested in obtaining equity or debt financing for their firms can benefit from having independent auditors monitor their businesses and certify their financial

[9] Here, the term *major accounting firm* refers to the top few elite firms, the number of which has changed over time. They were once known as the Big Eight and later as the Big Six. However, mergers and attrition have reduced this group to what is currently known as the Big Four.

condition and policies. As a result, in most cases the independence and corresponding rigor of audits could be expected to adapt to specific company and investor needs. In this regard, substantial evidence points to an important role for market forces in shaping the role of auditors to match, or correspond to, investors' needs.

Watts and Zimmerman emphasize that the audit committees used by the English merchant guilds, and later by the joint-stock companies, included mechanisms promoting independence and were created voluntarily in response to a business need. When the U.K. Companies Act of 1844 required directors to keep accounts and have them audited, the government was largely just putting into law a version of a longstanding practice. Market forces had already established sound auditing. The compulsory external audit requirement was subsequently dropped, and by the time it was reinstated in 1900, most companies were not only audited but were audited by chartered accountants, accredited by professional accounting organizations.

In the United States, the Securities Act of 1933 and the Securities Exchange Act of 1934 instituted several rules to promote accurate financial information, including a requirement that subject corporations be audited by independent public accountants. However, Benston (1969) indicates the legislation in large part merely codified existing practice. Among companies trading on the New York Stock Exchange in June 1935, and for which earlier data are available, 82 percent were already using professional auditors in 1926.

Chow (1982) provides evidence that this demand for auditing long before it was required reflected individual firms' need to address agency costs. Several agency-cost indicators for individual firms—business size, the prominence of debt in a firm's capital structure, and the number of accounting measures in a firm's debt covenants—raised the demand for external audits.

One of the most obvious determinants of the need for external auditing is firm size. Monitoring would seem to be especially important for large firms, as many investment dollars are typically at stake. Palmrose (1984), Healy and Lys (1986), Simunic and Stein (1987), Francis and Wilson (1988), Firth and Smith (1992), and Reed, Trombley, and Dhaliwal (2000) conclude that larger firms tend to have higher quality audits, consistent with Chow (1982).[10]

A firm's use of debt could influence agency costs and the demand for auditing, as in Jensen and Meckling (1976), Myers (1977), and Smith and Warner (1979). Firms that rely heavily on debt may have a heightened demand for audit quality to satisfy debtholders' desire for protection from managers' incentives to favor stockholders over debtholders. DeFond (1992), Firth and Smith (1992), and Reed, Trombley, and Dhaliwal (2000) find evidence for this idea, consistent with Chow (1982).[11]

[10] A related idea is that a firm's growth rate might also affect the demand for audit quality. Agency costs may be especially high at a growing firm, reflecting not only the expansion of current activities but also expansion into new activities. Healy and Lys (1986) find that higher growth increases the demand for audit quality, as do Simunic and Stein (1987), Francis and Wilson (1988), and DeFond (1992).

[11] Some earlier studies are not so supportive. Simunic and Stein (1987) and Francis and Wilson (1988) find a negative relationship between debt and the demand for audit quality.

The issuance of new equity or debt is another market-driven influence on audit quality. Firms issuing new securities would likely have a higher demand for audit quality than other firms. The price a new security issue could command might be reduced in cases of substantial uncertainty about the financial statements of the issuing firm. Francis and Wilson (1988), Johnson and Lys (1990), DeFond (1992), and Reed, Trombley, and Dhaliwal (2000) find firms issuing a large volume of new securities tend to have higher quality audits than other firms.

Management's ownership stake in a firm may also affect audit quality. The smaller the ownership stake retained by management, the potentially less aligned are the interests of management and the other owners. This increases agency costs and the need for high-quality audits, as in Jensen and Meckling (1976). In a similar vein, Datar, Feltham, and Hughes (1991) argue that to send investors a positive signal, managers can retain a large share of ownership. However, by issuing audited reports, managers can send the same signal, even while reducing their share of ownership, thereby facilitating their ability to share risk with investors. Simunic and Stein (1987), DeFond (1992), and Firth and Smith (1992) find a positive relationship between outside ownership and high-quality audits.[12] Moreover, Warfield, Wild, and Wild (1995) find outside ownership reduces the degree to which announced financial results trigger changes in a firm's stock price. These latter results are consistent with the view that when a firm's managers retain a relatively low ownership share, agency costs make investors more skeptical of the firm's financial statements.

While research results vary, the general point of the literature is that market forces have tended to promote sound auditing on a voluntary basis. In many cases, legal requirements followed, rather than led, progress in auditing practices.

