

Competing
Stage: Increasingly
complex standards,
raised cost
of quality

(↓ results)
= lower quality.

Add to website

→ Interaction
affected
changed
competitive
dynamics

Political Economy of Accounting Collapse in US: Hypotheses and a Research Agenda

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A Thumbnail Sketch of the Collapse

- Ninety years of antitrust laws and their enforcement
- These laws were applied with special consideration to the learned professions—doctors, lawyers, accountants, etc.
- Retained various anticompetitive clauses in the “Code of Ethics” of their respective professions

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Professional Codes of Ethics

- Self-regulation by professions in technical matters
- Limited self-regulation in economic and organizational matters
 - No advertising
 - No solicitation of competitors' clients or customers
 - No solicitation of employees of competitors
- Most professions justified such clauses in their rules of membership on the basis that they are necessary for "professional" behavior and public interest

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Economics of Restrictions on Professional Competition

- There were substantive economic arguments to justify restrictions of professional competition
 - Quality of professional services difficult to see
 - Customer/client depends on seller's recommendation about what he/she should buy
 - Professional must incur time/effort to find out what the customer/client needs, must charge for it
 - Markets for professional services are prone to failure under the pressure of full competition
 - Market for lemons—results would be even worse than the consequences of insufficient competition (Arrow 1963, Akerlof 1970)

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When will advertising restrictions on CPAs

greater in accounting than in medicine - acute repair? develop this a bit better - specific product attributes

Emphasis on Professional Competition

- Economic arguments for deregulation
- Stigler: robustness of competition paper
- Reputation effect as a counter to the lemons phenomenon
- Focus on economic efficiency of the system
- Shift from “public interest legislation” to “regulatory capture” theories

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Status Quo Till 1977

- This was the status quo of competition in markets for various kinds of professional services in U.S. until mid-seventies
- Then came a series of decisions from the U.S. Supreme Court
- In 1977: U.S. Supreme Court ruling on Bates v. State Bar of Arizona, held that the restrictions on lawyer advertising violated the protections given free speech by the First Amendment
- In 1978, the court ruled against restrictions on competitive bidding by civil engineers

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Change in U.S. Policy

- The shift in the Supreme Court decisions led to a change in the U.S. government policy on professional competition
- Under pressure from the Department of Justice and the Federal Trade Commission, most professional associations, including the American Institute of CPAs, deleted the anticompetitive provisions from their codes of ethics by the end of the seventies

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Intended Consequences

- The intent behind this change in the government policy (and the Supreme Court decision) had been to obtain for the public the presumed benefits of competition among professions
- The Court accepted the argument that, the risks of failure in the market for professional services are adequately counterbalanced by the tendency of the professionals to develop a reputation for the quality of services they provide
- Over time, customer and clients learn about the reputation of the professionals, as the basis of those they choose to patronize
- Reputation prevents market failure

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Reputation effects capital in auditing story

Does Reputation Work?

- In the case of doctors, at least the patient (or his family) know, after the treatment, whether the patient got better (even survived)
- In the case of lawyers, at least the client knows, after the trial, whether the case was won or lost
- These ex post observations are reasonably prompt and have at least a proximate correlation with performance. They enable the doctors/lawyers to develop a more or less precise reputation with their patients/clients that serve as the basis of their own (and their acquaintances' future decisions)

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Not the same as getting the best care

Generalizability to Auditors?

- Unfortunately, this argument, applicable to lawyers and doctors and many other professionals, does not work for the auditors
- The auditors' customers—the shareholders and other third parties—cannot tell, even after the fact, if the auditor provided quality services for three reasons:
 - The rate of audit failure is less than 1 percent
 - The customers never see the auditor do their work
 - Firm's decisions on hiring the auditor are made by managers who are the subject of the audit

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Same as class action suit & attorneys

Do you pay for it? "Selling" the work of a surgeon?

August 1977

Why would restriction or competition per se lead to higher product quality?