Government Intervention

Is there a need, then, for government oversight of auditing or even direct government involvement? As mentioned above, in the early 1930s the securities acts instituted several rules promoting accurate financial information, including a requirement that subject corporations be audited by independent or certified public accountants. One notable exception to this requirement was banks, which were not required to be audited until 1971.

Izan (1980) notes that forty of the sixty-three banks he studied did not already have audits voluntarily before the requirement was imposed, and his findings indicate the stock prices of these forty banks were adversely affected, suggesting investors viewed the requirement negatively. The stock prices of the twenty-three banks already being audited also fell, but only slightly. A viable interpretation of these findings is that investors thought the costs of the 1971 audit requirement outweighed its benefits.

At first glance, the negative valuation effects associated with the 1971 requirement are consistent with the conclusion that market forces tend to produce audit practices that conform to investor needs prior to, or

[12] Such studies tend to define outside ownership in terms of the proportion of common shares not held by a firm's officers and directors. It seems possible, though, that directors' ownership share could in some cases have a different effect on the demand for auditing than managers' share.

irrespective of, government mandates. But different considerations may apply in the case of banking.

One reason for the negative valuation effects of the 1971 bank audit law may be that the banks already had an external auditor, in the form of bank examiners. Because the federal government guarantees the safety of most bank deposits, the usual incentive for monitoring individual firms through independent audits has largely shifted from debtholders, in the form of depositors, to the government itself. As a result, the government uses its own auditors—bank examiners—to audit banks.[13]

Based on these considerations, there appears to be a major role for government in auditing banks, predicated on the effect of deposit insurance, and the financial safety net more generally, in largely eliminating both depositors' need for monitoring and managers' incentive for meeting that need. Gunther and Moore (2002) provide evidence of examiners' efficacy in uncovering financial problems and ensuring bank financial statements reflect them. The extensive audit function bank examiners already perform may have muted any benefit to shareholders from the additional external auditing the 1971 law required. As a result, the cost to banks of the added audit requirement may explain the fall in stock prices.

Taken together, the studies reviewed here point to the conclusion that substantial government involvement, either through oversight or direct participation, may be needed only when other types of government intervention, such as bank deposit insurance, have already disrupted market-based incentives for effective auditing. In the more typical situation, policymakers should take into account the successful track record of market forces, over the long run, in disciplining ineffective auditors and promoting effective audits.

WHAT LIES BEHIND RECENT AUDIT PROBLEMS?

Only recently was legislation enacted to establish a new regulatory structure for the accounting industry. Before that, the industry was largely self-regulated.[14] The question naturally arises that if market forces are so effective in promoting good auditing, why have the recent audit problems occurred? It is important to note that a definitive answer to this question is beyond the scope of this article. Nevertheless, previous research findings can shed light on the direction policy has taken in this area.

Accounting Restatements

While it is important not to downplay the substantial accounting problems that have recently occurred at some companies, it is equally im-

[13] While bank examiners do audit-type work, they are not technically auditors. For example, examiners do not publicly certify bank financial statements.

[14] Central to this self-regulation was the American Institute of Certified Public Accountants (AICPA), the industry's professional association. The Accounting Standards Executive Committee of the AICPA worked with the Financial Accounting Standards Board (FASB), itself a not-for-profit organization and part of the Financial Accounting Foundation (FAF), in promulgating accounting standards. A related organization, the Auditing Standards Board (ASB), established audit standards. The AICPA's SEC Practice Section (SECPS) provided peer review, continuing professional education, and investigation of alleged audit failures. Finally, the Public Oversight Board provided independent review of the ASB and SECPS.

portant to appreciate the effectiveness of the accounting and audit systems most firms employ. Watts and Zimmerman note that frauds did occur during the historical periods they analyze, despite the safeguards and incentives for independence built into the audit committees. However, while legal historians tend to focus on the audit failures that occurred—particularly among joint-stock companies, which even Adam Smith criticized—Watts and Zimmerman emphasize that given the number of joint-stock companies, allegations of fraud were relatively rare. Similarly today, it is easy to focus on the scandals, ignoring that the vast majority of firms have not had to restate earnings.

Nevertheless, most observers agree that recent accounting abuses have been too numerous and too serious. The incidence of firms having to revise their earnings substantially downward has risen appreciably (Greenspan 2002). The growing number of restatements, particularly by high-profile firms, is troublesome, as it raises the possibility many investors may have been misled about the finances and prospects of individual companies.

Audit–Consulting Combinations and Auditor Independence

Multiple factors likely contributed to recent breakdowns in auditing, and a full treatment is beyond the scope of this analysis. But a prominent theme in most popular accounts has been the growing tendency for accounting firms to provide a client with both audit and consulting services. Various policymaking groups, such as congressional committees and the SEC, have asserted for years that providing both services can impair auditor independence. The concern is that an accounting firm might allow misleading and possibly even fraudulent accounting to avoid jeopardizing growth in consulting revenue. When a single firm provides both auditing and consulting for a client, some argue that the fees the firm retains for consulting services may compromise its independence as an auditor.

The issue, however, is not as simple as it may appear. Recall DeAngelo's (1981) analysis for an accounting firm providing only auditing services. A client may try to prevent an auditor from reporting an accounting problem by threatening to end the relationship. The auditor has the incentive to refrain from reporting the breach, so as to avoid losing the quasi-rents from the audit relationship. For an accounting firm performing only audits and no consulting, the quasi-rents associated with other clients might induce the firm to report the problem, since these other rents could be lost were it revealed that the firm had failed to report it. Do consulting services change this equation?

Arruñada (1999) argues that if an accounting firm has a sufficiently large number of clients, the provision of consulting services can actually increase auditor independence. If a firm provides both auditing and consulting for a client, the incentive to refrain from reporting a breach becomes even greater, as the client could threaten to end both relationships. But Arruñada contends that this effect is outweighed by the fact that if it were discovered the accounting firm failed to report the breach, not only would the firm's audit business with other clients be hurt but its overall consulting business would suffer as well. The potential loss of both the auditing and consulting revenue derived from other clients would compel the accounting firm to report the problem.

It is important to note, though, that implicit in Arruñada's argument is the assumption, perhaps a strong one, that consulting revenues are as sensitive as auditing revenues to a failure to report an accounting breach. To take the opposite extreme, what if the disclosure that an accounting firm had failed to report a breach would not affect the firm's consulting business with other clients? In that case, the offending client's threat to terminate its consulting relationship with the accounting firm, in addition to its auditing relationship, would not be offset. As a result, the firm's consulting business might reduce the independence of its audits.

Nevertheless, it seems reasonable to suppose that consulting revenues would be at least somewhat sensitive to a failure to report an accounting breach. Even if these revenues were not directly affected, an indirect effect would seem almost inevitable following the loss of the accounting firm's audit business.

As such, the predicted effect of audit–consulting combinations on auditor independence is somewhat ambiguous, and empirical results pertaining to this issue are also mixed. Frankel, Johnson, and Nelson (2002) find evidence that firms purchasing relatively high levels of nonaudit services from their auditors are more likely to just meet or beat analysts' earnings expectations. They interpret this and related results as pointing to less independent audits. These authors also find negative stock market reactions when clients pay their auditors unusually high nonaudit fees. On the other side of the issue, DeFond, Raghunandan, and Subramanyam (2002) find no evidence that nonaudit fees impair auditor independence when independence is measured by auditors' propensity for issuing going-concern opinions. Palmrose and Saul (2001) argue that policymakers' push in recent years for greater separation between auditing and consulting has occurred without sufficient evidence that a consulting relationship influences an auditor's independence. Moreover, the details behind recent accounting scandals are still not entirely clear. Perhaps the recent spate of problems will eventually shed more light on the issue of conflicts of interest in audit–consulting combinations.

A relatively early research effort, though, points to an adverse effect on auditor independence resulting from audit–consulting combinations. Using data from 1978–80, Parkash and Venable (1993) find that agency costs help explain the level of recurring nonaudit services firms purchase from their auditors. Recall that the smaller the ownership stake retained by management, the potentially less aligned are the interests of management and the other owners of a firm, which increases agency costs and the need for high-quality audits. Interestingly, Parkash and Venable find firms with low management ownership tend to purchase a relatively low level of nonaudit services from their auditors, suggesting such firms seek to maintain the perception of auditor independence. Similarly, agency-cost considerations suggest that firms heavily reliant on debt may have a heightened demand for audit quality. Consistent with this view, these authors find firms with high long-term debt tend to purchase a relatively low level of nonaudit services from their auditors.

Overall, the limited evidence is mixed on the issue of whether audit–consulting combinations adversely affect auditor independence. But if independence is affected, why would a firm use the same accounting firm for both services? Based on Jensen and Meckling's results, reduced auditor independence could raise a company's cost of external funds.

Audit–Consulting Combinations and Costs

Even if providing a client with both auditing and consulting results in less auditor independence, there may be good reasons for the practice.