Lemon story problematic → quality decline

Lay out sociology story & nature of nonpecuniary penalties & social ostracism that accompanied audit failure

or cost of audit increased due to expanded litigation & complexity of acctg. steps increased that cost not be recovered fully in higher fees. → cut quality? (at least acctg. 15/4/4)

The Flaw

- Application of the reputation argument as the justification for competition in the market for auditing was fatally flawed
- With very low failure rate, and absence of direct contact and observability by the customers, it is not possible for auditors to develop meaningful, and accurate reputation with the shareholders in any reasonable length of time
- Under the pressure of free competition, the market for auditing broke down—a market for lemons

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Audit Market Breakdown

- Clients actively played audit firms against one another to lower their audit fees
- The amount and quality of the work done by the auditors was not observable to the clients
- Competition for audit services would not sustain a price to make auditing self-supporting
- Auditors responded by a new business model to survive in this cut rate environment

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But how did reputations develop before Supreme Court decision. SC decision had no impact on Auditor failure rate. Customer observance of audit work. Firms had by managers before 1977.

why didn't auditors provide quality audits prior to 1977? OK

Why would lifetime advantages restrictions address this? Didn't firms "before" advertise "informally" before 1977 - e.g. "network" & "word of mouth" & "word of mouth" 6

I agree @ George that this is best labeled as "economies of scope"

What do you mean by this - is it price less than cost?

Revised Business Model of Audit Firms

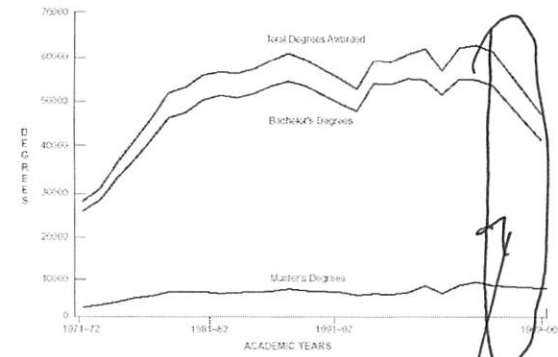
- Pricing: aggressive pricing of audit services
- Production function: cut labor intensive substantive testing, and replace it by cheaper analytical reviews
- Product mix: use audit service as "foot in the clients' door," to sell consulting services
- Incentives: share consulting revenue with audit partners
- Use consulting revenue to pay for any additional audit liability coverage arising from reduced substantive testing
- Factor prices: reduce the pay for fresh hires

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FIGURE 1
Trend in Accounting Degrees Awarded
1971-72 Through 1999-00



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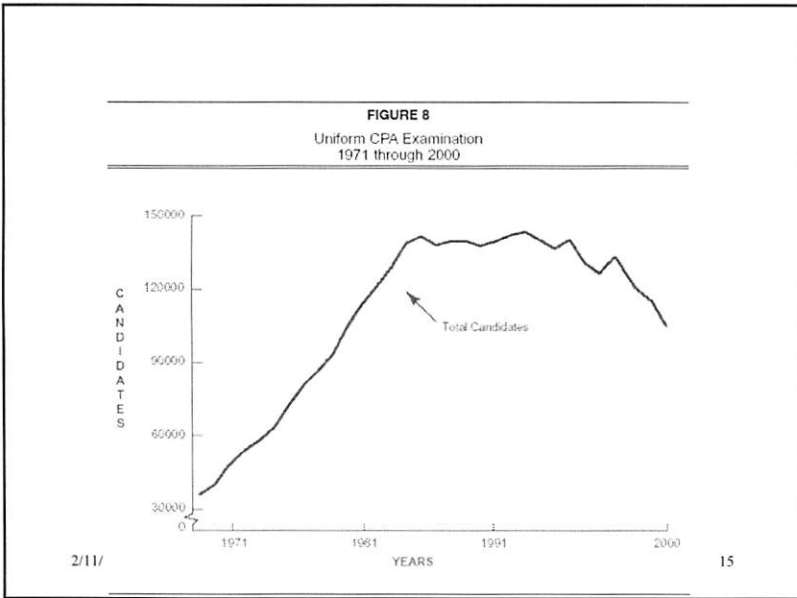
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Could this be a reaction to higher auditing costs related to increasing complexity of FASB acctg. stds?

Is this really affected by advertising?

5 year re-enrollment?



Consulting: A Consequence, Not the Cause of Failure

- In the debate on consulting services over the past decade, they have often been portrayed as the cause of failure of audit market by depriving auditors of their independence
- Instead, auditors turned to consulting services to earn a living when they found that they could not do so from audit services

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→ *Other*
is evidence
that
auditors
were
doing
"consulting"
before
Securities
Acts.