Firms and their shareholders may find it cost-efficient to obtain both services from a single provider if the cost of providing the two functions jointly is substantially lower than the cost of providing each one separately, as Arruñada (1999, 2000) argues. After assessing a client's accounting and internal control processes, an auditor would have much of the information needed to help the firm address any related shortcomings. A separate consultant, on the other hand, working only from an auditor's report, might require significant time and effort before becoming sufficiently familiar with a firm's situation to make specific recommendations. Similarly, consulting work could uncover firm-specific information useful to an audit. As a result, by hiring a single accounting firm for both functions, clients may be able to lower their costs for these services. Whisenant, Sankaraguruswamy, and Raghunandan (2002) find the joint provision of audit and nonaudit services leads to more efficient audits and reduced audit fees.

As such, the issues surrounding audit–consulting combinations become more involved. Such combinations may reduce auditor independence and thereby raise the cost of external funds, but they also likely lower the cost of audit and consulting services. The issue facing market participants, then, is whether the advantages of audit–consulting combinations outweigh the disadvantages.

Audit–Consulting Combinations and Market Outcomes

Based on Parkash and Venable's results, market participants are not only aware that audit–consulting combinations can reduce auditor independence but take it into account. So it is companies with comparatively low agency costs, and a correspondingly low need for independent audits, that most often take advantage of the efficiency gains from using a single source for both services. In short, the extent of audit–consulting combinations varies across companies to meet specific firm and investor needs.

But while such factors can help explain the use of audit–consulting combinations, another question remains: Why did investors allow the practice to grow to such prominence in recent years? One theory consistent with the considerations reviewed above is that investors thought the adverse effect of audit–consulting combinations on auditor independence was not very significant. In that case, the effect of these combinations in raising the cost of external funds would have been small relative to their effect in reducing the cost of audit and consulting services.

Such considerations suggest two possible reasons for the current situation. First, investors may have been correct, and the effect of audit–consulting combinations on independence is small. In that case, the focus of the business press and lawmakers on these combinations as a primary source of recent problems is misguided, and the underlying cause lies elsewhere. The other possibility is that audit–consulting combinations reduce auditor independence more than investors had thought. With these competing scenarios in mind, the next section analyzes some of the legislative responses to the recent accounting scandals.

HOW CAN THESE PROBLEMS BE FIXED?

Even if government intervention in auditing is usually not needed, does this apply to current circumstances? What about recent accounting problems? How can they be fixed? If the combination of auditing and consulting has reduced the independence of audits, how can this issue be resolved?

Sarbanes–Oxley Act of 2002

Legislation addressing these problems was passed in July. The Sarbanes–Oxley Act of 2002 establishes a new regulatory structure for the accounting industry. According to its preamble, the act's purpose is "to protect investors by improving the accuracy and reliability of corporate disclosures…." The act imposes new requirements on auditing and makes other changes affecting financial reporting. Some of its requirements apply to auditors and others to audited companies.[15]

Sarbanes–Oxley establishes the Public Company Accounting Oversight Board as a nonprofit corporation to regulate accounting firms. The board will determine accounting firms' eligibility to audit securities issuers, as defined in the Securities Exchange Act of 1934. To do so, the board will examine accounting firms to review their compliance with the act and the rules that implement it, as well as securities laws and professional standards. The SEC has oversight and enforcement authority over the board.

Sarbanes–Oxley includes several requirements intended to promote auditor independence. Audit–consulting combinations are treated as having an overwhelmingly adverse effect on auditor independence. The act prohibits a firm's auditor from providing a broad range of consulting services to the firm, in recognition of the potential for conflicts of interest that could undermine auditor independence.[16] Under some circumstances, however, the board may exempt an auditor from this restriction, subject to SEC review.

The act also institutes new requirements designed to enhance the informativeness of financial reports. A company's principal executive officer and financial officer are required to certify they have reviewed financial statements filed with the SEC and find them accurate. Officers who certify financial reports they know to be inaccurate can be subject to stiff penalties.

Market Discipline

If investors were correct, and the adverse effect of audit–consulting combinations on auditor independence is fairly small, Sarbanes–Oxley is obviously problematic. Its restrictions on audit–consulting combinations will do little to increase auditor independence, while imposing on clients the higher costs of maintaining separate audit and consulting relationships.

But what if audit–consulting combinations reduce auditor independence more than investors had thought and were, in fact, a primary source of recent accounting problems? Could Sarbanes–Oxley still be misguided? Could the costs of separating consulting from auditing still outweigh the benefits?

For some clients, the answer might be yes, despite recent events. But more important, it may have been unwise for lawmakers to try to answer this question themselves, when market participants could have answered it for them.

The reaction to recent accounting problems highlights market forces' effectiveness in disciplining ineffective auditors and promoting a sound

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[15] This article touches on only a few relevant highlights of Sarbanes–Oxley, which has eleven titles.

[16] Before the act, regulators had taken limited steps to restrict the types of nonaudit services accounting firms could provide to their audit clients. In November 2000, the SEC adopted a rule restricting public accounting firms from providing their audit clients with many of the consulting services specified in the act. The rule, however, included substantial exceptions. Its provisions generally became effective in February 2002.

audit function. Numerous companies, some of them large, were quick to find a new auditor when their current one became embroiled in scandal. Conversely, accounting firms that retained their reputation for fairness found substantial new business coming their way. These market developments indicate an auditor's reputation is as important now as it was in the days of Watts and Zimmerman's English guilds.

Given the market's responsiveness to new developments, it stands to reason that if investors had previously underestimated the potential for audit–consulting combinations to reduce auditor independence, the emergence of recent problems could be expected to correct this perception. In fact, even before Sarbanes–Oxley some major corporations had begun retaining separate firms for audit and consulting services, perhaps responding voluntarily to investor concern over using one firm for both. Moreover, accounting firms themselves had taken steps to sell some of their nonaudit business or avoid providing nonaudit services to audit clients (Litan 2002). These developments suggest accounting firms, their clients, and investors were continuing to develop, through their competitive interaction, the most effective method for providing audit services.

In this sense, Sarbanes–Oxley poses a potential problem, in that it may thwart a full market solution to the situation. Based on Parkash and Venable's results, the market solution would allow the extent of audit–consulting combination to vary across companies, so as to meet specific firm and investor needs, while taking into account the possible effect of consulting on auditor independence. However, it appears that the new oversight board will be the one to react to recent problems and determine whether it is appropriate for an accounting firm to provide both audit and consulting services to a particular company. One possibility is that the board might lack the capacity to account for differences in audit demand across companies and their investors and instead set arbitrary standards.

CONCLUSION

Recent breakdowns in auditing have increased investor uncertainty. Because the audit function is a key element of an efficient financial market, a sense of policy urgency has developed regarding the need to address the situation.

However, history has shown that market forces, and not government oversight, have shaped the role of auditors to match or correspond to the needs of investors in monitoring the performance of individual companies. This has proved true recently as well, as competitive forces, reacting to growing problems in the accounting industry, resulted in massive realignments in the relationship between companies and their auditors, enhancing auditor independence and effectiveness. Companies were quick to find a new auditor if their current one became embroiled in scandal, making auditor impropriety costly. In addition, a number of major corporations adopted a policy of retaining separate firms for audit and consulting services, thereby responding to investor concern over audit–consulting combinations. These events show how the financial marketplace, in conjunction with already existing law and government institutions, can remove an accounting firm from practice as a penalty for unfair audits, thereby itself determining accounting firms' eligibility to audit securities issuers.

Legislation has also been enacted to address recent accounting shortcomings. The case for greater regulation and oversight is typically more easily made following a period of turmoil, but it is important to remember that greater government involvement is not a panacea. Legislation has tended to follow, rather than lead, progress in auditing. Moreover, regulation and government involvement can contribute to a crisis, the large political element of the savings and loan debacle of the 1980s being a prime example. In this vein, it is well known that in the mid-1990s the accounting industry pushed to count as an expense the stock options companies use to compensate employees and executives. It was congressional pressure that stopped this effort, not loose self-regulation among accounting firms.

Sarbanes–Oxley brings with it some new concerns. Have policymakers overreacted and by restricting combinations of auditing and consulting, created a regulatory straitjacket that might unnecessarily raise the price firms must pay for these services? Might the new Public Company Accounting Oversight Board, itself under the oversight and enforcement authority of the SEC, set arbitrary standards, without due regard for differences in audit demand across different companies and their investors?

To minimize such concerns, both the legislation's salutary effect in stiffening legal sanctions against corporate fraud, and the demonstrated effectiveness of market forces in rewarding the maintenance of a reputation for sound auditing, suggest the board, together with the SEC, should consider a flexible policy that focuses not on implementing additional restrictions but on enhancing the accounting industry's demonstrated potential for self-regulation. Otherwise, policymakers run the risk of reacting only to extreme circumstances and creating an environment too restrictive for the natural evolution of business practices.

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