Large Liabilities

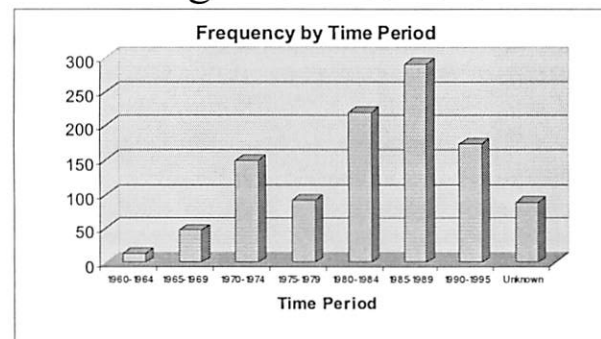
- The strategy of de-emphasizing substantive testing led to some spectacular audit failures, especially in the savings and loan banking industry in the mid-eighties
- Audit firms paid large court judgments or out-of-court settlements
- Drop in number and quality of students going into accounting majors
- Mid-course correction was needed to restore profitability

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Number of Settlements of Claims Against Auditors

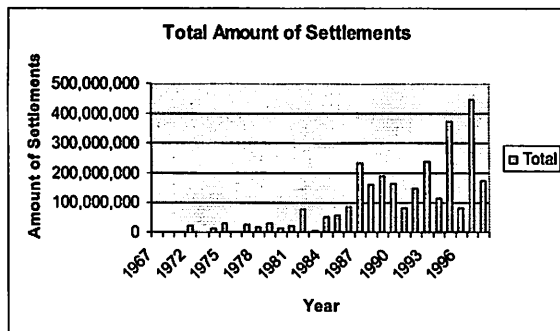


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Amounts of Settlements Against Auditors



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Joint and Several versus Proportional Liability

- The auditor liability had been joint and several; if other defendants could not pay, auditors had to pay their share
- New strategy
 - Lobby to change the law to proportional liability
 - Creation and financing of Accounting Education Change Commission to shift education of accountants
- Financing of elections as the lawyers and doctors had done for many years to advance their interests
- Payoff, Private Securities Litigation Reform Act, 1995

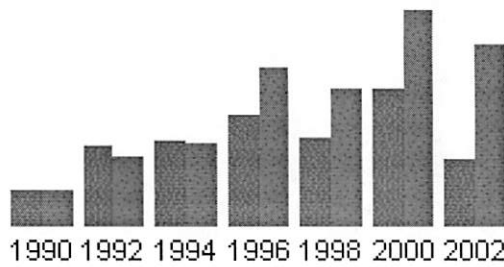
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Accountants' Contributions to Political Campaigns

■ Dems ■ Repubs



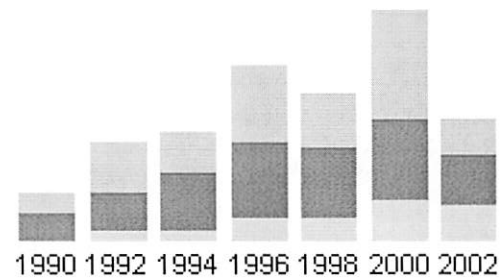
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Accountants' Contributions to Political Campaigns

■ Soft ■ PAC ■ Indiv



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Accountants' Contributions to Political Campaigns

| Electi on Cycle | Ran k† | Total Contrib utions | Contributi ons from Individual s | Contributi ons from PACs | Soft Money Contributi ons | Donatio ns to Democr ats | Donation s to Republic ans | % to Dem oc rats | % to Rep ub licans |
|-----------------------|-----------|----------------------------|---|--------------------------------|------------------------------------|-----------------------------------|-------------------------------------|------------------------------|-----------------------------|
| 2002 | 27 | \$7,8 | \$2,2 | \$3,3 | \$2,2 | \$2,1 | \$5,6 | 39% | 72% |
| 2000 | 28 | \$14,8 | \$7,0 | \$5,1 | \$2,6 | \$5,7 | \$8,9 | 39% | 61% |
| 1998 | 26 | \$9,4 | \$3,4 | \$4,5 | \$1,4 | \$3,6 | \$5,7 | 39% | 61% |
| 1996 | 21 | \$11,2 | \$5,0 | \$4,7 | \$1,5 | \$4,6 | \$6,5 | 41% | 59% |
| 1994 | 23 | \$6,9 | \$2,6 | \$3,6 | \$0,6 | \$3,4 | \$3,4 | 50% | 49% |
| 1992 | 29 | \$6,3 | \$3,2 | \$2,4 | \$0,5 | \$3,3 | \$2,9 | 54% | 46% |
| 1990 | 27 | \$3,1 | \$1,3 | \$1,7 | N/A | \$1,5 | \$1,5 | 50% | 50% |
| Total | 27 | \$59,7 | \$24,9 | \$25,6 | \$9,0 | \$24,5 | \$34,8 | 41% | 58% |

1995 Legislation

- For auditors: switch from joint and several to proportional liability
 - Reduced and less uncertain liability
- For corporate management: forward looking statements under safe harbor rule
 - Freedom to issue unverified (unverifiable) information in financial statements as long as it was marked forward looking
- The only instance during Clinton's eight year presidency when his veto was overturned by the Congress (election financing)

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Try to make clear the argument that this law could create incentives to subject more "estimation" in financial statements amounts.

in financial statements or supplementary info?

Prior to Secs. 10(b) and 17(d) of the Securities Act, and prior to the non-audit services regularly provided in effort to provide "value" to clients?

Is this really "new"? Look at historical evolution of American "balance sheet audit" which was prevalent in American practice until 1939 (McKesson-Robbey).

Another Supreme Court Ruling

- 1994 Ruling by the Supreme Court (Central Bank of Denver vs. First Interstate Bank of Denver): Private plaintiffs cannot bring suit (under the general antifraud provisions of the securities laws) against parties for aiding and abetting fraud by another person
- This ruling was often interpreted as a defense for consultants, investment bankers, etc.

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New Business Model

- With the 1995 legislation, the new audit firm business model came into full force
- Key elements: competition, lower audit fees, fast growing consulting business
- In 1999, the Securities and Exchange Commission saw the adverse consequences, wrongly identified consulting services as the culprit, and tried to stop consulting
- Audit industry beat back the effort with political help from the Congress (disclosure of fees only)
- Extensive failures of corporate audits are the results of this 25-year chain of events

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So the primary cause is unbridled competition?

Executive Compensation

- Aligning the interests of managers with the interests of shareholders is a fundamental challenge of corporate governance
- Since managerial contributions to the firm cannot be observed, and managers control the resources and information of the firm, there is ever-present moral hazard
- Accounting reports were designed to measure corporate performance to evaluate managers—contingent rewards
- But accounting measures have well-known weaknesses
- Solution: use market-based measures

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Assumptions Behind Market-Based Compensation

- Markets are efficient (not subject to manipulation by managers)
 - In spite of the support it enjoys in accounting academia, the assumption is false
- Financial reports are hard, based on unique accounting standards and incorruptible auditing
 - Again, a false assumption
- Governance mechanism to grant equity-based compensation is beyond manipulation
 - Yet another false assumption

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How Did Executive Compensation Soar?

- Director's compensation committees controlled by executives
- Annual survey techniques of executive compensation consulting firms
- Flexible accounting standards (not bad with vigilant analysts and investors)
- Auditor under pressure, controlled by managers
- Highly leveraged options, one-sided
- Skewed accounting for stock options
- Result: top to bottom ratio changed from 40 to 500

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Incentives to Manipulate

- With increased compensation, and increased dependence of compensation on accounting and market measures, incentives to manipulate accounting and stock prices rose
- If the governance, accounting and auditing were rock solid links, it would not matter ✓
- But they are not beyond manipulation ✓
- Attempts to better align manager and shareholder interests also resulted in more manipulation by managers

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These are the way
as synonymous
with "identical"
treatments - 'id', a move to
dictate uniformity.

Accounting Standards

- Uniformity and comparability of accounting standards has become sacred
- Monopoly of standards in U.S. and many other jurisdictions
- Elimination of signaling function of accounting in a world of flexible standards
- Standardized financial reports give more information in one sense, but less information in another

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Perspective on Events of 2002

- We can choose to view the events of 2002 as bad behavior by some individual managers, auditors, directors, lawyers, investment bankers, bankers, politicians, etc.
- Alternatively, we can see them as a chain a related events, arising from bad policy
- We pushed competition into a market that is not able to sustain competition because of ex ante or ex post unobservability of the quality of service provided

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Also led to increasingly complex standards which resulted in fin. statements that are more difficult to audit.

I personally believe these standards created cost pressures which, in turn, created incentives to reduce costs (i.e., by implication, quality).

What Are We Doing?

- Sarbanes-Oxley Act, 2002:
 - Creates a Public Company Accounting Oversight Board (there is little reason to think that this regulatory body would not, over time, be captured by the industry it is supposed to regulate)
 - Prohibits auditors from providing certain non-audit services to their audit clients (the Act incorrectly assumes that such services were the cause, not the consequence, of audit market failure)
 - Requires audit partner rotation every five years (will rotated partners be more or less vigilant? Collusive?)

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Sarbanes-Oxley Act, 2002

- Auditor reports to the audit committee
- Audit committee of independent directors with at least one expert
- Corporate responsibility for financial reports
- Forfeiture of bonuses/profits
- Disclosures of adjustments, OBSF, SPE
- Personal loans to executives

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The New Act

- Disclosure of trades within 2 days (why not advance notice of one week?)
- Conflict of interest rules for financial analysts
- Increased appropriations for SEC
- Minimum standards for attorneys
- Audit work papers for 5 years
- Whistle blower protection
- White collar crime penalty enhancements
- SEC: annual and quarterly reports in 60-45 days

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Effectiveness of New Measures

- It is doubtful if any of these measures, aside from the promise of adequate staffing of SEC and enforcement of existing laws, will have any significant impact on the auditing and accounting problems
- These ‘fixes’ do not deal with the root causes
- What are the root causes?

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*This is a problem; a huge one.
Be sure to be specific about
the costs of this, which
depend on how large the standard
can strictly enforce compliance
through SEC (along
Stand 1974).*

Areas of Concern

- Financial reporting standards: monopoly versus competition
- Market for audit services: breakdown under pressure of competition
- Insurance approach to audit market
- Corporate governance and qualifications of directors
- Control principle: choose rules to bring expected behavior in line with self interest

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Financial Reporting Standards

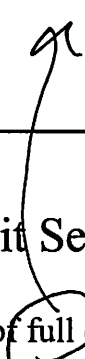
- U.S. monopoly of FASB, spreading to Europe and elsewhere
- Difficulty of assessing what is a good rule
- Cost of capital criterion
- Use market competition among standards to determine which rules lower the cost of capital of the firm empirically

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*What is the Alternative?
Monopoly? or
partial "competition"*



Regulatory Competition in Accounting Rules

- Each jurisdiction permits two or three sets of accounting standards
- Each firm chooses one set of standards
- Pays a fee to the standard-setting body
- Standard setting bodies compete like the stock exchanges, university accreditation, and appliance certification bodies do
- Will result in better standards which will lower the cost of capital

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Market for Audit Services

- Cannot bear the burden of full competition
- Choose one of two solutions
 - Allow auditors relief from antitrust laws (no advertising, solicitation, etc.; politically difficult)
 - Combine audit and insurance into one packet

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An Insurance Solution

- Each public firm is free to buy (or not buy) any amount of financial misrepresentation insurance, and indicate the amount of coverage bought in its report
- The insurer examines the financial reports and charges a premium
- The firm adjusts how much insurance to buy
- Investors adjust how they process the information based on how much insurance is provided

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Pros and Cons of the Insurance Solution

- Quality of audit services internalized by the insurance firm
- No external regulation necessary to monitor audit quality which is difficult anyway
- Will need an accounting court to settle insurance claims—whether the financial reports made a fair representation
- Audit will be driven by economic, not regulatory considerations

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→ this should have
been done
anyway, even
without insurance
solution. Issue
is
accy
arbitration
9/19
Williamson

Corporate Governance and Directors

- Recent emphasis on independence
- Also need competence, industry knowledge, contacts, and management's trust
- Criteria are often in conflict with one another
- How do we find directors who will have all these qualifications
- College professors? Unfortunately not

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Minority Directors

- Instead of framing it as a problem of independence, frame it as directors to represent the minority shareholders
- Have separate slate selected only by the minority holders
- More nominations than slots to make it a real election
- Better information to shareholders about the behavior of directors when they serve on the board

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Executive Compensation

- Giving incentives to corporate managers to work hard, and aligning their incentives with shareholders does not come for free
- It has its own cost
- Agency theory: we can only get a second best solution, not the first best solutions
- Scale back on incentives towards more fixed pay
- Fire those who do not measure up

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Summary

- The recent collapse of accounting and auditing requires careful analysis of root causes
- Bad people or bad policies?
- Need to think of alternative solutions, e.g.,
 - Competition for accounting standards
 - Reduce competition in audit market or bundle with insurance
 - Minority directors with real elections and better information for shareholders about directors
 - Scale back on performance-contingent managerial compensation
- Think of even better alternative approaches

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Thank You

<http://www.som.yale.edu/faculty/sunder/research.html>

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